Consultation Paper

Implementation of Basel III capital standards in Hong Kong (C2) Proposed amendments to Banking (Capital) Rules for implementation of Basel III Counterparty Credit Risk Framework

Purpose

1. This paper sets out the HKMA's proposed amendments to the Banking (Capital) Rules ("B(C)R") to introduce the Basel III standards for the counterparty credit risk ("CCR") framework and the use of external credit ratings. The industry is invited to provide comments on Annex 1 which sets out the proposed amendments in the form of amendments to the B(C)R. The HKMA particularly invites comments on those areas where certain modifications (as described in Annex 2) are proposed to be made to the relevant Basel III standards to facilitate implementation in Hong Kong.

Background

2. The consultation paper issued by the HKMA in January 2012 on the **Implementation of Basel III Capital Standards in Hong Kong** (C1) covered, among other things, proposals to strengthen the current risk-weighting framework for CCR exposures under the B(C)R. The proposals included the introduction of both the internal model method for the calculation of counterparty credit risk exposures ("IMM(CCR)") and the Basel III enhancements to the CCR framework. Some enhancements to the capital treatment of certain repo-style transactions were also proposed. All of these items are intended to be implemented on 1 January 2013. The consultation closed on 20 March and the HKMA issued its response to the industry associations in May.

3. The amendments to the B(C)R which are the subject of this consultation paper (C2) have been developed on the basis of the relevant policy proposals set out in the earlier consultation paper (C1), having regard to the comments received from the industry. Apart from the specific areas described in Annex 2, these amendments generally reflect the relevant standards set by the Basel Committee on Banking Supervision ("BCBS") in the following documents:

   - *International Convergence of Capital Measurement and Capital Standards – A Revised Framework (Comprehensive Version)* issued in June 2006, Annex 4 to which describes the IMM(CCR) for calculating counterparty credit risk;

   - *Basel III: A Global Regulatory Framework for More Resilient Banks*

and Banking Systems issued in December 2010 (including the subsequent refinements issued in June 2011), Section II of which describes the enhancements introduced under Basel III in relation to the CCR framework and the use of external credit ratings;

- "*Basel III Counterparty Credit Risk – Frequently Asked Questions*" issued in November 2011; and

- the consultative document "*Capitalisation of Bank Exposures to Central Counterparties*" issued in November 2011.

4. The HKMA is also proposing to-

- bring the capital treatment of trade finance under the B(C)R into line with the document "*Treatment of Trade Finance under the Basel Capital Framework*" issued by the BCBS in October 2011; and

- introduce a few refinements to certain existing provisions of the B(C)R for the purpose of clarifying the HKMA's policy intent or addressing issues identified since the rules were last amended.

5. Please note that the draft amendment rules in Annex 1 will be subject to change. The purpose of presenting the proposed amendments to the industry in the form of draft rules is to assist the industry in responding to the consultation by enabling AIs to better understand how the proposals would be factored into the B(C)R. Another draft of the text of the rules will be released to the industry under the statutory consultation process required pursuant to the Banking Ordinance. This is currently scheduled to be conducted during the third quarter of this year.

Major amendments to the B(C)R

6. The more significant amendments proposed to the B(C)R are summarized below:

CCR and CCP frameworks

6.1 **New definitions in section 2(1)** to set out the meaning of the technical terms used in the proposed new Part 6A (see paragraph 6.4 below);

6.2 **New sections in Division 2 of Part 2** to set out the requirements in relation to the prescribed methods for calculating the capital requirements for CCR. The new sections are modelled on the existing §§18 and 19 of the B(C)R with modifications to reflect specific arrangements for the use of the IMM(CCR), such as

national supervisors' discretion in providing a transitional period to individual banks for gradual migration from non-model based methods (e.g. the current exposure method ("CEM")) to the IMM(CCR);

6.3 **New Schedule 3A** to set out the qualifying criteria for using the IMM(CCR). The criteria are based on the corresponding qualifying criteria under Basel II as modified by Basel III;

6.4 Currently, the provisions in relation to the CEM are interspersed throughout Parts 4, 5 and 6 of the B(C)R. The HKMA considers that this drafting approach is neither practical nor desirable for the IMM(CCR) and the central counterparty (CCP) framework given their complexity. Hence, a **new Part 6A** is proposed to be incorporated into the B(C)R to cover the IMM(CCR), the two methods prescribed under Basel III for credit valuation adjustment (CVA) capital charge calculation and the Basel III CCP framework. The CVA capital charge calculation and the capital requirements for exposures to CCPs will be applicable to all locally incorporated AIs, while the IMM(CCR) will be applicable only to those locally incorporated AIs that have obtained an approval from the Monetary Authority to use the IMM(CCR).

6.5 AIs which have been approved under the new sections in Division 2 of Part 2 of the B(C)R to use the IMM(CCR) will need to follow the relevant provisions in Part 6A to calculate the value of their CCR exposures. Those without such approval will continue to use the CEM and the treatments for repo-style transactions under Part 4, 5 or 6 of the B(C)R (depending on which approach the AIs use to calculate their credit risk for non-securitization exposures) to calculate the value of their CCR exposures. All AIs, regardless of the approach adopted for CCR calculation, will need to calculate the risk-weighted amount of a CCR exposure by multiplying the value of the exposure (calculated under the CEM, the relevant enhanced treatment in the case of a repo-style transaction or the IMM(CCR) as the case may be) by the applicable risk-weight determined in accordance with Part 4, 5 or 6 of the B(C)R. As a result, **amendments to Part 4, 5 and 6** are required so that -

(a) the risk-weighted amount calculations under Parts 4, 5 and 6 will include CCR exposures calculated under the IMM(CCR) and the CVA capital charges (e.g. the amendments to §§52, 53, 106, 107, 140 and 141);

(b) provisions that are currently applicable only to the CEM will be applicable to the IMM(CCR) as well (e.g. the amendments

to §§52(3)(a), 64, 85, 106(3)(a), 129, 140A and 209);

(c) certain provisions (e.g. §§71(2) and (3), 72, 73(b) and (c), 95, 96, 97, 118(2) and (3), 119, 120(b) and (c), 131, 165, 166(b) and (c), 181 and 182(b) and (c)) will not be applicable to AIs that have an approval to use the IMM(CCR); and

(d) specific requirements under the IMM(CCR) (e.g. the amendments to §§168 and 203) and CCR-related enhancements introduced by Basel III (e.g. the amendments to §§74, 91, 97, 121, 125, 139, 153, 154, 156, 160(1) and 224, and proposed §§157A and 161(3)) are incorporated;

6.6 **Related and consequential amendments** (e.g. the amendments to §§33A, 34, 51, 88, 89, 105, 265, 278, 279, 313 and 321).

External credit ratings

6.7 **Amendments to Part 4, Part 7 and Schedule 7** to incorporate changes introduced by Basel III to address issues in the use of external credit ratings (e.g. §§69, 79, 80, 98, 99 and 211 and proposed §232A);

Treatment of trade finance

6.8 **Amendment to §59** to implement the Basel Committee's decision to reduce the capital requirements for certain trade financing activities to better reflect the self-liquidating nature of these activities;

Refinements initiated by the HKMA

6.9 Refinements initiated by the HKMA to clarify its policy intent or to address issues identified since the B(C)R were last amended, including-

(a) capital treatment for repo-style transactions (see the amendments to §§75, 76, 122, 123 and 202, and proposed §§76A and 123A);

(b) clarification of the requirement on correlation between collateral value and borrowers' credit quality (see the amendments to §§77 and 124);

(c) calculation of net credit exposure of credit derivative contracts (see the amendments to §§88 and 89)

(d) definition and treatment of default of obligors in a connected group under the IRB approach (see the amendments to §149);

(e) supervisory formula for calculating the capital charge for unrated securitization exposures (see the amendments to §§272 and 273)

(f) credit risk mitigation treatment for securitization exposures held in the trading book (see the amendments to §287A); and

(g) calculation of general market risk for interest rate exposures (see the amendments to §318(4)).

Legislative timetable

7. The HKMA aims to issue the draft amendment rules in the third quarter for statutory consultation, pursuant to the Banking Ordinance, before submitting them to the Legislative Council in October for negative vetting. This should enable the rules to come into effect from 1 January 2013.