



HONG KONG MONETARY AUTHORITY  
香港金融管理局

Our Ref.: B1/15C  
S4/3C

21 February 2012

The Chief Executive  
All Locally Incorporated Authorized Institutions

Dear Sir/Madam,

**Basel Guidance on High-cost Credit Protection**

As you may be aware, the Basel Committee on Banking Supervision issued a statement on high-cost credit protection on 16 December 2011. The statement highlights concerns among supervisors about potential capital arbitrage within the credit risk mitigation (CRM) framework relating to the calculation of regulatory capital requirements for credit exposures. A copy of the statement is attached for reference.

“High-cost credit protection” refers generally to situations where credit protection transactions are structured in such a way as to enable the protection buyer to receive favourable risk-based capital treatment in the short term (e.g. the protection buyer receives an immediate regulatory capital benefit in the form of a lower risk-weight on an exposure on which it is nominally transferring risk) and defer the recognition of losses and costs of protection in earnings over an extended period. In some instances, the terms and conditions of the credit protection combined with the premiums or fees or other direct or indirect costs paid for it, call into question the degree of CRM or credit risk transfer achieved by the transaction.

Such arbitrage opportunities exist generally under the CRM framework, however they are more likely to occur in the use of CRM techniques for securitization transactions where the difference in the risk-weight before and after buying protection can be very large.

To provide guidance on relevant factors that typically characterise high cost credit protection (which results in ineffective CRM or credit risk transfer), the Basel Committee’s statement sets out (i) a list of factors that banks should consider, and

supervisors will assess, in evaluating the degree of CRM or credit risk transfer of credit protection transactions; and (ii) a number of characteristics exhibited by transactions that would tend to suggest high cost credit protection and therefore merit the specific attention of supervisors.

Authorized institutions (AIs) should take note of the guidance provided in the statement in the course of conducting credit protection transactions. Among other things, AIs should analyse and document the economic substance of any credit protection transactions that have unusually high-cost or innovative features to assess the degree of risk transference and the associated impact on their overall capital adequacy. AIs should also bring to the attention of the HKMA any innovative positions which fall under the guidance to ensure they are subject to appropriate prudential treatment. The analysis should also specify how the transaction aligns with the AI's overall risk management strategy.

The HKMA will review the CRM techniques employed by AIs in its on-going supervisory process where necessary, and will incorporate the guidance set out in the Basel Committee's statement into its relevant supervisory guidance (such as that relating to credit risk transfer and supervisory review process) in due course.

Yours faithfully,

Karen Kemp  
Executive Director (Banking Policy)

Encl.

c.c.        The Chairman, The Hong Kong Association of Banks  
              The Chairman, The DTC Association  
              FSTB (Attn: Miss Natalie Li)