Guideline No.: 4.5

Our Ref: S4/1C(96) 8 June 1996

To: The Chief Executive,
All locally incorporated Authorized Institutions

Dear Sir/Madam,

Capital Adequacy Return -
Amendments to the Third Schedule to the Banking Ordinance

Following consultation with the two industry Associations, the HKMA has decided to bring the capital adequacy framework in line with the recent amendments to the Capital Accord made by the Basle Committee on Banking Supervision. The HKMA will amend the Third Schedule to the Banking Ordinance to:

(a) broaden the recognition of collateral in reducing credit risk to include securities issued by non-central government public sector entities (PSE) in Hong Kong and other Tier 1 countries;

(b) expand the coverage of off-balance sheet derivatives contracts under Table B of the Third Schedule to include contracts relating to equity, precious metals and other commodities;

(c) modify the residual maturity classifications relating to the current exposure method of valuation; and

(d) recognize the effects of netting in the calculation of potential future credit exposure of the derivatives contracts under Table B.

The HKMA will also take the opportunity of amending the Third Schedule to clarify the treatment of :

(a) capitalisation of property revaluation reserves through the issue of bonus shares and converting property revaluation surpluses of subsidiaries into general reserves; and
(b) subordinated tranches of mortgage-backed securities.

These proposed amendments were endorsed by Members of the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee at their meetings in March 1996.

The amendments to the Third Schedule which provide the legal framework for implementing the above proposals will be gazetted on 27 September 1996 and take effect on 30 September 1996. A copy of the latest draft of the revised Third Schedule is in Annex A. It has yet to be finalised, but we consider that it would be helpful for institutions to see it at this stage.

Locally incorporated authorized institutions should also note the modifications which will be made to the reporting requirements after the revised Third Schedule takes effect. Annexes B and C sets out the changes which will be made to the Capital Adequacy Ratio return (MA(BS)3) and the accompanying completion instructions, with the changes highlighted in bold. Reporting institutions are required to start using the revised return, a copy of which is in Annex D, to report their positions at **30 September 1996.** Printed returns will be sent to institutions in due course.

The HKMA will incorporate these new reporting requirements into the CAR return template of the STEM system. However, it is estimated that the new templates (to be used under the Windows environment) would only be available in January 1997. As a transitional arrangement, therefore, institutions are required to continue to use their CAR return template for reporting in the following manner:

(a) For institutions which have positions in derivatives contracts with a residual maturity of over 5 years and are using the current exposure method for reporting purposes, they are required to report such derivatives positions and their capital adequacy ratios in paper form i.e. to complete items 12b, 13b, 14, 15 and 16 of Part III as well as Part IV of the revised Return at Annex D.

(b) Other "STEM" users should continue using their CAR return template for reporting. However, they are required to confirm that they do not have any positions to be reported under the items as mentioned above. A copy of the confirmation is in Annex E.

Should you have any queries on the reporting requirements, please feel free to contact Mr. Danny Leung (2878 8202) or Mr. Jackson Young (2878 1624) of this office.

Yours faithfully,

D T R Carse
Deputy Chief Executive (Banking)

Encl

c.c. The Chairman, HKAB
The Chairman, DTC Association