Standardized CVA method

Q1: According to §226S(5A) of the Banking (Capital) Rules, if the eligible CVA hedge used by an authorized institution is a CDS swaption, the authorized institution may use the delta-adjusted notional amount, instead of the notional amount, of the swaption as the input to Formula 23J. Guidance is sought on the calculation of the delta-adjusted notional amount of the swaption.

A1: The use of the delta-adjusted notional amount is intended to reflect the "moneyness" of a swaption. The delta of the swaption is the ratio of the change in the swaption's price (or spread) to the change in the price (or spread) of the underlying forward CDS. The delta-adjusted notional amount is generally calculated as the product of the swaption notional amount (i.e. the notional amount of the underlying forward CDS) and the delta of the swaption.

Authorized institutions that use, or intend to use, swaptions to hedge CVA risk should be capable of deploying appropriate swaption valuation methodologies for the purposes of risk management and financial reporting. The delta of the swaption can be derived from such valuation methodologies.

Netting of repo-style transitions

Q2: Paragraph 173 of the document "International Convergence of Capital Measurement and Capital Standards - A Revised Framework (Comprehensive Version)" (Basel II) issued by the Basel Committee in June 2006 states that bilateral netting agreements covering repo-style transactions must, among other things—

(a) provide for the netting of gains and losses on transactions (<u>including the value of any collateral</u>) terminated and closed out under them so that a single net amount is owed by one party to the other; and

(b) <u>allow for the prompt liquidation or setoff of collateral upon the event of default</u>.

The definition of "valid bilateral netting agreement" in the Banking (Capital) Rules (BCR) does not specifically reference these criteria. Clarification is sought as to what requirements a netting agreement for repo-style transactions should meet in order for the netting to be recognized in the capital adequacy calculation.

A2: In order to be recognized for the purposes of capital adequacy calculation, the netting agreement for repo-style transactions (repos) should meet the requirements set out in the definition of "valid bilateral netting agreement" in BCR §2(1). In this context, for example, "mark-to-market values of the individual contracts covered by the agreement" in paragraph (b) of the definition essentially refers to the aggregate of all outstanding obligations due on the repos as at the early termination date net of the mark-to-market values of collateral. Paragraph (b) of the definition therefore covers item (a) above.

Moreover, the collateral under the repos must be "recognized collateral" within the meaning of BCR §77 (in the case of repos booked in the banking book) or the arrangements for the provision of collateral must satisfy the applicable requirements of BCR §77 (in the case of repos booked in the trading book) (see BCR §96(2)(b)). In either case, the requirement in item (b) above is addressed by paragraph (b) of BCR §77 which requires that the legal mechanism by which the collateral is pledged or transferred ensures that the authorized institution concerned has the right to realize, or to take legal possession of, the collateral <u>in a timely manner</u> in the event of a default by, or the insolvency or bankruptcy of, or any other event specified in the relevant legal documentation occurring in respect of, the relevant obligor for the exposure or the custodian (if any) holding the collateral.

On-balance sheet netting

Q3: Paragraph 188 of Basel II provides that if a bank, among other things, monitors and controls its "roll-off risks", it may use the net exposure of loans and deposits as the basis for its capital adequacy calculation. Which section of the BCR covers this requirement?

A3: On-balance sheet netting can be recognized for the purposes of capital adequacy calculation if the requirements set out in the definition of "valid bilateral netting agreement" in BCR §2(1) are met. One of the requirements is that the authorized institution manages the transactions covered by the netting agreement on a net basis (see paragraph (e) of the definition). The HKMA considers the monitoring and control of roll-off risks to be part of the risk management process for managing an authorized institution's net credit exposures to counterparties under netting agreements.

Commitments eligible for a credit conversion factor of 0%

Q4: The Completion Instructions for Form MA(BS)3(IIIb) of the Return of Capital Adequacy Ratio (p.28) state that commitments to be reported in item 9a of Division B of the Form include commitments that are unconditionally cancellable <u>without prior notice</u> by the reporting institution other than for "force majeure" reasons. However, §71(1) Table 10 item 9(c) of the BCR does not include the "without prior notice" requirement. Clarification is sought in this regard.

A4: The HKMA considers the requirement set out in BCR §71(1) Table 10 item 9(c) that the commitments must be <u>unconditionally</u> cancellable already covers the "without prior notice" requirement. The HKMA is of the view that if a bank is required to give prior notice before cancelling a credit facility, the prior notice can be regarded as a condition.

Disclosure of additional information (average gross exposures)

Q5: Section 16(1) of the BDR requires an authorized institution, in addition to the disclosures it is required to make under the BDR, to include in its disclosure statement such other information that it is necessary to so include to ensure that: (a) the information contained in the statement is not false or misleading in any material respect; and (b) the operations of the institution are clearly explained. What would be an example of how this provision should work?

A5: To promote transparency and facilitate users of the disclosure statement in understanding the risk position of an authorized institution, paragraph 3.2.4 of CA-D-1 encourages authorized institutions to make more comprehensive disclosures than the minimum required in respect of the approach they use for calculation of their regulatory capital.

For instance, the required disclosures under sections 57 and 78 of the BDR relating to different classes of credit risk exposures are based on period-end figures. There may, however, be circumstances where such figures may not be genuinely representative of the risk positions of an authorized institution (e.g. where the period-end figures happen to be exceptionally large or small, or where significant fluctuations in the figures were observed during the period). To facilitate information users' understanding of the risk profile of the authorized institution, the authorized institution should follow the Basel Committee's guidance (as indicated in footnote 195 of the Basel II text) by supplementing such disclosure with meaningful average figures for the period and disclose the way in which the average figures are arrived at.