

II. Use of ECAI ratings for the purposes of the BCR

1. **Nomination of ECAIs under §4C of the BCR**

For the purpose of using ECAI ratings to derive risk-weights for exposures under the STC approach or for securitization exposures under the SEC-ERBA, an AI should nominate the ECAIs it intends to use for each ECAI ratings based portfolio or specific exposures within certain ECAI ratings based portfolios in accordance with the requirements set out in §4C.

AIs that use the STC approach and/or SEC-ERBA only for the purposes of output floor calculations are also required to nominate ECAIs in accordance with §4C.

The recognition of the HKMA given to a particular ECAI may only cover ECAI ratings with respect to a particular market segment or geographical region (such an ECAI is referred to as Type B ECAI in the BCR). In such case, AIs should not nominate such ECAI for ECAI ratings based portfolio(s) or exposures that are outside the scope of the HKMA's recognition. The scope of recognition of each Type B ECAI will be published on the HKMA's website¹ upon commencement of Part 3 of the Banking (Capital)(Amendment) Rules 2023 ("BCAR").

In selecting ECAIs to be nominated, AIs should pay special attention to the criterion of "reasonable coverage" specified in §4C(3). AIs should ensure that their nominations are made in such a way to ensure that significant exposures within their ECAI ratings based portfolios are covered by at least one of the ECAIs.

Source: Paragraphs 25, 27 and 28 of Policy paper on Recognition of External Credit Assessment Institutions² ("ECAI policy paper"), with updates to align with the changes introduced by the BCAR. Part V of the ECAI policy paper, which sets out guidelines applicable to AIs, will be superseded by this Chapter.

2. **Treatment of nominations made before commencement date of §4C**

As provided for by §4E, any nomination made before the commencement date of §4C for securitization exposures remains effective on and after that date. No action is required from AIs.

AIs are required to make new nomination(s) under §4C for the following ECAI ratings based portfolios—

- (a) multilateral development bank exposures;
- (b) unspecified multilateral body exposures;
- (c) eligible covered bond exposures;

¹ <https://www.hkma.gov.hk/eng/key-functions/banking/banking-legislation-policies-and-standards-implementation/capital/>

² https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/Recognition_of_External_Credit_Assessment_Institutions_Revised.pdf

- (d) qualifying non-bank financial institution (“QNBFI”) exposures;
- (e) general corporate exposures;
- (f) specialized lending exposures.

Existing nominations for securities firm exposures and corporate exposures cannot be carried forward because the classification criteria has been changed. Some exposures that are currently classified as securities firm exposures will be reclassified as corporate exposures and some exposures (e.g. insurance firms) that are currently classified as corporate exposures will be reclassified as QNBFI exposures. AIs are required to reassess whether the ECAIs nominated for, say corporate exposures, have reasonable coverage for exposures to securities firms (see §4C(3)).

There is no specific requirement on the format of the written notice to be given to the MA under §4C(5) for the new nominations in respect of the portfolios listed above. AIs only need to declare in the notice that the requirements in §4C(3) or (4), as the case may be, are complied with. Also, AIs are not required to submit the assessment of “reasonable coverage” to the MA. However, the assessment should be properly documented.

Source: Responses to HKAB dated 20221216 (Seq.7) and 20230927 (Seq.4).

For administrative convenience, AIs may submit the written notice to their usual supervisory contact at the HKMA before the commencement date of §4C, but the effective date of the written notice and the new nominations must be specified as that commencement date.

Consultation Question:

Do you have any view on the proposed administrative arrangement for submitting the written notice of the new nominations to the HKMA?

3. Use of ECAI ratings issued by nominated ECAIs

- (a) An AI should use the ECAI ratings of its nominated ECAIs within the ECAI ratings based portfolios consistently for both risk-weighting and risk management purposes, and, as required by §4D(1), seek the consent of the HKMA on any subsequent changes to the nomination (e.g. the addition or removal of a nominated ECAI in respect of an ECAI ratings based portfolio or any change in the scope of application of the ECAI ratings of a nominated ECAI).

The above requirements aim to ensure that AIs use the ECAI ratings of their nominated ECAIs consistently and to avoid any possible cherry-picking of ECAI ratings provided by different ECAIs or any arbitrary change of the use of ECAIs.

- (b) As a general rule, AIs should use solicited ratings from ECAIs.
- (c) Under §54F(1)(a), if an AI intends to use an ECAI rating issued by a nominated ECAI to risk-weight an exposure, the ECAI rating must take into account and reflect the entire amount of the exposure with regard to all payments owed to the AI. For example, if the AI is owed both principal and interest, the ECAI rating must fully take into account and reflect the credit risk associated with repayment of both principal and interest.
- (d) ECAI ratings for one entity within a group cannot be used to risk-weight other entities within the same group.

Source: Paragraphs 25(c), 26 and 29 of the ECAI policy paper, with updates to align with the changes introduced by the BCAR, and Basel Framework CRE21.20 and CRE21.21.

4. §54F(1)(b) - Implicit government support

According to §54F(1)(b), AIs may continue to use ECAI ratings with assumptions of implicit government support for public banks owned by governments (i.e. even after 5 years from the commencement of §54F). In determining whether a financial institution is a public bank owned by a government, AIs must first verify whether the institution falls within the definition of “bank” in §2(1) before considering the ownership. If an AI has any difficulty in determining whether a bank to which it has a credit exposure is owned by a government, it may consult the HKMA.

Source: Responses to HKAB dated 20230515 (Seq.9).

5. §54F(1)(c) - Use of ECAI ratings assigned to banks and bank exposures with assumptions of implicit government support

After the 5-year transitional period provided for under §54F(2) has expired—

- (a) as specified in §54F(1)(c)(i), in determining the applicable ECAI rating in accordance with §54E (application of ECAI ratings) for the purposes of §54D (mapping ECAI rating to credit quality grade), the ECAI ratings assigned to banks and their exposures mentioned in §54D and §54E should not include those ratings that incorporate assumptions of implicit government support;
- (b) according to §54F(1)(c)(ii), if an AI’s bank exposure has only one ECAI issue specific rating but such rating incorporates assumptions of implicit government support, the bank exposure is regarded as falling within (as applicable) paragraph (a)(i)(B) or (b)(i)(B) of the definition of “unrated exposure” in §51(1). Similarly, when determining whether a bank falls within paragraph (a)(ii) or (b)(ii) of that definition, any ECAI rating that incorporates assumptions of implicit government support should not be counted; and
- (c) in cases where ECAI ratings without assumptions of implicit government support are not available, AIs should not continue to use ECAI ratings with such assumptions by making any adjustments to any of such ECAI ratings in an attempt to remove the impact of implicit government support on the rating,

regardless of whether such adjustment is based on information on the rating methodologies provided by the ECAI concerned.

The HKMA will keep in view ECAIs' progress in providing ECAI ratings without the assumptions of implicit government support and revisit the related policy near the time of the expiry of the 5-year transitional period.

Source: Responses to HKAB dated 20230515 (Seq.9).