Annex C

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14. Where a claim has reached final maturity, it should be treated as a sight asset (less any specific provision) and weighted in the normal way. In cases where interest on a claim is overdue but final maturity of the principal has not yet been reached, the claim should continue to be weighted according to its residual maturity.

15. Where claims on a counterparty are collateralized by cash or covered by a right of set off, or are secured against securities issued by, or guaranteed by the parties listed below, institutions may choose to weight the claims according to the risk weight appropriate to the collateral or the guarantor as follow:

	Risk Weight
collateralized by cash deposit (or covered by a right of set-off on credit balances).	0%
guaranteed by the central governments and central banks of Tier 1 countries.	0%
collateralized by securities issued by the central governments and central banks of Tier 1 countries.	10%*/20%*
guaranteed by the central governments and central banks of Tier 2 countries, where the claims (loan or securities) are denominated and funded in the local currency	
• for claims in the form of a loan	0%
• for claims in the form of securities	10%*/20%*
guaranteed by the public sector entities of Tier 1 countries.	20%
collateralized by securities issued by the public sector entities of Tier 1 countries.	***20%***
guaranteed by, or secured by securities issued by, multilateral development banks.	20%
guaranteed by authorized institutions or banks incorporated in Tier 1 countries.	20%
guaranteed by all other banks for claims with a residual maturity of under 1 year	20%

(* depending on the interest rate structure of the securities as well as the residual maturities of these instruments.)

Section C: Specific Instructions

Item	Nature of item
Part 1	**Capital Base**
	For any capital instruments which are issued at a discount or in a partly-paid form, only the net proceeds of such an issue should be counted as capital. *Shares issued through capitalising any property revaluation reserves referred to in Item Category II (h) should be excluded from Core Capital*
Category I	**Core Capital**
(c) & (d)	Share Premium and Reserves
	Report share premium accounts and reserves, including audited retained earnings and other published reserves but excluding those reserves which are included in items (g) to (i) of Category II of this part.
(e)	Profit and loss account
	Report here profits or losses of the current year and of the previous year pending audit completion. Institutions are expected to set aside or earmark from the current year's profit and loss account provisions for major items such as bad and doubtful debts, tax, depreciation and audit fees at least on a quarterly basis.
(f)	Minority interests (in core equity capital)
	Report minority interests on consolidation of core capital items.
Deduction	Goodwill
	Report the amount of goodwill that is shown on the balance sheet.
Total	Total Core Capital
	This is the sum of items (a) to (f) minus goodwill.

Category II Supplementary Capital

(g) Inner reserves

This refers to inner reserves maintained by locally incorporated banks.

(h) Reserves on revaluation of *land and interest in land*

This refers to the reserves arising from the revaluation of -

(i) the land and interests in land owned by the reporting institution other than any interest in land mortgaged to it to secure a debt; and

(ii) the share of the net asset value of any subsidiary to the extent that such value has changed as a result of a revaluation of such subsidiary's land and interests in land other than any interest in land mortgaged to such subsidiary to secure a debt

To be eligible for inclusion in this item, the revaluation must be formally carried through in the accounts and shown on the balance sheet. The amount to be included is limited to 70% of the revaluation surplus. For details please refer to Guideline 4.2.1 issued by the HKMA on 17 January 1990.

All institutions are expected to have a policy on the frequency and method of revaluation of premises. Institutions should not depart from this policy without first discussing their intentions with the HKMA. Revaluation will normally be required to be undertaken by an independent professional valuer, although in certain circumstances an internal valuation may be accepted provided that an independent valuer's name has been added to it. Revaluation will also need to be approved by the institution's external auditors and explicitly reported in the audited accounts.

For the purpose of this item "reserves" includes any shares issued by the reporting institution through capitalising reserves arising from revaluation referred to in the first sub-paragraph.

(i) Latent reserves on revaluation of long-term holdings of equity securities

Report reserves or deficits arising from a revaluation of long-term holdings of listed equity securities where such reserves or deficits, calculated as the difference between the market value and book value, have not been incorporated into the accounts. The securities referred to here are those listed on the Unified Exchange or on any exchange referred to at Annex 2. The

- they have an original maturity of over 5 years (and notwithstanding that in the case of term subordinated debt, that period may be reduced with the consent of the Monetary Authority); and

- they are not repayable or redeemable prior to maturity without the prior consent of the Monetary Authority.

The amount counted as capital should be discounted by one-fifth each year during the four years preceding maturity. In addition, the total amount of these two items included in Supplementary Capital shall be limited to 50% of Core Capital as reported in Category I of Part I.

(o) Minority interests (in supplementary equity capital)

Report minority interests on consolidation of irredeemable cumulative preference shares and term preference shares of subsidiaries.

Total Total eligible value of Supplementary Capital

The amount to be included is limited to a maximum of 100% of Core Capital.

Deduction Deductions from total capital

(A) Shareholdings in subsidiaries or holding company

Report shareholdings in any subsidiary or holding company of the reporting institution except where:

(i) The shareholding falls to be deducted under the deduction items (B), (C) or (D) below; or

(ii) in the case, of a consolidated return, its shareholding in a subsidiary included in the consolidation; or

(iii) its reserves arising from the revaluation of the land and interests in land of any subsidiary not falling within the meaning of reserves under item (h).

Category III Claims on Public Sector Entitles

For the purposes of this category, a public sector entity does not include any commercial company which is owned by it. Such commercial company will be treated as a private-sector commercial enterprise and will attract a risk weight of 100%.

15. Claims on. claims guaranteed by *or claims collateralised by securities issued by* public sector entities in Hong Kong

Public sector entities in Hong Kong include the Mass Transit Railway Corporation, the Kowloon-Canton Railway Corporation, the Hong Kong Housing Authority, the Hospital Authority, *the Airport Authority* and such other entities as may be specified by the HKMA from time to time.

16. Claims on claims guaranteed by *or claims collateralised by securities issued by* public sector entities of any other Tier 1 country

Public sector entities in any other Tier 1 country include any entity which is regarded as such by the recognized banking supervisory authority in the place in which it is incorporated. In general, they may include the local governments, the local authorities and other bodies owned by the central or local governments or local authorities which perform administrative, executive, regulatory or other non-commercial functions. Institutions may refer to the Monetary Authority in case of doubt.

Category IV Claims on Banks

For the purposes of this category, export trade bills negotiated under other banks' letters of credit should be reported as claims on the LC issuing banks.

19. Claims on or claims guaranteed by or collateralized by securities issued by, a multilateral development bank

Multilateral development bank means the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the Asian Development Bank, the European Investment Bank, the Nordic Investment Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development, and the International Finance Corporation.

21 Claims on or claims guaranteed by any other bank with a residual maturity of 1 year and over

Report claims on banks other than those reported under items 18 to 20.

Category V Residential Mortgages

22. Loans fully secured by a residential mortgage

Please refer to the Third Schedule to the Banking Ordinance for definition of a "residential mortgage".

23. Securities backed by residential mortgages and participations in residential mortgages

The underlying residential mortgage of the securities and of the participation reported in this item must satisfy all the criteria for residential mortgage specified in the Third Schedule to the Banking Ordinance. ***In addition, the holders of such securities must not absorb more than their pro rata share of losses in the event of arrears or default on payment of interest on, or principal of, the underlying mortgage loans***

Category VI Other Assets

24. Claims on non-bank private sector

Report all claims on non-bank private sector which have not been included elsewhere.

25. Investments in the equity or other capital of other banks

Report all investments in the equity or other capital instruments of other authorized institutions or banks, for which the Monetary Authority is satisfied that a deduction from capital base is not required.

26. Premises plant and equipment and other fixed assets for the reporting institution's own use

Report all investments in premises, plant and equipment and all other fixed assets of the reporting institution which are held for own use. Report also any fixed asset which is held by the reporting institution as lessee under a finance lease in accordance with the Statements of Standard Accounting Practice (SSAP 14) issued by Hong Kong Society of Accountants.

27. Other interests in ***land***

Report the institution's other interests in ***land*** which are not occupied or used in the operation of the institution's business.

28. All assets not elsewhere specified

Report all other investments or assets which are not classified elsewhere. This includes any fixed asset leased by the reporting institution under an operating lease. Assets which have been deducted from Capital Base in Part I need not be included.

29-33 Report any other on-balance-sheet items as instructed by the Monetary Authority.

Original maturity is defined as the length of time between the date the commitment is made and the earliest date on which the reporting institution can, at its option, unconditionally cancel the commitment.

12- ***16*** ***Exchange rate, interest rate, equity, precious metals and other commodities related contracts***

Exchange rate contracts include cross-currency interest rate swaps, forward foreign exchange contracts, currency futures, currency options purchased and similar instruments. They include also contracts involving *gold.*

Interest rate contracts include single-currency interest rate swaps, forward rate agreements, interest rate futures, interest rate options purchased and similar instruments.

Equity contracts include forwards, swaps, purchased options and similar derivative contracts based on individual equities or on equity indices.

Precious metal (other than gold) contracts include forwards, swaps, purchased options and similar derivative contracts that are based on precious metals such as silver, platinum and palladium.

Other commodity contracts include forwards, swaps, purchased options and **similar derivative** ***contracts based on energy contracts, agricultural contracts, base metals (such as aluminium, cop; per, and zinc) and any other non-precious metal commodity contracts.***

Exemption from capital weighting will be permitted for:

(a) instruments traded on exchange which are subject to daily margining requirements;
(b) exchange rate ***(except gold)*** contracts which have an original maturity of 14 calendar days or less. When such contracts are covered by a valid bilateral netting agreement (as defined below), institutions may at their own discretion net the profit or loss on such contracts against those on other contracts covered by the same agreement in arriving at the net exposure for capital weighting purposes. The inclusion or exclusion of such contracts for netting purposes must however be done on a consistent basis; or
(c) forward exchange rate contracts arising from swap deposit arrangements. Under such contracts, the money deposited by the customer remains under the control of the institution at all times during the transaction. The institution concerned will therefore be in a position to ensure that the customer does not default on the settlement of the forward contract.

Exposures in respect of *contracts covered by items 12-16* which are subject to a valid bilateral netting agreement may be reported on a net basis. A valid bilateral netting agreement is an agreement with a counterparty under which, in the event of the counterparty's failure to perform due to default, bankruptcy or liquidation, the institution's claim (or obligation) would be to receive (or pay) only net sum of the mark-to-market values of included transaction. The institution concerned must be able to demonstrate the legal enforceability of the netting agreement in all relevant jurisdictions, and its compliance with all the requirements set out in the HKMA's Policy Paper entitled "Amendment to the 1988 Capital Accord for bilateral netting".

Institutions should use either the current exposure method or, with the agreement of the Monetary Authority, the original exposure method to weight exchange rate and interest rate contracts. Institutions which have a significant volume of business in such contracts will normally be expected to adopt the current exposure method. Institutions with a small volume of such business may, however, choose either the original or current exposure method. ("Small' in this context means that the aggregate face value of outstanding contracts does not exceed 10% of the reporting institution's capital base. Other factors may also apply on a case by case basis.) ***For contracts relating to equity, precious metals other than gold and other non-precious metal commodities, the current exposure method must be used***

Items 12a and 13a are for completion by authorized institutions which are allowed to weight their contracts under the original exposure method. lie following two sets of credit conversion factors, used to calculate the credit equivalent amounts, are applicable to exchange rate and interest rate contracts of different original maturities:

Original Maturity	Exchange rate contracts	Interest rate contracts
1 year or less	2.0%	0.5%
Over 1 year to 2 years	*5.0%* (i.e.2%+3%)	1.0%
For each additional year	3.0%	1.0%

For contracts covered by valid bilateral netting agreements, the credit conversion factors to be used when calculating the credit equivalent amounts of contracts of different original maturity are as follows:

Original Maturity	Exchange contracts	Interest rate contracts
1 year or less	1.5%	0.35%
Over 1 year to 2 years	3.75% (i.e. 1.5%+2.25%)	0.75%
For each additional year	2.25%	0.75%

Items 12b and 13b are for completion by authorized institutions which are required to weight their ***exchange rate and interest rate*** contracts under the current exposure method. ***Items 14, 15 and 16 are for other derivatives contacts which must be reported by using the current exposure method***.

Under this method, the credit equivalent amount of these contracts should be the sum of:

(a) current exposure, which is the total replacement cost (obtained by "marking to market") of all contracts with a positive value, or where, contracts are covered by valid bilateral netting agreements, the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the bilateral netting , if positive; and

(b) ***potential exposure (the add-on), which is derived by multiplying the principal amount of each contract by the credit conversion factor specified below. Where contracts are covered by valid bilateral netting agreements, the netted add-on (A_{Net}) is derived by adding 40% of the sum of the products derived by multiplying the principal amount of each of those contracts by the credit conversion factors and 60% of the Net/Gross Ratio (NGR) multiplied by the sum of the products derived by multiplying the principal amount of each of those contracts by the credit conversion factors. This is expressed through the following formula:***

$$A_{Net} = 0.4 \times A_{Gross} + 0.6 \times NGR \times A_{Gross}$$

where

- A_{Gross} equals the sum of the individual add-on amounts (derived by multiplying the principal by the credit conversion

factors) of all contracts covered by valid bilateral netting agreements with one counterparty.

- NGR means the ratio of net replacement cost to gross replacement cost for contracts covered by valid bilateral netting agreements. (The NGR can be calculated on a **counterpart by counterparty** **or on an aggregate basis for all** ***transactions covered by valid bilateral netting agreements. However, the basis chosen by the reporting institution should be used consistently. An illustration of the calculation of the NGR based on the two methods is given in Annex 3.)***

The credit conversion factors applicable to contracts of different residual **maturities are as indicated in the following table:**

Residual maturity	***Exchange rate and gold***	***Interest rate***	***Equity***	***Precious metals except gold***	***Other commodities***
1 year or less	***1.0%***	***Nil***	***6.0%***	***7.0%***	***10.0%***
Over 1 year to 5 years	***5.0%***	***0.5%***	***8.0%***	***7.0%***	***12.0%***
Over 5 years	***7.5%***	***1.5%***	***10.0%***	***8.0%***	***15.0%***

For contracts with multiple exchanges of principal, the credit conversion factors are to be multiplied by the number of remaining payments in the contract. For contracts structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity would be set equal to the time until the next reset date. In case of interest rate contracts with remaining maturities of more than one year that meet this criteria, the credit conversion factor is subject to a floor of 0.5%.

Where a valid bilateral netting agreement covers ***more than one type of contracts such as*** both exchange rate and interest rate contracts, institutions should consult the HKMA in the reporting of the risk weighted positions under each contracts type.

It is not necessary to calculate the potential exposure of single currency floating/floating interest rate swaps. The current exposures, i.e. replacement cost, of these contracts shall be taken as their credit equivalent amounts.

Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of the above table should be treated as "other commodities". For all contracts the add-ons should be based on effective rather their apparent principal amounts. In the event that the stated principal amount is leveraged or enhanced by the structure of the transaction the effective principal amount must be used when determining the potential future exposure

Once the credit equivalent amount of ***a derivative*** contract has been determined using either the original exposure method or the current exposure method, that amount should be weighted according to the risk weight of the counterparty, or if relevant, that of the guarantor or the collateral security.

Hong Kong Monetary Authority

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Annex 1

Summary of risk categories

0% weight

Notes and coins

Hong Kong Government certificates of indebtedness

Gold bullion held in own vaults of the reporting institution or, on an allocated basis, by another institution, to the extent backed by gold liabilities

Claims to the extent that they are collateralized by cash deposits held by the reporting institution

Receivables arising from the sale of securities and, the purchase of securities on behalf of customers, which are outstanding up to and including the fifth working day after the due settlement date

Loans to, or loans to the extent that they are guaranteed by, the Exchange Fund, or the central government or the central bank of any Tier 1 country

Loans denominated in the currency of a Tier 2 country and funded in that currency to, or to the extent that they are guaranteed by, the central government or the central bank of that country

Off-balance-sheet commitments as specified under item 10 of Table B of the Third Schedule to the Banking Ordinance with an original maturity of under 1 year, or which may be cancelled at any time unconditionally by the reporting institution

10% weight

Fixed interest securities with a residual maturity of under 1 year, or floating rate securities of any maturity issued by or guaranteed by the central government or by the central bank of a Tier 1 country, or by the Exchange Fund, or claims to the extent that they are collateralized by such securities

Fixed interest securities with a residual maturity of under 1 year, or floating rate securities of any maturity issued by or guaranteed by the central government or by the central bank of a Tier 2 country, where such securities are denominated and funded in the currency of that country

20% weight

Cash items in the course of collection

Fixed interest securities with a residual maturity of 1 year and over issued by or guaranteed by the central government or by the central bank of a Tier 1 country, or by the Exchange Fund, or claims to the extent that they are collateralized by such securities.

Fixed interest securities with a residual maturity of 1 year and over issued by or guaranteed by the central government or by the central bank of a Tier 2 country, where such securities are denominated and funded in the currency of that country

Claims on, or claims to the extent that they are, guaranteed by, *or to the* extent that *they are collateralized by securities issued by,* public sector entities of Hong Kong and any other Tier 1 countries

Claims on, or claims to the extent that they are guaranteed by, authorized institutions or banks incorporated in Tier 1 countries

Claims on, or claims to the extent that they are guaranteed or collateralized by securities issued by, a multilateral development bank

Claims on, or claims to the extent that they are guaranteed by, any other bank which is incorporated in a Tier 2 country but which is not an authorised institution, with a residual maturity of under 1 year

50% weight

Loans fully secured by a residential mortgage

Securities backed by residential mortgages and participations in residential mortgages

100% weight

Gold held which is not backed by gold liabilities

Claims on the central government or on the central bank of a Tier 2 country which are not denominated and funded in local currency

Claims on public sector entities of a Tier 2 country

Claims on, or claims to the extent,. that they are guaranteed by, any bank which is incorporated in a Tier 2 country but which is not an authorized institution, with a residual maturity of 1 year and over

Claims on non-bank private sector entities

Investments in the equity or other capital instruments of other authorized institutions or banks other than those deducted from the capital base

Premises, plant and equipment and other fixed assets for the reporting institution's own use

Other interests in **land**

All assets not elsewhere specified

Annex 3

Example of calculating the Net to Gross Ratio ("NGR")

The following table summarizes the calculation of the NGR under the per counterparty and the aggregate basis:

Transaction	Counterparty A		Counterparty B		Counterparty C	
	Notional amount	Mark to market value	Notional amount value	Mark to market	Notional amount value	Mark to market
Outstanding contract 1	100	10	50	8	30	-3
Outstanding contract 2	100	-5	50	2	30	1
Gross replacement cost (GR)		10		10		1
Net replacement cost (NR)		5		10		0
NGR (per counterparty)	0.5		1		0	
NGR (aggregate)	$\sum NR/\sum GR = 15/21 = 0.71$					

The gross replacement costs (GR) include only the sums of positive market values, they are th 10, 10 and 1 respectively for counterparties A, B and C. The corresponding net replaceme (NR) are the non-negative sums of both positive and negative market values, i.e. 5, 10 and 0 fo and C respectively. Accordingly, the NGR calculated in the per counterparty basis should be 5/ 10/10=1 and 0/1=0 for A, B and C respectively. Based on the per counterparty NGR, the net can be calculated by the given formula in the per counterparty basis. The aggregate net add-on would be the sum of per counterparty net add-ons.

In case the NGR is calculated in the aggregate basis, it would be the ratio of total net replacement costs to total gross replacement costs, i.e. 15/21=0.71. The aggregate net add-on is then calculated by applying this ratio to the given formula for the individual counterparty subject to valid bilateral netting agreement, i.e. A, B and C.