

Proposed modifications to Basel III CCR framework for implementation in Hong Kong

The HKMA proposes to modify the Basel III CCR framework as set out in the attached table for the following reasons:-

- the Basel capital adequacy framework is designed for internationally active banks (see para. 9 of Basel II) and may not be appropriate in some aspects for small-to-medium size banks with simple or small operations (for example, items 1 and 7 below); and
- the Basel capital adequacy framework sets a minimum standard. National supervisors can adopt arrangements that result in higher levels of minimum capital or supplementary measures of capital adequacy for banks under their supervision (see para. 9 of Basel II). Items 2, 4 and 5 below arise out of prudential concerns about model risk and objectivity of model output.

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1.	NA	NA	Under Basel II, any banks may apply for an approval to use internal models to calculate CCR exposures. Since the IMM approach and IMM(CCR) approach require similar technical competence and risk management capability, AIs with IMM approval should be in a better position, in terms of their competence and experience in using internal models for capital calculation (including model development and model validation) to use the IMM(CCR) approach. The HKMA therefore proposes that at least initially, only AIs with approval to use the IMM approach may apply to the HKMA for approval to use the

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			IMM(CCR). This should also enable the HKMA to process more expeditiously applications that are more likely to meet the minimum qualifying criteria.
2.	Para. 34 and 35 of Annex 4 to Basel II (Own estimates for alpha)	Banks may seek approval from their supervisors to compute internal estimates of alpha subject to a floor of 1.2. (Note: If banks do not estimate their own alpha, they will use the supervisory value of 1.4 provided by the Basel Committee)	As internal estimates of alpha will introduce additional model risk, the HKMA proposes to adopt, at least initially, a more conservative approach, allowing AIs to only use the alpha specified by the HKMA. The HKMA will reconsider the feasibility of making the option of computing internal estimation of alpha available in future in light of implementation experience.
3.	Para. 39 of Annex 4 to Basel II	For netting sets in which all contracts have an original maturity of less than one year, the formula for effective maturity (M) in paragraph 320 of this Framework is unchanged and a floor of one year applies, with the exception of short-term exposures as described in paragraph 321 to 323 of this Framework.	The original text in para. 39 of Annex 4 to Basel II refers to contracts that “have an original maturity of less than one year”. However, this creates a problem with contracts that have an original maturity of 1 year as these contracts will be covered by neither §168(1)(ba) nor §168(1)(bb) of the proposed amendments to the Banking (Capital) Rules. To address this issue, the HKMA proposes to refer to contracts that “have an original maturity of not more than 1 year” in section 70(3) of the proposed amendment rules.
4.	Footnote 241 of Annex 4 to Basel II (Maturity)	A bank that uses an internal model to calculate a one-side CVA can use the effective credit duration estimated by such a model in place of the maturity calculated by the formula in para. 38 with prior	The HKMA proposes not to make available this option for the reasons mentioned in item 2.

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		approval of its supervisor.																	
5.	Page 50 – 51 of Basel III (new para. 46(i))	Under the IMM, a measure that is more conservative than the metric used to calculate regulatory EAD for every counterparty may be used in place of alpha times Effective EPE with the prior approval of the supervisor. The degree of conservatism will be assessed upon initial supervisory approval and at the regular supervisory reviews of the EPE models. The bank must validate the conservatism regularly. (It should be noted that this is not a new requirement introduced by Basel III but an existing requirement in Annex 4 to Basel II (para. 45).)	The HKMA proposes not to make available this option for the reasons mentioned in item 2. The HKMA has concerns (in terms of objectivity) regarding the process for generating a fair and non-biased benchmark (represented by the value of alpha times Effective EPE) for assessing the degree of conservatism. Moreover, the requirement to subject the degree of conservatism to regular review by supervisors and regular validation by banks may also have significant resources implications.																
6.	Para. 99 of Basel III (i.e new para. 104 of Annex 4) – Table on page 36	Under Basel III, there is only one table for mapping external ratings to weights. The weights given in the table are based on the external rating of the counterparty: <table><tr><th>Rating</th><th>Weight w_i</th></tr><tr><td>AAA</td><td>0.7%</td></tr><tr><td>AA</td><td>0.7%</td></tr><tr><td>A</td><td>0.8%</td></tr><tr><td>BBB</td><td>1.0%</td></tr><tr><td>BB</td><td>2.0%</td></tr><tr><td>B</td><td>3.0%</td></tr><tr><td>CCC</td><td>10.0%</td></tr></table>	Rating	Weight w_i	AAA	0.7%	AA	0.7%	A	0.8%	BBB	1.0%	BB	2.0%	B	3.0%	CCC	10.0%	The HKMA proposes that in addition to the standard table prescribed under Basel III, a second table be added to cater for the 3 Indian ECAIs whose ratings are only recognized by the HKMA for the purpose of risk-weighting exposures to corporates incorporated in India under the STC approach. As can be seen from Part 2 of Table C of Schedule 6 to the Banking (Capital) Rules the risk-weight allocated to an AA rating issued by an Indian ECAI is 30% instead of 20%. The second table will reflect such difference in risk-weight by changing the weight applicable to AA ratings issued by an Indian ECAI from 0.7% to 0.8%. Such change is to ensure consistency within
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			the current capital framework and the adequacy of the weight in reflecting the level of credit risk associated with the external credit rating concerned.
7.	Para. 99 of Basel III (page 35) – determination of the weight to be assigned to a counterparty under the standardised CVA method	When a counterparty does not have an external rating, the bank must, subject to supervisory approval, map the internal rating of the counterparty to one of the external ratings.	The HKMA proposes to adopt the following approach to implementing this requirement: (i) if an AI uses the IRB approach to calculate its credit risk for non-securitization exposures, it may, with the prior consent of the HKMA, map the internal rating of the unrated counterparty to an ECAI issuer rating in order to determine the weight applicable to the counterparty; and (ii) in all other cases (e.g. AIs using the BSC approach or STC approach), an AI must assign a flat weight of 1% (corresponding to an investment grade / triple B external credit rating) to the unrated counterparty. The proposed approach recognizes that AIs which do not use the IRB approach are mostly medium-size or smaller AIs and they may not have an internal rating system to map to external ratings. The HKMA believes that the proposed approach strikes a reasonable cost / benefit balance, and a 1% weight can be regarded, on the whole, as a fair and conservative approximation for the average weight of

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			a pool of counterparties with varying credit qualities. This approach is, to the best of the HKMA's current knowledge, likely to be in line with the treatment intended to be adopted by the MAS in Singapore ¹ and the EU authorities ² .

¹ See paragraphs (i) and (ii) on the top of page 7-297 of the consultation paper "Proposed amendments to MAS Notice 637 to implement Basel III capital standards in Singapore" issued in December 2011 by the Monetary Authority of Singapore.

² See proposed article 374 of "Proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms" issued by the European Commission in July 2011.