

Q&As on Part 7 of the Banking (Capital) Rules (BCR)

(This set of Q&As supersedes the Q&As on Securitization set out in pages 52 to 66 of the Q&As on Banking (Capital) Rules issued on 31 December 2014 (Q&As 2014))

Meaning of “securitization transaction” for the purposes of Part 7 of the BCR

Q1.	How should one determine whether a transaction involving securitization of assets is a securitization transaction for the purposes of the BCR?¹
A1.	A transaction involving securitization of assets is a securitization transaction for the purposes of the BCR if there are at least two different tranches of credit risk associated with the assets securitized, where the junior tranche absorbs credit losses first in order to reduce the likelihood of credit losses being allocated to the more senior tranche(s). If the differences between different tranches or different classes are solely due to different coupon rates, yields or maturities, and any credit losses will be allocated to all tranches or classes on a pro-rata basis (i.e. the tranches or classes rank equally with each other in terms of repayment priority), the transaction is not a securitization transaction for the purposes of the BCR.
Q2.	What is the capital treatment for an exposure held by an authorized institution (AI) in its banking book in respect of a transaction involving securitization of assets that is not a securitization transaction for the purposes of the BCR?²
A2.	<u>Capital treatment for exposures (e.g. debt securities) to the transaction held by an AI in its banking book</u> The exposure is a non-securitization exposure and therefore should be risk-weighted by using the BSC approach, STC approach or IRB approach, as the case requires. <u>Capital treatment for assets securitized by an AI through the transaction</u> If the credit risk of the assets is transferred to other parties through the use of credit risk mitigation (CRM) (e.g. credit derivative contracts), the AI may take into account the CRM when calculating the risk-weighted amount (RWA) of the assets under the BSC approach, STC approach or IRB approach, as the case requires. However, the CRM must be recognized credit risk mitigation under the approach used. If the securitization of the assets is through selling the assets to a special purpose entity (SPE) and the assets have been derecognized from the AI's financial statements/accounts in accordance with prevailing accounting standards, the AI

¹ Equivalent to Q&As 2014 Q1 under the subject “Securitization transaction” (p. 60-61).

² Equivalent to Q&As 2014 Q2 under the subject “Securitization transaction” (p. 61-62).

	may exclude the assets from its calculation of the RWA for credit risk under the BCR.
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Recognition of Credit Risk Transfer under Securitization Transaction

Q3.	Please briefly explain the procedures of recognition of credit risk transfer under a securitization transaction.
A3.	Under the BCR, if an originating institution (originating AI) of a securitization transaction intends to obtain capital relief for the underlying exposures of the transaction (i.e. to apply the treatment set out in section 230(1) and (2) of the BCR to the underlying exposures), the AI must have conducted a prudent assessment against the criteria set out in section 229(1)(a) or (b) of the BCR, as the case requires, and ascertained that the transaction is an eligible securitization transaction. The AI should then make a notification to the HKMA in the manner prescribed in section 230(3) and (4) of the BCR (also see Q6 and Q7 below). The HKMA may, where necessary, require the AI to provide further information to support its claim that the transaction is an eligible securitization transaction. The HKMA will issue an acknowledgement letter to the AI when it receives the notification made by the AI under section 230(3) of the BCR. The AI could presume the HKMA has no objection to its application of the treatment under section 230(1) or (2), as the case may be, to the underlying exposures if it does not receive a notice issued by the Monetary Authority (MA) under section 230(5) of the BCR on or before a date specified in the acknowledgement letter. In general, if a notice is intended to be issued under section 230(5), the HKMA will indicate such intention to the AI and will provide an opportunity to the AI to make representations to the HKMA. After representations are made, the HKMA will take them into account in deciding whether to serve the notice concerned.
Q4.	Can an originating AI of a securitization transaction simply calculate the RWA of the underlying exposures of the transaction as if they had not been securitized (i.e. not applying the treatment under section 230(1) or (2) of the BCR to the underlying exposures although the transaction is able to meet the criteria for being regarded as an eligible securitization transaction)?³
A4.	Yes. This is entirely at the discretion of the AI. If the AI does not act in accordance with section 230(3) and (4) of the BCR for the transaction, the AI must treat the transaction as a non-eligible securitization transaction and determine the capital requirement of the underlying exposures of the transaction in accordance with section 233 of the BCR.

³ Equivalent to Q&As 2014 Q1 under the subject “Treatment to be accorded to securitization transaction by originating institution” (p. 63-64).

Q5.	Section 230(4)(b)(ii) of the BCR requires a written confirmation provided by a person who has sufficient seniority and authority. What persons are considered by the HKMA as having sufficient seniority and authority?
A5.	The persons below are considered by the HKMA as having sufficient seniority and authority for this purpose— (a) a qualified external or in-house legal counsel; or (b) a manager (within the meaning of section 2(1) of the Banking Ordinance (BO)) of the originating AI who— (i) is principally responsible for the affairs of the AI specified in section 4 (relating to risk management), 7 (relating to internal audits and inspections) or 8 (relating to compliance) of the Fourteenth Schedule to the BO; and (ii) has the necessary knowledge and experience to understand the assessment for supporting the issuance of the confirmation.
Q6.	In general, what information or supporting documents would the HKMA expect an originating AI to provide for the purpose of section 230(4)(b)(i) of the BCR?⁴
A6.	The AI should provide sufficient information to help the HKMA understand the risk profile of the securitization transaction concerned and the nature and size of the risks retained by the AI. The information generally includes— (a) a summary of the self-assessment of compliance with the criteria set out in section 229(1)(a) or (b), as the case requires, including the values of the two ratios mentioned in Q7 below calculated for the transaction; (b) the terms and structure of— (i) the securitization transaction, including any special features (e.g. amortization schemes, excess spread features, call options, materiality thresholds, replenishment mechanisms, loss allocation mechanisms, workout agreements, and, if applicable, the cost and the terms (such as credit events and early termination) of credit protection); and (ii) any recourse, warranty, credit enhancement, credit protection, liquidity facility or other commitments (e.g. to repurchase certain underlying exposures) provided by the AI; (c) details of the underlying exposures of the transaction, including exposure size, composition, and credit quality;

⁴ Based on Q&As 2014 Q1 (1st half) under the subject “Significant credit risk transfer” (p. 58-59) and Q4 under the subject “Treatment to be accorded to securitization transaction by originating institution” (p. 65-66).

	(d) the identity of the parties that provide credit enhancement or credit protection to the transaction and their respective obligations and rights, and evidence that the parties (including key investors) to which significant credit risk is transferred are not connected to the AI; and (e) the particulars (e.g. size, nature, terms and conditions) of the credit risk to the underlying exposures retained by the AI, such as first loss positions retained (including partial first loss positions), debt securities held, credit enhancement, liquidity facilities or credit protection granted, and any other form of support provided, by the AI.
Q7.	Any minimum standards the self-assessment referred to in the answer to Q6 is expected to meet?⁵
A7.	The self-assessment must be well-documented and conducted by a party (whether inside or outside the originating institution) that is independent of the parties responsible for originating— ◆ the securitization transaction concerned; and/or ◆ the underlying exposures of the transaction. The self-assessment must consider each relevant requirement set out in section 229(2) of the BCR and in Schedule 9 or 10 to the BCR individually and clearly set out references to the corresponding supporting documents and legal or accounting opinions. The assessment should be updated regularly to ensure compliance on a continuous basis (see Q8). In assessing whether there is significant credit risk transfer under a securitization transaction (see paragraph (a) of Schedule 9 or section 1(a) of Schedule 10 to the BCR), the self-assessment must include analyses to— ◆ measure and compare the level of reduction in regulatory capital as a result of applying the treatment under section 230(1) or (2) to the underlying exposures relative to the level of credit risk retained by the originating AI and substantiate that the reduction is justified by a commensurate transfer of credit risk to third parties; and ◆ in the case of a synthetic securitization transaction, substantiate that the credit protection through which the credit risk is transferred does not exhibit any characteristics of a “high-cost credit protection” described in the circular on “Basel Guidance on High-cost Credit Protection” issued by the Monetary Authority on 21 February 2012 and Annex G of the Supervisory Policy Manual module CA-G-5 “Supervisory Review Process”. The AI must identify and measure the risks it retains based on substance rather than form. The AI’s self-assessment should address whether the AI is actually

⁵ Based on Q&As 2014 Q1 (2nd half) under the subject “Significant credit risk transfer” (p. 59).

	exposed to substantial credit risk even though the transaction might appear to have isolated the AI from the credit risk associated with the underlying exposures. Since different originating AIs may use different methodologies to measure the degree of credit risk transfer achieved by a securitization transaction, the HKMA also expects an originating AI to, besides the figures calculated by using its own methodologies, provide the values of the following two ratios calculated for the transaction to the HKMA for its reference— (a) the ratio of the AI’s aggregate holding of non-senior securitization issues of the transaction (including funding provided by the AI to third parties for their acquisition of the issues) to the total non-senior securitization issues of the transaction; and (b) the ratio of the AI’s aggregate holding of non-senior securitization exposures to the transaction (including not only the holding of non-senior securitization issues, but also other forms of non-senior securitization exposures such as first loss position held or provision of liquidity facilities or credit enhancement to the transaction) to the total non-senior securitization exposures to the transaction. For the purpose of the calculation of the two ratios— (a) “AI” includes the AI and any member of its group (i.e. a set of entities whose positions are required to be consolidated with those of the AI under the accounting standards applicable to it); (b) the numerator and the denominator of each ratio must be measured at the RWAs of the securitization issues or securitization exposures calculated in accordance with Part 7 of the BCR; and (c) securitization issues held by the AI and any member of its group resulting from underwriting of the securitization issues can be excluded from the calculation only if— (i) the underwriting has been done at an arm’s length basis; and (ii) there is a timetable for disposal of the holding within a reasonable period.
Q8.	How will the change in eligibility of a securitization transaction affect the capital treatment of it?⁶
A8.	The requirements set out in section 229(1) of the BCR must be satisfied on a continuing basis throughout the life of the securitization transaction concerned. Hence, the HKMA expects the AI concerned to continue to monitor risks related

⁶ Replace Q&As 2014 Q5 under the subject “Treatment to be accorded to securitization transaction by originating institution” (p. 66).

	to the transaction to which it may still be exposed and review its assessment (including any legal advice) against the requirements regularly and whenever there are any changes (e.g. changes in law or regulation, amendments of any provisions of the securitization documentation, or triggering of any call options or early amortization provisions) that may impact the extent to which the requirements are complied with. If the review indicates that the transaction is no longer an eligible securitization transaction, the AI must stop applying the treatment under section 230(1) or (2) to the underlying exposures concerned. However, there might be cases where the change in the eligibility of the transaction is only temporary. In these cases, if the AI wants to reapply the treatment under section 230(1) or (2) after the transaction becomes an eligible securitization transaction again, the AI has to notify the MA such intent in accordance with section 230(3) and (4).
Q9. A9.	One of the requirements that must be met in order for a traditional securitization transaction to be regarded as an eligible securitization transaction is that the originating AI does not maintain effective control, directly or indirectly, over the underlying exposures in the transaction (paragraph (b) of Schedule 9 to the BCR). Please give examples of circumstances where an originating AI will be considered as failing to meet this requirement⁷. An originating AI will be considered to have maintained effective control over the underlying exposures being transferred to a third party under a traditional securitization transaction if the AI— (a) has the right to repurchase the underlying exposures, or is otherwise in a position to bring about the repurchase of the underlying exposures, from the third party without the repurchase being made on an arm's length basis in order to realize benefits from the underlying exposures; or (b) is obligated to retain the risk of the underlying exposures to an extent that exceeds the level necessary to comply with the risk retention requirements applicable to the transaction imposed by regulatory authorities. To avoid doubt, servicing rights retained by the originating AI in respect of the underlying exposures does not of itself constitute effective control of the underlying exposures.

⁷ Equivalent to Q&As 2014 Q3 under the subject “Effective control over underlying exposures” (p. 57-58)

Implicit support

Q10.	What factors will be considered when determining whether there is “implicit support” for the purpose of section 234 of the BCR?⁸
A10.	The HKMA will determine whether there is implicit support based on the specific circumstances of each case. The following situations, if they are beyond the predetermined contractual obligations of an AI under the securitization transaction concerned, are examples that may be considered as implicit support provided by the AI to the transaction – (a) purchase of the securitization issues of the transaction or repurchase of the underlying exposures of the transaction by the AI— (i) at a price above their fair market value; or (ii) that does not appear to be supported by any legitimate or commercially sound reason (Note 1); (b) sale by the AI of credit exposures at discounted prices into the pool of underlying exposures of the transaction; (c) increase in the AI’s holding of the first loss tranche of the transaction when there is deterioration in the credit quality of the underlying exposures; (d) substitution or replenishment of underlying exposures, or addition of underlying exposures or other assets (including cash), by the AI that will improve the credit quality of the pool of underlying exposures; (e) waiver by the AI of its contractual rights to receive future margin income generated from the transaction; (f) renegotiation of any annual fee for any liquidity facility provided by the AI at below market rates; or (g) payments made by the AI under the guise of fulfilling its contractual obligations under the transaction (e.g. representations and warranties) where the amount of the payments exceeds the amount that the AI is contractually obliged to make. The above list of examples is by no means exhaustive. It should also be noted that implicit support may be provided indirectly through other means (e.g. the use of SPEs). <u>Note 1:</u> The following are examples of situations which may be considered as legitimate or sound

⁸ Based on Q&As 2014 Q1 under the subject “Implicit support” (p. 53-54) and Q1 under the subject “Significant credit risk transfer” (p. 60).

	commercial reasons— (a) purchase of securitization issues in order not to breach the risk retention requirements applicable to the securitization transaction imposed by regulatory authorities; (b) an obligation of an originating AI to repurchase underlying exposures due to breach of a representation or warranty given by the AI (i.e. the situation allowed by paragraph (g)(ii)(A) of Schedule 9 to the BCR); (c) an obligation of an originating AI to repurchase an underlying exposure to a borrower in order to enable the AI to provide further advances to the borrower and the repurchase does not expose the AI to excessive credit risk (a case that falls within paragraph (g)(ii)(B) of Schedule 9); or (d) there is a case to facilitate a more cost-effective workout of those underlying exposures that have defaulted.
Q11.	What does “predetermined contractual obligations” mean in the definition of “implicit support” in the BCR?⁹
A11.	In the context of credit support provided by an AI under a securitization transaction, “predetermined contractual obligations” means— (a) the support that may be given by the AI is expressly set out in the contractual and marketing documents for the transaction; (b) the nature of the support that may be given by the AI is precisely described in the documents referred to in paragraph (a) above; and (c) the maximum degree of support that may be given by the AI can be ascertained at the time of the securitization both by the AI or by any person based on the information given in the marketing documents for the transaction. The credit support that may be provided by the AI within its predetermined contractual obligations must be— (a) if the AI is the originating institution of the transaction concerned—taken into account in the assessment of significant credit risk transfer for the purpose of determining whether the transaction is an eligible securitization transaction under section 229 of the BCR. The assessment should be made on the basis that the AI will provide support to the maximum degree possible under the contractual documents for the transaction; and (b) if the AI is the originating institution of the transaction and the transaction is an eligible securitization transaction or the AI is an investing institution—included in the calculation of the AI’s RWA for credit risk, assuming that the AI has provided support to the maximum degree possible under the contractual documents for the transaction (unless otherwise stated in the BCR, e.g. in the case of servicer cash advance facilities).

⁹ Equivalent to Q&As 2014 Q2 under the subject “Implicit support” (p. 54-55).

Classification of underlying exposures of a securitization transaction

Q12.	Under what circumstances the MA may, under section 16(5) of the BCR, require an AI to classify a pool of underlying exposures of a securitization transaction as an SA pool.
A12.	The circumstances include securitization transactions with highly complex loss allocations, tranches of which credit enhancement could be eroded for reasons other than pool losses, and tranches backed by a pool with high correlations within the pool (e.g. high concentration to a single sector or a geographical region). Incidentally, if an AI uses the IRB approach to calculate the credit risk of non-securitization exposures and the AI holds a securitization exposure backed by a pool of underlying exposures that contains only IRB underlying exposures (see the definition in section 16(7) of the BCR), the HKMA expects the AI to be able to obtain sufficient information to estimate the capital requirements for the IRB underlying exposures by using the IRB approach. If the AI fails to do so for all the IRB underlying exposures, this may cast doubt on whether the AI meets the due diligence requirements in section 15A. The AI should therefore inform the HKMA of the situation and demonstrate to the HKMA why it cannot do so. Depending on the explanation given by the AI, the HKMA may consider requiring the AI to take necessary actions to enhance its credit risk management system.

SEC-IRBA and SEC-SA

Q13.	In Part 7 of the BCR there are provisions that require an AI to verify or assess prudently certain matters (e.g. sections 251(5) and 256(2)). What is the HKMA's supervisory approach in this regard?
A13.	The verification or assessment performed by the AI must be well-documented and supported by detailed analysis accompanied by proper supporting documents. The documentation must be made available to the HKMA for review upon request. For example, if an AI intends to exclude an SPE's exposure, which is resulted from an interest rate swap entered into by the SPE, from the pool of underlying exposures under section 256(2) on the ground that the risk of the SPE's exposure has been mitigated, the AI should ascertain that the SPE has adopted measures to eliminate or at least significantly reduce the potential risk from a default of the swap provider. Examples of such measures could be: ♦ cash collateralization of the market value of the swap, coupled with a margin

	agreement that provides for prompt additional payments when the market value of the swap increases; and ♦ minimum required credit quality of the swap provider with an obligation to post collateral or present an alternative swap provider without any costs for the SPE in the event of a credit deterioration on the part of the original swap provider. The AI should also assess the extent of risk posed by the SPE's exposure to the securitisation exposure held by the AI.
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Credit enhancement

Q14.	Please provide examples of credit enhancement.¹⁰
A14.	Credit enhancement can be in the form of subordination, excess spread, over-collateralization, guarantee or insurance, etc.
Q15.	If the amount of credit enhancement provided by an AI to a securitization transaction cannot be readily ascertained (e.g. the exposure is not limited to a specified amount), how should the AI calculate the RWA of the credit enhancement?¹¹
A15.	In such a case, the AI should calculate the RWA of the credit enhancement as if the credit enhancement covered the full value of the securitization exposures that are the subject of the credit enhancement.

Gain-on-sale

Q16.	Should the amount of capital deduction in respect of gain-on-sale arising from a securitization transaction be the “accumulated” amount recorded in the originating AI’s books (i.e. including the amount of gain-on-sale recognized for the current year and the amounts recognized in previous years)?¹²
A16.	The amount of deduction should be the “accumulated” amount of the gain-on-sale recorded in the originating AI’s books because such an amount represents the total amount of increase in the AI’s CET1 capital resulted from the sale of the underlying exposures concerned.

¹⁰ Equivalent to Q&As 2014 Q1 under the subject “Credit enhancement” (p. 52).

¹¹ Equivalent to Q&As 2014 Q2 under the subject “Credit enhancement” (p. 52-53).

¹² Equivalent to Q&As 2014 Q1 under the subject “Gain-on-sale” (p. 55-56).

Recognition of External Credit Assessment Institutions

Q17.	Is the HKMA’s policy paper of “Recognition of External Credit Assessment Institutions” (Sep 2013) relevant to the SEC-ERBA under the revised securitization framework?
A17.	<u>Securitization exposures booked in an AI’s banking book</u> Yes. An AI may use the SEC-ERBA to risk-weight its securitization exposures booked in the banking book only if the credit ratings concerned are issued by an external credit assessment institution recognized by the HKMA in accordance with the criteria set out in the policy paper. For this purpose– (a) paragraph 3, second bullet, subparagraph (ii) of the policy paper should be read as “the securitization external ratings-based approach (“SEC-ERBA”) for securitization exposures booked in the banking book – Section III”; and (b) any references in the policy paper to “STC(S) approach” or “RBM” should be construed to mean the SEC-ERBA. <u>Securitization exposures booked in an AI’s trading book</u> Yes. The STC(S) approach and the ratings-based method will continue to be used for risk-weighting securitization exposures booked in the trading book.