Subcommittee on
Banking (Capital) (Amendment) Rules 2012,
Banking (Specification of Multilateral Development Bank)
(Amendment) Notice 2012 and
Banking (Amendment) Ordinance 2012 (Commencement) Notice 2012

Administration's Response to the Issues
arising from the meeting held on 5 November 2012

At the meeting of the Subcommittee held on 5 November 2012, Members asked the Administration to –

(a) advise whether there is proper Chinese rendition for the bodies specified in section 2 of the Banking (Specification of Multilateral Development Bank) Notice (Cap. 155, sub leg. N); and

(b) set out major modifications or deviations in the Banking (Capital) (Amendment) Rules 2012, vis-à-vis the relevant regulatory capital standards promulgated by the Basel Committee on Banking Supervision ("BCBS") in relation to the implementation of Basel III, the reasons therefor, and the banking sector's views in those respects.

Administration's Response

Banking (Specification of Multilateral Development Bank) Notice

2. As explained in paragraph 11 of the Legislative Council brief issued by the Administration on 17 October 2012[1], and the Explanatory Note to the Banking (Specification of Multilateral Development Bank) (Amendment) Notice 2012 (hereinafter referred to as the "MNB Amendment Notice 2012"), the MNB Amendment Notice 2012 has a specific legislative scope to implement a decision of the BCBS to include the "Multilateral Investment Guarantee Agency" ("MIGA"), a member of the World Bank Group, in the list of "multilateral development banks" for the purposes of the Basel capital framework.

3. The current Chinese text of the Banking (Specification of Multilateral Development Bank) Notice contains names of several multilateral development banks without Chinese rendition from the time when this subsidiary legislation was made and subsequently amended in the

[1] File Ref: G4/16/44C.

past[2]. This will, however, not affect the legal effect and operation of the relevant provisions of the subsidiary legislation.

4. At Members' request, the Administration is reviewing such relevant provisions, and will where necessary confirm with such multilateral development banks their proper and official Chinese names, if any. Subject to this review and confirmation, we will introduce further legislative amendments to address this textual issue via a future Statute Law (Miscellaneous Provisions) Bill as appropriate.

Hong Kong's Modifications to Basel III Capital Framework

5. As we emphasised at the meeting held on 5 November 2012, the Banking (Capital) (Amendment) Rules 2012 substantially reflect the elements of Basel III relating to the new minimum levels of risk-weighted capital ratios, the constituent components of the new definition of capital, and the reforms of the counterparty credit risk framework. By requiring authorized institutions to hold more and better quality (in terms of loss absorption) capital, the rules represent a balanced approach to bolster the resilience of the banking sector in the interests of depositors and the Hong Kong financial markets, whilst enabling the banking sector, through the extended phase-in period, to perform its lending and other credit intermediation activities.

6. There are a few areas of the Basel III capital framework to which the Monetary Authority has proposed modifications in the Banking (Capital) (Amendment) Rules 2012. These address specific local circumstances and prudential issues. Such modifications are permissible, as the Basel III capital framework sets minimum standards and, subject to that, the BCBS allows domestic supervisors to adopt adjustments to address domestic concerns. The banking sector has been consulted on these issues, and their views have been taken into consideration by the Monetary Authority in the process of finalising the rules.

7. The issues, together with the relevant justifications of the Monetary Authority, and the feedback of the banking sector gauged during the consultation process, are set out at **Annex**.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
13 November 2012

---

2 See section 2 of the current Banking (Specification of Multilateral Development Bank) Notice.

Annex

Major Modifications in the Banking (Capital) (Amendment) Rules 2012 as Compared to the Basel Committee's Basel III Text

No.	Items	Section no. of Banking (Capital) Rules	Summary of the relevant Basel III requirements	Modifications made in the Banking (Capital) (Amendment) Rules 2012
1.	**Unrealised gains on property revaluation as CET1 capital**	38(2)(c) and (d) (pages 87 & 88 of Sub-Committee version) 40(1)(d) and (e), and 41 (pages 90 and 92 of Sub-Committee version)	Unrealised gains/losses recognised on the balance sheet of banks are generally allowed to be included in the determination of Common Equity Tier 1 ("CET1") capital.	Unrealised gains on property revaluation of authorized institutions ("AIs") are only allowed to be recognised in Tier 2 capital with the application of a 55% haircut. Although the industry would prefer to follow Basel III and allow property revaluation gains to be recognised as CET1 capital (with or without haircut), the HKMA remains concerned about the historical volatility in the prices of commercial property in Hong Kong whether held for own-use or investment and the fact that, for some AIs, such gains could amount to a sizeable portion of their CET1 capital. Allowing property revaluation gains into the CET1 capital of AIs will introduce an element of significant volatility into their CET1 ratios that could have a potentially adverse effect on their ability to support and continue their lending activities (if, for instance, there were to be a rapid fall in property prices in future such as that seen in 1998 – 2004) which could in turn have an adverse spill-over effect on the real economy. Even with the 55% haircut, the HKMA would still have concerns from a prudential supervisory perspective for significant portions of AIs' CET1 capital to be constituted by unrealised gains on property revaluation. The CET1 ratio will likely become the key measure of an AI's financial

No.	Items	Section no. of Banking (Capital) Rules	Summary of the relevant Basel III requirements	Modifications made in the Banking (Capital) (Amendment) Rules 2012
				strength and CET1 capital should be constituted by genuinely available, readily loss-absorbing, capital.
2.	**Deferred Tax Assets and Mortgage Servicing Rights**	43 to 46 (pages 95 to 101 of Sub-Committee version) Schedule 4G (pages 515 to 517 of Sub-Committee version)	Exemption from capital deduction is allowed for each of (i) Deferred Tax Assets ("DTAs") arising from timing differences and (ii) Mortgage Servicing Rights ("MSRs"), up to a threshold of 10% each of a bank's CET1 capital, subject to the aggregate amount of the two items together with a bank's significant investments in the common shares of unconsolidated financial institutions not exceeding 15% of the bank's CET1 capital.	Whilst the industry would prefer to follow Basel III, the HKMA has reservations regarding the genuine loss absorption ability of these two items and hence does not propose to provide the 10% and 15% concessionary thresholds. DTAs can only be reversed over time, thus at best they represent some future potential for reducing profits tax payable and hence increase in earnings. MSRs, created by capitalizing future income streams from the servicing of mortgage loans which have been sold, are not common in Hong Kong and there was no experience locally upon which to base a robust judgement about the continued availability of income from MSRs in times of stress. The HKMA invited further submissions from the industry on the loss absorption capacity of DTAs/MSRs if the industry considered that, contrary to the HKMA's views, DTAs and MSRs do have demonstrable loss absorption capacity in the Hong Kong's context. The industry made no further submission on this point.

No.	Items	Section no. of Banking (Capital) Rules	Summary of the relevant Basel III requirements	Modifications made in the Banking (Capital) (Amendment) Rules 2012
3.	**Anti-avoidance provisions**	46(1) and (2) (page 101 of Sub-Committee version)	No such provision in Basel III	In recognition of the fact that capital investments might be structured to resemble credit exposures, the HKMA originally proposed that credit exposures with the characteristics of capital investments (i.e. exposures which are perpetually rolled-over on non-commercial terms) should be subject to similar treatment as capital investments. The industry raised concerns that such "anti-avoidance" provision might hamper AIs' normal funding activities in general. To address the industry's concerns, the HKMA narrowed the scope of the "anti-avoidance" provision along the lines of the existing section 48(2)(f) of the Banking (Capital) Rules, so that it covers only exposures to connected companies which cannot be demonstrated by the lending AI to have been incurred in the ordinary course of business. The industry subsequently proposed some operational criteria for applying the "anti-avoidance" provision which the HKMA considers reasonable and will take into account in developing supporting supervisory guidance.
4.	**Standardised CVA risk capital charge – India ECAIs**	226S(1) Tables 23A and 23B (pages 349 & 350 of Sub-Committee version)	Banks that do not have the approvals for using models to calculate counterparty credit risk and specific interest rate risk should calculate their credit valuation adjustment (CVA) risk capital charge using the	In addition to the standard table prescribed under Basel III (Table 23A), a second table (Table 23B) has been added to cater for the 3 Indian external credit assessment institutions ("ECAIs") whose ratings are only recognised by the HKMA for the purpose of risk-weighting exposures to corporates incorporated in India under the

<table>
<tr><th>No.</th><th>Items</th><th>Section no. of Banking (Capital) Rules</th><th>Summary of the relevant Basel III requirements</th><th>Modifications made in the Banking (Capital) (Amendment) Rules 2012</th></tr>
<tr><td></td><td></td><td></td><td>formula on page 35. One of the inputs to the formula is w_i (i.e. the weight applicable to counterparty “i”), which is determined by mapping the external rating of the counterparty to the corresponding weight in accordance with the table below.

<table><tr><th>External rating</th><th>w_i</th></tr><tr><td>AAA</td><td>0.7%</td></tr><tr><td>AA</td><td>0.7%</td></tr><tr><td>A</td><td>0.8%</td></tr><tr><td>BBB</td><td>1.0%</td></tr><tr><td>BB</td><td>2.0%</td></tr><tr><td>B</td><td>3.0%</td></tr><tr><td>CCC</td><td>10.0%</td></tr></table></td><td>standardized approach (“STC approach”). As can be seen from Part 2 of Table C of Schedule 6 to the Banking (Capital) Rules the risk-weight allocated to an AA rating issued by an Indian ECAI is 30%, instead of 20% as in the case of an AA rating issued by an international ECAI such as Moody’s. The second table (i.e. Table 23B) reflects such difference in risk-weight by changing the weight applicable to AA ratings issued by an Indian ECAI from 0.7% to 0.8%. Such change is to ensure consistency within the current capital framework and the adequacy of the weight in reflecting the level of credit risk associated with the external credit rating concerned.

The industry did not raise any comment on this during the industry consultations.</td></tr>
<tr><td>5.</td><td>Standardised CVA risk capital charge – mapping of internal ratings</td><td>226S(1)(b) (pages 345 & 346 of Sub-Committee version)</td><td>For the purpose of determining the value of w_i, when a counterparty does not have an external rating, the bank must, subject to supervisory approval, map the internal rating of the counterparty to one of the external ratings.</td><td>Instead of requiring all AIs to map internal ratings to external ratings, the HKMA has adopted the following approach to implement this Basel III requirement:

(i) If an AI uses the internal ratings-based approach (“IRB approach”) to calculate its credit risk for non-securitization exposures, it should map the internal rating of the unrated counterparty to an ECAI issuer rating based on a mapping scheme approved by the</td></tr>
</table>

No.	Items	Section no. of Banking (Capital) Rules	Summary of the relevant Basel III requirements	Modifications made in the Banking (Capital) (Amendment) Rules 2012
				HKMA in order to determine the weight applicable to the counterparty. If the AI has not yet obtained an approval for its mapping scheme, the HKMA may allow the AI to use a flat weight of 1% or a weight specified by the HKMA until the approval is obtained; (ii) If an AI does not use the IRB approach to calculate its credit risk for non-securitization exposures, it must assign a flat weight of 1% (corresponding to an investment grade / triple B external credit rating) to the unrated counterparty. The requirement in (i) that the mapping scheme must be approved by the HKMA reflects the Basel III requirement that the mapping should be subject to supervisory approval. The approach set out in (ii) recognizes that AIs which do not use the IRB approach are mostly medium-size or smaller AIs and they may not have an internal rating system to map to external ratings. The HKMA believes that the proposed approach strikes a reasonable cost / benefit balance, and a 1% weight can be regarded, on the whole, as a fair and conservative approximation for the average weight of a pool of counterparties with varying credit qualities.

No.	Items	Section no. of Banking (Capital) Rules	Summary of the relevant Basel III requirements	Modifications made in the Banking (Capital) (Amendment) Rules 2012
				Paragraph (b) of section 226S(1) as currently drafted already incorporates revisions to address requests from the industry for clarification of the following two issues: • whether the mapping of internal ratings is mandatory (i.e. whether an AI that uses the IRB approach may choose to apply the 1% weight to an unrated counterparty); and • the transitional treatment if an AI has not yet received approval from the HKMA for its mapping scheme. The 1% weight is a broad-brush approach intended to address practical difficulties that may be faced by less sophisticated AIs. IRB AIs should have an internal rating system that differentiates different levels of credit risk in a granular manner. Therefore they should use a more accurate and risk-sensitive approach to determine the weight applicable to an unrated counterparty which reflects the level of credit risk associated with that counterparty as reflected by the internal rating assigned to the counterparty. The industry finds this approach acceptable.

Hong Kong Monetary Authority
13 November 2012