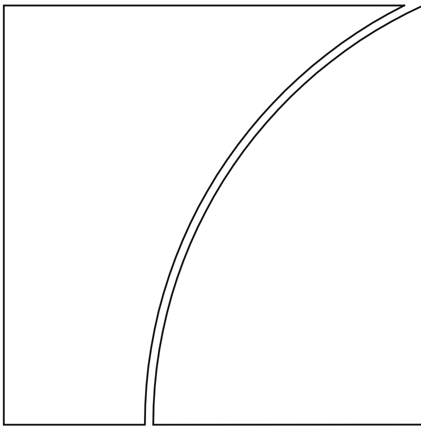
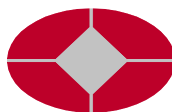
Basel Committee
on Banking Supervision



Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III risk-based capital regulations– Hong Kong SAR

March 2015



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Glossary

ABCP	Asset-backed commercial paper
AIRB	Advanced Internal Ratings-Based Approach (credit risk)
AI	Authorised Institution
AMA	Advanced Measurement Approaches (operational risk)
AT1	Additional Tier 1 (capital)
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BCR	Banking (Capital) Rules (Hong Kong)
BDR	Banking (Disclosure) Rules (Hong Kong)
BIA	Basic Indicator Approach (operational risk)
BIS	Bank for International Settlements
BO	Banking Ordinance
C	Compliant (grade)
CAR	Capital adequacy ratio
CCF	Credit Conversion Factor
CCR	Counterparty credit risk
CEM	Current Exposure Method (counterparty credit risk)
CET1	Common Equity Tier 1
CIS	Collective Investment Schemes
CP	Core Principle (Basel Core Principles)
CRM	Credit risk mitigation
CVA	Credit valuation adjustment
D-SIB	Domestic systemically important bank
DTA	Deferred tax assets
ECAI	External Credit Assessment Institution
FAQ	Frequently asked question
FSAP	Financial Sector Assessment Program
FIRB	Foundation Internal Ratings-Based Approach (credit risk)
FSSA	Financial System Stability Assessment
FX	Foreign exchange
GDP	Gross domestic product
G-SIB	Global systemically important bank
HK	Hong Kong
HKD	Hong Kong dollar
HKMA	Hong Kong Monetary Authority
HVCRE	High Volatility Commercial Real Estate
HVCRE SL	High Volatility Commercial Real Estate Specialised Lending
IAA	Internal Assessment Approach (securitisation)
IAS	International Accounting Standard
ICAAP	(Internal) Capital Adequacy Assessment Process
IMA	Internal Models Approach (market risk)
IMM	Internal Model Method (counterparty credit risk)
IRB	Internal Ratings-Based Approach (credit risk)
LC	Largely compliant (grade)
LERS	Linked Exchange Rate system
LGD	Loss-given-default
MDB	Multilateral Development Bank

MNC	Materially non-compliant (grade)
N/A	Not applicable
NC	Non-compliant (grade)
RBA	Ratings-Based Approach (securitisation)
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted asset
SCVA	Standardised CVA
SIG	Supervision and Implementation Group
SMM	Standardised Measurement Method (market risk)
SPM	Supervisory Policy Manual (Hong Kong)
SRP	Supervisory Review Process (Hong Kong)

Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. Through its Regulatory Consistency Assessment Programme (RCAP), the Basel Committee monitors, assesses, and evaluates its members' implementation of the Basel framework.

The assessments under the RCAP aim to ensure that each member jurisdiction adopts the Basel III framework in a manner consistent with the framework's letter and spirit. The framework's intent is to establish prudential requirements that are based on a sound, transparent and well defined set of regulations that will help strengthen the international banking system, improve market confidence in regulatory ratios, and ensure an international level playing field.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel risk-based capital standards in Hong Kong SAR and their consistency with the Basel III framework.[1] The Hong Kong Monetary Authority (HKMA) originally issued its Banking (Capital) Rules (BCR) and Banking (Disclosure) Rules (BDR) in 2006 to implement Basel II taking effect from January 2007. Since that time the HKMA has undertaken several initiatives designed to strengthen the prudential framework relating to bank capital. In October 2011, the HKMA amended the BCR to implement Basel 2.5. In October 2012, the BCR was amended further to implement the first phase of Basel III taking effect from 1 January 2013. More recently, in October 2014, a new set of amendments was made to the BCR (taking effect on 1 January 2015) to implement the capital buffers and higher loss absorbency buffer requirements for systemically important banks. Given the structural features of the Hong Kong banking system, including the significant presence of subsidiaries of several large global systemically important banks (G-SIBs), these are important steps towards ensuring financial stability in Hong Kong, within the region and globally.

The Assessment Team was led by Mr Arthur Lindo, Senior Associate Director at the Federal Reserve Board, and comprised five technical experts from the Bank for International Settlements, Denmark, India, Russia, and the United Kingdom. The counterpart for the assessment was the HKMA. The overall work was coordinated by the Basel Committee Secretariat with support from Federal Reserve Board staff. The assessment relied upon the data and information provided by the HKMA up to 31 December 2014. The report's findings are based primarily on an understanding of the current processes in Hong Kong as explained by counterpart staff and documents provided to the Assessment Team.

The assessment work was carried out in the following three phases: (i) completion of an RCAP questionnaire (a self-assessment) by the HKMA; (ii) an off- and on-site assessment phase by the Assessment Team; and (iii) a post-assessment review phase. The off- and on-site phase included a visit to Hong Kong, during which the Assessment Team held discussions with the HKMA, the seven largest banks in Hong Kong (which were used as the RCAP sample banks for the purpose of impact assessment), three audit firms, and three credit rating agencies. These discussions provided the Assessment Team with a deeper understanding of the implementation of the Basel III regulations and practices in Hong Kong. The third phase consisted of a two-stage technical review of the assessment findings by a separate RCAP review team and a discussion by the Basel Committee's Supervision and Implementation Group (SIG), followed by a review and clearance by the RCAP peer review board. This two-step review process is

[1] Please see the accompanying assessment report on Hong Kong's compliance with the LCR. Other Basel III standards, namely the NFSR, the leverage ratio, and the framework for systemically important banks will be assessed as those standards become effective per the internationally agreed phase-in arrangements.

a key part of the RCAP for substantive quality control and to facilitate the consistency of RCAP assessments.

The scope of the assessment was limited to the consistency and completeness of the domestic regulations in Hong Kong with the Basel framework. Where domestic regulations and provisions were identified to be inconsistent with the Basel framework, those deviations were evaluated for their current and potential impact on the capital ratios for the sample of internationally active banks in Hong Kong. Issues relating to the adequacy of prudential outcomes, capital levels of individual banks, loan classification practices, or the HKMA's supervisory effectiveness were not in the scope of this RCAP assessment exercise.[2]

This report has the following three sections and a set of annexes: (i) an executive summary on the material findings including a statement from the HKMA; (ii) the primary set of assessment findings including a description of the assessment's scope and methodology; and (iii) details of the deviations and their materiality along with other assessment-related observations.

The Assessment Team sincerely thanks Mr Arthur Yuen, Deputy Chief Executive, Ms Karen Kemp, Executive Director, Mr Richard Chu, Head (Banking Policy Division), Ms Rita Yeung, Head (Banking Policy Division), and the staff of the HKMA for the professional and efficient cooperation extended to the Assessment Team throughout the assessment.

[2] Some of these issues, including Hong Kong's compliance with the Basel Core Principles for Effective Banking Supervision (BCP) have recently been reviewed under the IMF-World Bank Financial Sector Assessment Program (FSAP) in 2014. See www.imf.org/external/pubs/cat/longres.aspx?sk=41752.0.

Executive summary

The HKMA has implemented the Basel III risk-based capital regulations consistently with the internationally agreed timeline, and has also applied the transitional arrangements in line with Basel III. The HKMA's risk-based capital rules (BCR) apply to all 57 locally incorporated authorised institutions (AIs).

Overall, the Assessment Team finds the HKMA prudential regulations compliant with the standards prescribed under the Basel framework. Twelve of the 13 components of this review are assessed as compliant while one component, the Pillar 3 disclosure requirements, is assessed as largely compliant with Basel standards. The Advanced Measurement Approaches (AMA) to Operational Risk have not been implemented in Hong Kong and thus are not within the scope of this review.

In the Pillar 3 component, the HKMA requires banks to disclose their capital adequacy ratios on a semiannual basis rather than quarterly, which contributed significantly to the assessment of largely compliant. However, most of the major locally incorporated banks have been subject to the listing rules in Hong Kong, which require them to disclose price sensitive information to the public as soon as possible (formally incorporated as a statutory requirement since 1 January 2013). Market discipline may thus only be compromised to a limited extent, whereby this deviation is not considered material.

Among the components which the Assessment Team determined to be compliant with the Basel Framework, there were a few differences in the standardised approach to credit risk, market risk, operational risk, and counterparty credit risk components that the Assessment Team deemed to be noteworthy. With respect to the standardised approach to credit risk, the BCR do not require banks to apply a granularity criterion to regulatory retail portfolios (to ensure that the retail portfolio remains sufficiently diversified, thus warranting a preferential risk weight of 75%); with respect to exposures secured by commercial real estate, there is no separate asset class requiring a 100% risk weight. Rather the risk weights are assigned by reference to the credit quality and nature of the counterparty (corporate, regulatory retail etc) and this has the potential to permit a lower risk weight; and the BCR also permit potentially lower risk weights for domestic currency claims on sovereigns that have not exercised the discretion to allocate a lower risk weight to their domestic currency debt under Basel II, claims on certain securities firms, and off-balance sheet exposures arising from partly paid securities. With respect to the market risk component, the BCR standardised measurement method (SMM) permits the offsetting of opposite foreign exchange (FX) positions denominated in USD and HKD. This was found to be a difference from the Basel framework, but reflects the effect of the long-standing Linked Exchange Rate system (LERS) adopted by Hong Kong (which can be characterised as a Currency Board). With respect to the operational risk component, two large banks make use of the Basic Indicator Approach, which runs contrary to the Basel framework's requirement that internationally active banks should, at a minimum, use the Standardised Approach. Regarding the counterparty credit risk component, the BCR exempt FX rate contracts with an original maturity of less than 14 days from counterparty credit risk capital requirements (which is a legacy provision from Basel I). The Assessment Team did not identify any deviations related to the capital buffers, Internal Models Approach (IMA) to market risk, or Pillar 2 components. It identified only minor deviations relating to the scope of application, definition of capital, credit risk IRB and securitisation components.

The Assessment Team recognises the efforts made by the HKMA to strengthen and align its capital rules to the Basel III framework throughout the course of the assessment process. These amendments became effective on 1 January 2015 (see Annex 6 for a complete list of the amendments

made by the HKMA). For most of the remaining list of deviations, the HKMA intends making additional changes at a later date (in 2015 or, if the relevant deviation appears likely to be addressed by anticipated changes to international standards, when the HKMA implements the revised standards).[3]

[3] These include international standards which have been finalised (such as the standardised approach for measuring counterparty credit risk exposures and the revised securitisation framework) or those currently in contemplation (such as the revised standardised approach to credit risk, and the revised Pillar 3 disclosure package).

Response from HKMA

The HKMA would like to record its appreciation of the dedication and professionalism with which the Assessment Team, under the leadership of Arthur Lindo, approached the RCAP review of Hong Kong SAR.

The RCAP assessment has offered a valuable opportunity, and provided the impetus for a thorough review of the regulatory capital framework in Hong Kong. The HKMA is pleased that Hong Kong has received an overall compliant rating.

The HKMA rectified 17 potential deviations identified in its self-assessment and by the Assessment Team by the cut-off date on 31 December 2014. Further amendments will be made to the BCR and BDR to address other identified issues. The HKMA's intention is to address these issues through amendments as far as possible in 2015, except where the relevant deviation appears likely to be addressed by anticipated changes to the revised Basel Committee standards. In these latter cases, the HKMA would intend to address the issues when implementing the revised standards.

On the whole, the HKMA considered the RCAP process a useful exercise, and is fully supportive of its goals to promote consistency of implementation and thereby contribute to the safety, soundness and stability of the global banking system.

1. Assessment context and main findings

1.1 Context

Status of implementation

The HKMA is the prudential regulator for the banking sector in Hong Kong SAR. The Basel II/2.5 standards have been in effect from 1 January 2007 and 1 January 2012, respectively, implemented via the BCR, the main regulatory instrument in Hong Kong (see Annex 2 for a complete timeline). In October 2012, the HKMA published an amended version of the BCR to include the Basel III standards. This amendment became effective on 1 January 2013, in line with the international timetable, after a period of consultation with the industry. The BCR apply to all 57 locally incorporated AIs in Hong Kong (see Annex 8).

Implementation context

Structure of the banking system

With total financial assets of HKD 17.4 trillion (US$2 trillion; or 818% of its GDP, Table 1), the banking system in Hong Kong is one of the largest financial systems in the world.[4] In March 2014, 202 AIs operated in Hong Kong (see Annex 8), 57 of which were locally incorporated AIs, and 145 were branch entities.

The seven largest banking groups (which include 10 AIs on a legal entity basis) account for approximately 57% of Hong Kong's banking sector assets, and the largest bank alone makes up 29% of the sector's total assets. Individually, none of these AIs is currently considered systemically important at a global level (G-SIB), but four of the seven banking groups are part of larger consolidated groups designated as G-SIBs. Overall, 29 of the 30 G-SIBs are present in Hong Kong. Of these, 28 are present in the form of AIs, with nine having significant local operations. From 2015, the HKMA will designate certain AIs as Domestic Systemically Important Banks (D-SIBs) and these DSIBs will be subject to additional Higher Loss Absorbency capital buffers as of 1 January 2016.

The international nature of Hong Kong's banking system is reflected by the fact that nearly half of the banking sector assets are foreign-owned, and the 145 branches in Hong Kong include those of 138 foreign licensed banks and seven foreign restricted licence banks.[5, 6]

Basel standards

Table 2 shows how the Basel advanced approaches have been adopted by the seven largest banks in Hong Kong that comprise the RCAP sample banks.[7] Five of these banks have adopted the advanced

[4] The 2014 FSAP found the Hong Kong banking system to be well capitalised, profitable, and liquid. See www.imf.org/external/pubs/ft/scr/2014/cr14130.pdf.

[5] The foreign branches account for approximately 35% of the banking sector assets. The HKMA favours converting branches with a sizeable domestic business into subsidiaries.

[6] In Hong Kong there are three tiers of AIs which may take deposits: (i) licensed banks which may carry on the full range of banking business; (ii) restricted licence banks (mostly merchant or investment banks) which may take deposits of not less than HKD 500,000 and (iii) deposit-taking companies (principally consumer and trade finance companies) which may take only deposits of not less than HKD 100,000 on tenors of at least three months.

approaches for credit risk while two use the standardised approach. For market risk, three of the seven sample banks have adopted the Internal Models Approach (IMA), while four have adopted the standardised approach. For operational risk, five of the banks use the Standardised Approach and two use the Basic Indicator Approach (BIA). None of the banks uses the Internal Models Method (IMM) for counterparty credit risk, which was introduced into the BCR in January 2013. The other banking groups use the non-advanced approaches for all risk types.

Credit risk comprises 86% of total risk-weighted assets (RWAs), while operational risk, market risk, and counterparty credit risk comprise 8%, 5%, and 2% of RWAs, respectively.

Overview of the banking sector in Hong Kong

Table 1

	31 March 2014 (HKD billions)	Percentage in terms of Hong Kong's GDP (2013)
Total assets[8] of all banking institutions	17,397	818%
Total assets of major locally incorporated banks[9]	9,695	456%
Market share of major locally incorporated banks (ie total assets of major locally incorporated banks divided by total assets of all banking institutions)	56%	

Note: Not including off-balance sheet assets.

Source: HKMA.

[7] Data were collected from the following banks: The Hongkong and Shanghai Banking Corporation Ltd, Bank of China (Hong Kong) Ltd, Standard Chartered Bank (Hong Kong) Ltd, Bank of East Asia Ltd, Industrial and Commercial Bank of China (Asia) Ltd, China Construction Bank (Asia) Corporation Ltd, and DBS Bank (Hong Kong) Ltd.

[8] The amount of "total assets" is extracted from the following two prudential returns: "MA(BS)1 – Assets and Liabilities (Hong Kong Office)" (which includes the local branches of the AIs) and "MA(BS)1B – Assets and Liabilities (Combined)" (which includes both local and foreign branches of the AIs), whichever is applicable. The total asset numbers are based on those reported by AIs on an unconsolidated legal entity basis.

[9] These refer to the seven RCAP sample banks.

Status of approval of the advanced approaches in the Basel framework

Number of banking groups, June 2014 Table 2

	Standardised Approach	Banks under the Standardised Approaches with intent to move to advanced approach	Advanced approach approved by HKMA
Credit risk	RCAP banks: 2 Other banks: 17	RCAP banks: 1 (move from FIRB to AIRB) Other banks: Nil	RCAP banks: AIRB: 2 FIRB: 3 Total IRB : 5 Other banks: Nil
Counterparty credit risk[10]	RCAP banks: 7 (CEM) Other banks: 46 (CEM)	RCAP banks: 0 Other banks: 0	RCAP banks: 0 Other banks: 0
Market risk[11]	RCAP banks: 4 Other banks: 15	RCAP banks: Nil Other banks: 1	RCAP banks: 3 Other banks: Nil
Operational risk	RCAP banks: 5 Other banks: 3	RCAP banks: 0 (0) Other banks: 0	RCAP banks: 0 (0) Other banks: 0

Source: HKMA.

Regulatory system and model of supervision

The HKMA was established on 1 April 1993 by merging the Office of the Exchange Fund of the Hong Kong Government with the Office of the Commissioner of Banking. Its main functions and responsibilities are maintaining monetary and banking stability. The HKMA can be regarded as a de facto central bank and is accountable to the Financial Secretary (finance minister) of Hong Kong. The HKMA's monetary policy objective is to maintain currency stability within the framework of the Linked Exchange Rate system (LERS). The HKMA manages the Exchange Fund, established in 1935, which is a discrete fund of the Hong Kong government that can be used to affect (directly or indirectly) the exchange value of the Hong Kong dollar (HKD), and to maintain the stability and integrity of Hong Kong's monetary and financial systems. The Exchange Fund has two major portfolios: (i) the Backing Portfolio which holds highly liquid US dollar-denominated assets to provide full backing to the monetary base of Hong Kong, and (ii) the investment portfolio. The role of issuing banknotes in Hong Kong is largely performed by the three note-issuing banks[12] (which deliver US dollar (USD) backing to the Exchange Fund for all banknotes issued), although the HKMA issues the HKD 10 banknote.

Currency stability for the purpose of the HKMA's mandate is defined as a stable external exchange value of the HKD, in terms of its exchange rate in the foreign exchange market against the USD (approximately HK$7.80 to US$1; ie 7.8). The structure of the monetary system is characterised as a Currency Board arrangement, a rule-based monetary regime requiring the HKD monetary base to be fully backed by USD reserves held in the Exchange Fund at the fixed exchange rate of 7.8, and changes in the HKD monetary base to be 100% matched by corresponding changes in USD reserves. The stability of

[10] All AIs use the current exposure method (CEM) to calculate CCR exposures.

[11] Thirty-two non-internationally active banks that were assessed to have immaterial market risk positions (against established de minimis criteria set out in the BCR) were exempted from the market risk calculation.

[12] Namely the Hongkong and Shanghai Banking Corporation Ltd, Standard Chartered Bank (Hong Kong) Ltd, and Bank of China (Hong Kong) Ltd.

the HKD exchange rate is maintained through an automatic interest rate adjustment mechanism and the HKMA's firm commitment to honour Convertibility Undertakings to sell HKD to licensed banks at the rate of HKD 7.75 to the USD, and to buy HKD from licensed banks at the rate of HKD 7.85 to the USD, when the market exchange rate strengthens to the strong side of the Convertibility Undertaking (7.75) or weakens to the weak side of the Convertibility Undertaking (7.85), respectively.

In its role as Hong Kong's banking regulator, the HKMA is charged with promoting financial stability and the stability and effective working of the banking system, as well as helping to maintain Hong Kong's status as an international financial centre, in part through the maintenance and development of Hong Kong's financial infrastructure. To this end, the HKMA is strongly committed to closely following international regulatory developments.

The HKMA's supervisory practices, standards and approaches are well developed, risk-based and of high quality. The most recent assessment of Hong Kong's compliance with the Basel Committee's *Basel Core Principles for Effective Banking Supervision* (BCP) was conducted in 2013 as part of the FSAP, the results of which were published in July 2014.[13] That assessment found a high level of compliance with the BCP, and noted the HKMA's setting of prudent and appropriate capital adequacy requirements for banks.[14]

Structure of prudential regulations

The relevant hierarchy of prudential rules through which the Basel framework is implemented in Hong Kong consists of the following (see Annex 4):

- Primary and secondary legislation, enacted by the Legislative Council; and
- Different forms of regulation issued by the HKMA, which clarify legislative and supervisory frameworks, and articulate regulatory and supervisory expectations, including:
  - Codes of practice
  - Statutory guidelines
  - Other guidance

Enforceability and binding nature of prudential regulations

As a general principle, RCAP assessments only take into consideration "binding" regulatory documents that implement the Basel framework. This is to ensure that the Basel requirements are set out clearly and that a formal basis exists for supervisors and the industry to ensure compliance with the minimum Basel requirements.

The Assessment Team examined the binding nature of various regulatory documents issued by the HKMA using seven different criteria applied in RCAP assessments.[15] Based on the HKMA's self-

[13] See www.imf.org/external/pubs/ft/scr/2014/cr14207.pdf.

[14] Hong Kong was assessed as compliant on, among other items, CP 16 (capital adequacy), CP 17 (credit risk), CP 22 (market risk), CP 23 (interest rate in the banking book), CP 25 (operational risk), and CP 28 (disclosure and transparency related to Pillar 3).

[15] The seven RCAP criteria commonly applied to determine the binding nature of regulatory instruments and documents are that: (i) they are part of a well defined, clear and transparent hierarchy and regulatory framework; (ii) they are public and freely available; (iii) they are viewed as binding by banks as well as by supervisors; (iv) they would generally be legally upheld if challenged; (v) they are supported by precedents of enforceability; (vi) they are properly communicated and the consequences of failure to comply with them are properly understood and carry a similar practical effect as the primary law

evaluation (see Annex 7), as well as discussions with the HKMA and the RCAP sample banks (as referred to on page 3), the Assessment Team recognises that the rules enacted by the Legislative Council and the regulations issued by the HKMA for the purpose of implementing the Basel standards are publicly available, enforceable, and viewed as binding by banks. As a result, the rules and regulations were considered eligible.

Areas where HKMA rules are stricter than the Basel requirement

The Assessment Team also notes the HKMA's more rigorous implementation of the Basel framework in several areas.

This includes implementation of the countercyclical buffer where AIs must follow the buffer requirement as announced by an overseas jurisdiction during the transition period whether or not that requirement is set within the Basel transitional levels. Within the area of the Standardised Approach for Credit Risk, there is a more restrictive treatment for: claims on multilateral development banks (MDBs), past-due loans, use of credit risk mitigation techniques (only the simple approach under credit risk mitigation techniques is permitted for past-due exposures), and the use of guarantees and credit derivatives.

In the Securitisation Framework, a number of additional applicable operational requirements for the recognition of risk transference and for synthetic securitisations are required in order to determine whether the assets have been transferred in the form of a "clean sale" or whether a similar effect has been synthetically achieved through the use of derivatives. The HKMA also adopts a narrower treatment of credit risk mitigation for securitisation exposures. The HKMA does not recognise "eligible IRB collateral" (eg financial receivables, real estate, physical assets), which are permitted under the credit risk mitigation techniques of the FIRB.

With respect to the IRB Framework, the HKMA only made the phased rollout option available during the Basel II transitional period (ie 2007 to 2009), and prohibits the use of "re-ageing" for the definition of default. In addition, IRB banks are required to apply a risk-weight floor of 15% to their residential mortgage loans secured by Hong Kong properties and granted after 22 February 2013.[16]

In the calculation of the capital base, certain items that the Basel III standard would permit in Common Equity Tier 1 capital (CET1) may be recognised only in Tier 2 capital. Unrealised gains on property revaluation can be recognised only in Tier 2 subject to a 55% haircut. Shares issued through capitalising any part of reserves or retained earnings attributable to fair value gains arising from revaluation of land and buildings can be recognised only in Tier 2 subject to a 55% haircut. Retained earnings earmarked for a regulatory reserve (which the HKMA requires AIs to hold (broadly to reflect a general provision against expected loss)) are excluded from CET1 and included in Tier 2 (in the aggregate with collective provisions) subject to the respective criteria and limit for recognition of eligible provisions prescribed under Basel II for the standardised approach (1.25% of standardised credit RWA) and the IRB approach (0.6% of IRB credit RWA) for credit risk. Deferred tax assets and mortgage servicing rights are deducted in full from CET1 (without the benefit of the Basel III thresholds), and credit exposures to related companies which are not assumed in the ordinary course of business are deducted from CET1 (this latter provision is an "anti-avoidance" device designed to address investments re-characterised as loans).

or regulation; and (vii) the instrument is expressed in clear language that complies with the Basel provision in substance and spirit.

[16] Pursuant to the relevant provisions in the Banking (Capital) Rules, this measure was implemented to provide an additional cushion against any potential downside risks arising from their residential property lending activities in the light of significant increases in Hong Kong property prices in recent years.

1.2 Scope of the assessment

Scope

The Assessment Team has considered all documents that effectively implement the Basel risk-based capital framework in Hong Kong as of 31 December 2014. This includes the rectifications of certain assessment findings identified during the assessment process (See Annex 6).

The assessment consisted of the following two parts: (i) comparison of domestic regulations with Basel capital requirements to ascertain if all the required Basel provisions have been adopted (*completeness* of the regulation); and (ii) a determination of substantive differences between the domestic regulations and the Basel framework and the significance of any differences (*consistency* of the regulation).

The assessment did not evaluate the adequacy of capital or the resilience of the banking system in Hong Kong, or the HKMA's overall supervisory effectiveness.

Any identified deviations were assessed for their materiality (current and potential) by using both quantitative and qualitative information. In assessing potential materiality, in addition to the data provided, the Assessment Team used expert judgment on whether the domestic regulations met the Basel framework in letter and spirit.

Bank coverage

The assessment of the quantitative impact of the findings was made based upon submissions from the seven largest banks in Hong Kong. Together, these banks account for 56% of the Hong Kong banking sector's total assets. For the assessment of materiality of identified deviations, the HKMA provided anonymised data from these RCAP sample banks on a best-efforts basis, using the quantification methodologies and approaches agreed between the HKMA and the Assessment Team.[17]

1.3 Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was rated using the following four-grade scale, both for each of the 15 key components of the Basel framework and for the overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.[18] A regulatory framework is considered:

Compliant with the Basel framework if all minimum provisions of the international framework have been satisfied and if no material differences have been identified that would give rise to prudential concerns or provide a competitive advantage to internationally active banks;

Largely compliant with the Basel framework if only minor provisions of the international framework have not been satisfied and if only differences that have a limited impact on financial stability or the international level playing field have been identified;

[17] Data were collected from the following banks: The Hongkong and Shanghai Banking Corporation Ltd, Bank of China (Hong Kong) Ltd, Standard Chartered Bank (Hong Kong) Ltd, Bank of East Asia Limited, Industrial and Commercial Bank of China (Asia) Ltd, China Construction Bank (Asia) Corporation Ltd, and DBS Bank (Hong Kong) Ltd.

[18] This four-grade scale is largely consistent with the approach used for assessing countries' compliance with the Basel Committee's *BCP*. The definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of Basel III that are not relevant for an individual jurisdiction may be assessed as not applicable (N/A).

Materially non-compliant with the Basel framework if key provisions of the framework have not been satisfied or if differences that could materially impact financial stability or the international level playing field have been identified; and

Non-compliant with the Basel framework if the regulation has not been adopted or if differences that could severely impact financial stability or the international level playing field have been identified.

The materiality of the quantifiable findings was assessed in terms of their current or, where applicable, potential future impact on the capital ratios and/or RWAs of the agreed population of seven RCAP sample banks. Expert judgment was applied where required.

Non-quantifiable gaps were discussed with the HKMA, taking into account its regulatory processes, and outcomes were guided by expert judgment based on principles set out in the RCAP assessment methodology.

Moreover, as a general principle, the burden of proof lies with the assessed jurisdiction to show that a finding is not currently or potentially material.

Further information on the materiality assessment is given in Section 2 and Annex 9.

1.4 Main findings

Overall

The HKMA has adopted and implemented the Basel framework in a timely and consistent manner. The assessment concluded that the prudential risk-based capital regulation in Hong Kong is *compliant* with the Basel framework. Twelve of the 13 components assessed are graded as *compliant* and one component is assessed as being *largely compliant*.

Summary assessment grading — Table 3

Key components of the Basel capital framework	**Grade**
Overall grade:	C
Scope of application	C
Transitional arrangements	C
Pillar 1: Minimum capital requirements	
Definition of capital	C
Credit risk: Standardised Approach	C
Credit risk: Internal Ratings-Based Approach	C
Credit risk: Securitisation framework	C
Counterparty credit risk framework	C
Market risk: Standardised Measurement Method	C
Market risk: Internal Models Approach	C
Operational risk: Basic Indicator Approach and Standardised Approach	C
Operational risk: Advanced Measurement Approaches	Not implemented
Capital buffers (conservation and countercyclical)	C
G-SIB additional loss absorbency requirements	N/A

Pillar 2: Supervisory review process	
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions	C
Pillar 3: Market discipline	
Disclosure requirements	LC

Compliance assessment scale (see Section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant), NC (non-compliant) and N/A (out of scope at this stage).

The assessment outcome was also the result of a number of edits and rectifications made by the HKMA during the RCAP process that further strengthened and aligned the regulatory capital framework in Hong Kong with the Basel framework (Annex 6). The Assessment Team also noted areas where the HKMA regards itself to be stricter than the Basel minimum (see Annex 10).

Specific methods, particularly the AMA to operational risk, have not been implemented.[19] The Assessment Team does not see a potential for the observed omissions to have a material effect on banks' capital ratios.

A summary of the Assessment Team's findings is given below. This should be read together with the list of detailed findings in Sections 2.1–2.3. Other observations related to the Hong Kong banking sector are discussed in Section 2.4. The issues that were rectified during the assessment period are listed in Annex 6.

Main findings by component

Scope of application

The HKMA's implementation of the scope of application is compliant with the Basel framework. The Assessment Team noted two deviations.

Contrary to Basel II paragraphs 20–23, the BCR do not clearly subject holding companies that are not AIs to capital adequacy requirements. However, §70 of the Banking Ordinance ("BO") permits the HKMA to require holding companies not otherwise subject to consolidated capital requirements to comply with the Basel III capital requirements on a consolidated basis as if they were locally incorporated AIs. Thus, the Assessment Team found this deviation non-material.

The BCR require the deduction from CET1 capital of any significant investment in a related entity of an AI that is a commercial entity rather than the risk-weighting of such significant investment at 1250%. Significant investments in commercial entities that are not related entities of an AI are required under the BCR to be risk-weighted at 1250%. Basel III makes no distinction between commercial entities related to banks, and those that are not, and requires all significant investments in commercial entities to be risk-weighted at 1250%. As of the first quarter 2014, no AI reported deductions from CET1 capital of significant investments in related entities that are commercial entities. Hence, the Assessment Team found this deviation non-material.

[19] At the time of introducing Basel II in 2007, the HKMA took an incremental approach to introducing certain "less immediately relevant" advanced approaches in the light of the prevailing state of industry development and appetite for the approaches. Accordingly, the Internal Model Method for counterparty credit risk (IMM) was introduced relatively recently, in January 2013 (see Annex 11).

Definition of capital and transitional arrangements

The definition of capital in the BCR was assessed to be compliant. The Assessment Team found that the BCR deviated from the Basel III capital requirements with respect to the calculation of minority interest and the deduction of significant investments in commercial entities that are related entities of an AI. This latter finding relates to the same issue discussed above in the "Scope of application" section, and is not included in the count of total findings in order to avoid double-counting of deviations.

With respect to the minority interest finding, the BCR do not require the Pillar 2 capital add-on to be included as surplus capital when computing the amount of minority interest recognised as capital. This results in a larger proportion of minority interest being recognised at the consolidated level and hence a higher capital ratio compared with that obtained by using only the Pillar 1 requirement plus conservation buffer (7% CET1, 8.5% Tier 1 and 10.5% Total capital as referred to in the Basel III standard) as the minimum "hard" capital requirement for the purposes of determining surplus capital. For the RCAP sample banks, the inclusion of the Pillar 2 add-on in these circumstances does not materially affect their capital ratios.

Capital buffers (conservation and countercyclical)

In October 2014, the HKMA issued a proposed amendment to the BCR to implement the Basel III capital conservation and countercyclical buffer requirements as well as the Higher Loss Absorbency buffer requirements for G-SIBs and D-SIBs. The amendment completed the necessary legislative processes in November and is scheduled to take effect on 1 January, 2015. The assessment team determined the proposed buffer requirements compliant with Basel III.

Credit risk: Standardised Approach

The standardised approach to credit risk was found compliant with the Basel standards, and the HKMA corrected three of the identified deviations throughout the course of this review. Two of the seven RCAP sample banks use the standardised approach. These two banks represent 10% of the total assets in the aggregate of the seven RCAP sample banks. Some 90% of the total RWA of the two banks was attributable to their credit risk RWA under the standardised approach.

The BCR do not require AIs to apply the granularity criterion for regulatory retail portfolios. The granularity criterion requires that supervisors must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree which reduces the risks in the portfolio, thus warranting a preferential 75% risk weight. The data analysis provided by the HKMA suggests that the impact of this omission on the sample banks using the standardised approach is currently non-material.

For exposures secured by commercial real estate, the BCR do not reference a separate asset class requiring 100% risk-weighting. Instead, these exposures could be treated by banks as exposures to corporates, regulatory retail, or other exposures with risk weights lower than under the Basel standards. Data analysis provided by the HKMA suggests that the impact on the sample banks using the standardised approach is currently non-material, but may result in a greater impact in future should there be a very significant increase in banks' exposures secured by commercial real estate. This, however, is not assessed to be potentially material.

The BCR require that claims on securities firms be risk-weighted similarly to claims on banks. However, the eligibility criteria for risk-weighting such claims as required in terms of footnote 27 of Basel II (ie subject to consolidated regulation and supervision like banks) are not required to be fully met by licensed corporations supervised by the Securities and Futures Commission of Hong Kong. The data analysis suggests that this deviation's impact on the capital ratios and RWA of the sample banks is currently not material.

Credit risk: Internal Ratings-Based Approach

Hong Kong's implementation of the IRB regime is considered compliant with the Basel text. Two deviations were found. Five of the seven RCAP sample banks use the IRB – two of them use the Advanced Internal Ratings-Based Approach (AIRB) and three of them use the Foundation Internal Ratings-Based Approach (FIRB). On average, IRB exposure contributes 67% to the seven RCAP sample banks' total RWAs.

The two deviations identified relate to exposures to real estate: one relates to the definition of retail residential mortgages and the other relates to the non-classification of High-Volatility Commercial Real Estate (HVCRE). Two findings under the standardised approach are also relevant to the IRB given the cross-referencing between the two approaches within the Basel text. However, these findings under the standardised approach did not contribute to the IRB "compliant" score.

The inclusion of property-holding shell companies within the definition of retail residential mortgages has a non-material impact on RWAs and capital ratios, but it is a deviation from the Basel standard. It is noted, however, that due to the eligibility criteria prescribed in the BCR, specifically the requirement that a personal guarantee be in place for the full amount of the exposure, loans to property-holding shell companies that are treated as retail residential mortgages will have similar credit risk characteristics to mortgage loans to individuals. As such, this deviation is not considered material. Similarly, the non-classification of HVCRE as a specialised lending type is mitigated by strict underwriting criteria defined by the HKMA, such that lending to finance the land acquisition, development or construction phases of a Commercial Real Estate (CRE) project can be considered to have a credit risk similar to that of other specialised lending types. Therefore, the non-use of the HVCRE Specialised Lending (SL) type is considered a non-material deviation from the Basel text.

Credit risk: Securitisation framework

The securitisation framework in Hong Kong was found to be compliant with Basel standards. The total securitisation exposure of Hong Kong banks is limited, representing only 0–0.4% of total RWAs.

The Assessment Team identified two deviations. Neither deviation is considered material, and the HKMA intends to address both when it implements the revised international approach to securitisation.

One of the deviations relates to the scope and definition of securitisation exposures, whereby interest rate and currency swaps related to transactions covered under securitisation were not included in the risk-weighting under the securitisation framework within the BCR. Instead, such derivatives were risk-weighted according to the non-securitisation framework. A survey indicates that one RCAP sample bank had securitisation exposures arising from interest rate/currency swaps in the period 2008 to 2014. However, the amount was minimal and the impact was non-material. The other deviation relates to the cap for maximum capital requirement for securitisation exposures under the standardised approach. The cap in the BCR was modelled on the requirements with respect to the IRB approach to securitisation. However, unlike the IRB approach, Basel II does not cap the capital requirement for securitisation exposures under the standardised approach except where the bank at issue is subject to the early amortisation treatment. No AIs have used the cap in the period 30 June 2007 to 30 June 2014, and no AIs under the standardised approach have acted as an originator. Therefore the cap is not deemed to have an impact.

Counterparty credit risk framework

The HKMA's implementation of counterparty credit risk was found to be compliant with Basel standards.

The RCAP sample banks are using the Current Exposure Method (CEM) to measure counterparty credit risk exposure (Table 2). Specific banks might migrate to the Internal Model Method (IMM) which was made available in January 2013, subject to the HKMA's approval. The Standardised

Method is not implemented. Counterparty credit risk (CCR) represents approximately 2% of total RWAs on average, ranging from 0–4% at the individual bank level.

There was one cited deviation, which is not material. With respect to exchange rate contracts, the BCR provide for a specific carve-out treatment where an AI is not required to hold regulatory capital with respect to an exchange rate contract that has an original maturity of not more than 14 calendar days. This is a carry-over provision from Basel I and, as Basel II did not explicitly address the issue, the HKMA retained the existing treatment when it implemented Basel II in 2007. Current data analysis suggests that this deviation has no material impact on the sample banks and it is unlikely to become material even in the case of a significant increase of the respective exchange rate contracts.

Market risk: Standardised Measurement Method

The implementation of the Standardised Measurement Method (SMM) for market risk is compliant with the Basel framework. In terms of total RWAs, the SMM for market risk represents only approximately 1% of the RCAP sample banks' total RWAs (while it contributes about 24% to banks' total RWAs for market risk), ranging from 0% to 7% for each individual bank. It is the approach adopted by four of the seven RCAP sample banks, while the three other banks use the Internal Models Approach (IMA).

In assessing the regulations relating to market risk capital requirements, the Assessment Team was cognisant of the relationship between the US dollar (USD) and the Hong Kong dollar (HKD) resulting from Hong Kong's Linked Exchange Rate system (LERS) (see discussion above). Hong Kong's effective use of the Currency Board has spanned over 30 years. Given the historical use of the Currency Board and the resulting low volatility in the exchange rate between the USD and HKD,[20] when implementing Basel II in 2007 the HKMA decided to allow AIs using the SMM to offset their net open positions in USD and HKD where they are opposite positions for the calculation of their FX capital charge under the market risk capital framework. This approach differs from the 8% capital charge on such open positions specified in the Basel II framework and the use of the Basel standards rather than the HKMA's rules would make this a material deviation in terms of total RWAs of the SMM sample banks (but not in terms of their capital ratios).

The successful and effective implementation of the Currency Board has significantly reduced the FX risk between the HKD and USD since its inception. Should Hong Kong have taken the decision to follow the requirement under Basel II paragraph 718(xLi),[21] the HKMA could have been perceived as appearing to contradict, or cast doubt on, its commitment to the LERS. Given the operation of the Currency Board, AIs using the SMM may have been forced to overestimate their HKD/USD risk substantially in comparison with other currencies and to IMA banks (as these banks are allowed to factor the effects of the LERS into their internal models for calculating market risk).

The Assessment Team also notes that the HKMA has exercised the discretion under the Basel framework not to implement the maturity ladder approach for commodities risk (see Annex 11).

[20] The volatility of the HKD/USD exchange rate, as measured by the annualised standard deviations of changes over 30 days, averaged 0.46% over the period from October 1983 (the adoption date of the LERS) to 31 March 2014 (the agreed position date for conducting the RCAP impact assessment).

[21] Arguably, the Basel standards for FX risk as implemented in the SMM are considered to be more relevant for application in jurisdictions with a floating exchange rate regime.

Market risk: Internal Models Approach

The IMA is used by three of the seven RCAP sample banks (Table 2). The RWAs based on the IMA represent approximately 4% to the RCAP sample banks' total RWAs (76% of the total RWAs for market risk), ranging from 0% to 6% for each individual bank.

Hong Kong's capital framework for the IMA to market risk is assessed to be compliant.

Operational risk: Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approaches

The HKMA rules implementing the BIA and STA (ASA) approaches to measure operational risk are considered compliant with the Basel framework. The HKMA has not implemented the AMA. Five of the seven RCAP banks use the Standardised Approach, and two use the Basic Indicator Approach. Capital requirements for operational risk represent 9% of total RWAs at an aggregate level, and range from 3% to 12% for each sample bank. The Basel standards for operational risk were implemented in Hong Kong effective January 2007. The HKMA has implemented the Alternative Standardised Approach (see footnote 104 of Basel II).

The Assessment Team notes one non-material issue. Regular independent reviews of the operational risk assessment system is permitted by internal auditors in Hong Kong, whereas the Basel standards require that operational risk assessment systems must be subject to review by external auditors and/or supervisors.

The team also observes that the HKMA does not provide explicit encouragement to AIs to move along the spectrum of approaches. However, the relevant Supervisory Policy Manual (SPM) stipulates that an AI is expected to develop an operational risk management framework commensurate with its size, complexity, and risk profile. Nevertheless, two of the RCAP sample banks use the Basic Indicator Approach.

Supervisory review process (Pillar 2)

The HKMA's Pillar II framework is compliant with the Basel standards. Under Paragraph 6 of the Seventh Schedule to the BO in Hong Kong, all AIs must satisfy the expectation that they maintain, on and after authorisation, adequate financial resources, both actual and contingent, according to the nature and scale of their business. The HKMA has implemented all four principles of Pillar 2 in Hong Kong as an integral part of its capital adequacy framework and risk-based supervisory process. From 2016 onwards, to address any potential overlap between the Basel III capital buffers (ie the capital conservation buffer and the countercyclical capital buffer) and its Pillar 2 add-on, the HKMA has devised a method for identifying any degree of overlap (which is not anticipated to be significant, given that most of the Pillar 2 add-on relates to risks not covered, or not adequately covered, under Pillar 1) and allowing such overlap to be absorbed into the capital buffers.

To facilitate the Supervisory Review Process (SRP), the HKMA has developed a set of 13 scorecards for the assessment of risk factors that are commonly applicable. These scorecards are publicly available to AIs. However, the individual weightings of the risk factors on the scorecards which form the basis for the capital add-on are not publicly disclosed (as these weightings are periodically reviewed by the HKMA and hence are subject to change). Other supervisory techniques and tools, such as quantitative and qualitative assessments, statistical and sensitivity analyses, stress and scenario tests, and peer group comparisons, are also employed by the HKMA in the course of its SRP. Based on the results of the SRP, the MA imposes a Pillar 2 add-on, as a part of AIs' minimum capital requirements (ie a "hard" minimum). As such, the HKMA arrives then at bank-specific minimum capital requirements based on Pillar 1 plus additional capital requirements, which are not disclosed to the public. These are based on its detailed supervisory risk assessment, explicitly including Pillar 2 risks.

The results of the SRP on an AI will also feed into the HKMA's assessment of the AI's CAMEL ratings (which in turn may affect the amount of the premium to be paid under Hong Kong's Deposit Protection Scheme in the case of a locally incorporated bank) and the HKMA's supervisory plan for the AI.

Disclosure requirements (Pillar 3)

The HKMA's implementation of the Pillar 3 disclosure requirements is largely compliant with the Basel framework.

Five deviations were identified by the RCAP team, four of which were minor.

The main deviation relates to the disclosure frequency, where the Banking (Disclosure) Rules (BDR) require semiannual disclosure of Tier 1 and total capital adequacy ratios, and their components, rather than quarterly disclosure, and annual disclosure of all risk exposures rather than semiannual disclosure. However, most of the major locally incorporated banks are subject to the listing rules in Hong Kong which require them to disclose price sensitive information to the public as soon as possible (formally incorporated as a statutory requirement since 1 January 2013). Furthermore, some of the required semiannual disclosures are available in the financial reporting of accounting information and through disclosures made pursuant to listing rules. Market discipline may thus only be compromised by the limited information that will not be available to the public, whereby this deviation is not considered material.

The team understands that it is the HKMA's intention to adopt the Basel Committee's revised international disclosure standards under Pillar 3, and that it proposes to amend the BDRs to align them with the new standards in accordance with the timeline set by the Basel Committee.

2. Detailed assessment findings

The component-by-component details of the assessment of Hong Kong's compliance with the risk-based capital standards of the Basel framework are set out in this part of the report. The focus of Sections 2.1 to 2.3 is on findings that were assessed to be *deviating* from the Basel minimum standards and their materiality.[22] Section 2.4 lists some observations and other findings specific to the implementation practices in Hong Kong.

2.1 Pillar 1: Minimum capital requirements

2.1.1 Scope of application

Section grade	Compliant
Summary	The BCR apply to all locally incorporated AIs, which include not only internationally active banks. The team has identified two findings for the scope of application.
Overview of findings by Basel paragraph:	
Basel paragraph no	Basel II paragraphs 20–23
Reference in the domestic regulation	BO §97B and §97C and BCR §3C
Finding	The BCR only require consolidation up to the level of locally incorporated AIs, but do not subject holding companies that are not AIs to capital adequacy requirements. The HKMA clarified that there are only very few AIs, none of which are internationally active, whose holding companies are not subject to supervision by the HKMA or other relevant banking supervisory authorities. In these cases (ie where the holding companies are unregulated entities), §70 of the BO permits the HKMA to impose conditions on the approval of the holding companies as controllers of AIs, and the HKMA uses this power to require these holding companies to comply with the Basel III capital requirements on a consolidated basis as if they were locally incorporated AIs.
Materiality	Not material. Based on the data provided, the few banks affected have aggregate assets equal to 2% of the Hong Kong market, and less than 3% in terms of RWAs of all locally incorporated AIs.
Basel paragraph no	Basel II paragraphs 35–36
Reference in the domestic regulation	STC Approach: §68A, IRB Approach: §183(6), §43(1)(n), §46(1), §66(2)
Findings	The BCR §43(1)(n) require the deduction from CET1 capital of any significant investment in a commercial entity that is also a connected company of an AI. (Significant investments in commercial entities that are not connected companies of AIs are risk-weighted at 1250%). The Basel standards make no distinction between significant investments in commercial entities that are connected to banks and those that are not, requiring all such significant investments to be risk-weighted at 1250%. The team notes that a deduction approach may not always be the most conservative approach. For AIs with capital levels in excess of the minimum, the deduction approach may result in higher CET1/total capital ratios than the risk-weighting approach.

[22] No findings were observed with respect to the Pillar 1 components on transitional arrangements, capital buffers and market risk internal models approach (IMA) or with respect to the Pillar 2 component.

Materiality	The HKMA indicated that as of the first quarter of 2014, no AIs reported deductions of significant investments in connected commercial entities from CET1 capital. Thus, this finding is not currently material. However, the HKMA indicated that it will review the appropriateness of its existing capital treatment when implementing the Basel Committee's revised large exposure regime.
Materiality	Not material

2.1.2 Definition of capital

Section grade	Compliant
Summary	The team has identified one deviation for the definition of capital, which is not material.
Overview of findings by Basel paragraph:	
Basel paragraph no	Basel III paragraphs 62–65
Reference in the domestic regulation	BCR §38(1)(d) and §§2(1) and 3 of Schedule 4D to the BCR BCR §39(1)(c) and §§2(2) and 4 of Schedule 4D to the BCR BCR §40(1)(c) and §§2(2) and 5 of Schedule 4D to the BCR
Findings	Basel II, as amended by Basel III, calculates surplus minority interest using the minimum capital requirements plus the capital conservation buffer only. The BCR include any Pillar 2 add-on capital requirement imposed on individual subsidiary AIs under BO §97F in the AI's minimum capital requirement rather than regarding the add-on as surplus capital. This results in a higher minimum capital requirement when computing the amount of minority interests recognised as capital and thus in a higher capital ratio at the consolidated level compared to the Basel III calculation. Based on data provided by the HKMA, the impact of this deviation is less than 1 basis point for two banks; thus it is not deemed material.
Materiality	Not material

2.1.3 Capital buffers (conservation and countercyclical)

No findings

2.1.4 Credit risk: Standardised Approach

Section grade	Compliant
Summary	The HKMA has implemented the Standardised Approach for credit risk in line with the Basel framework. Nine deviations in the domestic rules vis-à-vis the Basel text were observed. The HKMA has expressed strong intention to take steps to rectify five deviations within 2015. The remaining four deviations will be addressed in the implementation of either the BCBS standard on "Capital requirements for banks' equity investments in funds" (ie by 1 January 2017) or the BCBS revised Standardised Approach for Credit Risk, in each case in the light of how the relevant issues are addressed in these new standards. None of the deviations identified has currently a material impact on the disclosed capital adequacy ratios of the RCAP sample banks using the Standardised Approach.
Overview of findings by Basel paragraph:	

Basel paragraph no	Paragraphs 53–56: Claims on sovereigns
Reference in the domestic regulation	BCR §56
Findings	BCR §56(3) allows banks to apply comparatively lower risk weights (the paragraph prescribes certain differential treatment to sovereign exposures denominated and funded in local currencies), even in cases where other national supervisory authorities have not exercised the discretion to apply lower risk weights to banks' exposures to their sovereign in terms of paragraph 54 of Basel II.
Materiality	The impact analysis suggests that none of the sample banks applied BCR §56(3) to risk-weight their sovereign exposures. The HKMA agreed that this was an unintended deviation to be rectified in 2015.
Basel paragraph no	Paragraph 65: Claims on securities firms
Reference in the domestic regulation	BCR §2(1) (Definition of "securities firm") BCR §60(1), (3)–(5), Schedule 6 Table B
Findings	BCR §60 requires that claims on securities firms should be risk-weighted similarly to claims on banks. However, the eligibility criteria mentioned in Basel II paragraph 65, including footnote 27, are not required to be fully met with respect to claims on licensed corporations supervised by the Securities and Futures Commission of Hong Kong.
Materiality	The data provided by the HKMA suggest that the impact on the RCAP sample banks' capital ratios and the RWA of the bank most impacted by this deviation (at the component level) is 4 basis points and 0.4% respectively. Accordingly, the Assessment Team considered this a non-material deviation. The HKMA acknowledged the deviation and indicated that it proposed to revisit this issue in the course of implementing the BCBS's revised standard on the Standardised Approach for Credit Risk once the new standard has been finalised. Keeping this aspect in view, the impact could become potentially material should banks' claims on securities firms increase very substantially (given that, even if such exposures of the sample banks were to increase by 100%, the impacts on RWA and total capital ratio would respectively only be 0.3% and 0.6 basis points (weighted average across sample banks), and 0.9% and 7.7 basis points (the most affected bank), which are still below the thresholds for the deviation to be considered as potentially material).
Basel paragraph no	Paragraphs 69–71: Claims included in the regulatory retail portfolios
Reference in the domestic regulation	BCR §64
Findings	The BCR do not include the granularity criterion for determining whether claims may be included in the regulatory retail portfolio as required under Basel II paragraph 70.
Materiality	The data analysis provided suggested that the impact of this omission on capital ratios and risk-weighted assets of the RCAP sample banks is currently not material. The HKMA clarified that a higher risk weight can be prescribed if the default experience for retail exposures warrants it. The HKMA indicated that it proposed to revisit this issue in the course of implementing the BCBS's revised standard on the Standardised Approach for Credit Risk once the new standard has been finalised.
Basel paragraph no	Paragraph 74: Claims secured by commercial real estate
Reference in the domestic regulation	The BCR contains no similar provision.
Findings	Basel II paragraph 74 requires a 100% risk weight for claims secured by commercial real estate (subject to meeting criteria under footnote 29, 50% risk-weighting is also possible). The BCR do not contain a similar provision, ie there is no separate asset class for commercial real estate exposure under the BCR requiring a 100% risk weight or higher. Rather, commercial real estate exposures can be treated as exposures to corporate, regulatory retail, or as other exposures.
Materiality	The data provided by the HKMA suggested that the deviation is not material.

	However, the HKMA indicated that it proposed to revisit this issue in the course of implementing the BCBS's revised standard on the Standardised Approach for Credit Risk once the new standard has been finalised, given that the revised standard may affect how this issue is treated going forward. The materiality data analysis suggests that the impact on the sample banks using the standardised approach does not become potentially material even in the case that banks' claims secured by commercial real estate were to increase very substantially (given that even if such exposures of the sample banks were to increase by 100%, the impacts on RWA and total capital ratio would respectively only be 0.6% and 1.1 basis points (weighted average across sample banks), and 0.9% and 9 basis points (the most affected bank), which are still below the thresholds for the deviation to be considered as potentially material).
Basel paragraph no	Paragraph 81: Other assets
Reference in the domestic regulation	BCR §62
Findings	BCR §62 provides that exposures to rated Collective Investment Schemes (CIS) investing only in cash or fixed income assets may be treated similarly to corporate exposures by reference to the External Credit Assessment Institution (ECAI) ratings assigned to the CIS based on the credit quality of the investments held by the CIS instead of receiving the standard risk weight of 100% as required for "all other assets" under paragraph 81 of Basel II. Other CIS (eg equity funds) are risk-weighted at 100% under BCR §62(3).
Materiality	Based upon the data provided by the HKMA, there was no material deviation. The HKMA indicated, however, that BCR §62 would be replaced by new provisions effective from 1 January 2017 to implement the BCBS standard on "Capital requirements for banks' equity investments in funds" issued in December 2013.
Basel paragraph no	Paragraphs 82–89: Off-balance sheet items
Reference in the domestic regulation	BCR §74(1)
Findings	BCR §74(2)(f) requires 100% risk weights for partly paid-up shares and securities. However, footnote 35 of paragraph 84(i) of Basel II requires that forward asset purchases, forward deposits and partly paid shares and securities are to be weighted according to the type of assets and not according to the type of counterparty with whom the transaction has been entered into. Thus, with respect to partly paid-up shares and securities, §74(2)(f) would be less stringent than footnote 35 in the case of securities when the risk-weight applicable to the underlying securities is 150% (ie rated below B– in the case of securities issued by sovereigns, PSEs and banks and below BB– in the case of securities issued by corporates). The HKMA noted that this was likely to be an unintended omission from the BCR, and indicated its intention to rectify this deviation during 2015.
Materiality	Non-material based on qualitative considerations.
Basel paragraph no	Paragraphs 145–146 as amended by revised framework: Collateral – Eligible financial collateral
Reference in the domestic regulation	BCR §79, §80
Findings	Basel II paragraph 145(d) permits unrated debt securities issued by banks to serve as collateral so long as they satisfy certain criteria. However, BCR §79(1)(m) permits unrated debt securities issued by securities firms (in addition to banks) to be recognised as eligible collateral.
Materiality	Data provided by the HKMA suggest that this is a non-material deviation. The HKMA indicated its intention to amend the BCR to address this issue within 2015.
Basel paragraph no	Paragraphs 147–155 as amended by revised framework: Collateral – The comprehensive approach; Calculation of capital requirement; Own estimates for haircuts
Reference in the domestic	BCR Schedule 7

regulation	
Findings	The haircut table in BCR Schedule 7, Part 1 Item 7 includes debt securities without ECAI issue-specific ratings issued by banks or securities firms. The haircut table included in Basel II, paragraph 151 (as amended under Basel III), does not include debt securities issued by securities firms.
Materiality	Data provided by the HKMA suggested that this is a non-material deviation. The HKMA indicated that it intends to amend the BCR to address this issue within 2015.
Basel paragraph no	Paragraphs 182–187: Collateral – the simple approach
Reference in the domestic regulation	BCR §82
Findings	BCR §82(4)(c) provides that collateral in the form of gold bullion held by an AI, or gold bullion held on an allocated basis for an AI by another person, which is backed by gold bullion liabilities, may be assigned a risk-weight of 0% regardless of the risk-weight floor of 20% imposed by BCR §82(1)(b). Basel II has not exempted gold bullion from the risk-weight floor of 20%.
Materiality	The data provided by the HKMA indicated that the deviation was not material. The HKMA agreed to amend the BCR to correct the deviation during 2015.

2.1.5 Credit risk: Internal Ratings-Based Approach

Section grade	Compliant
Summary	The Assessment Team identified two deviations, both of which were non-material. The first deviation was the non-use of the high volatility commercial real estate (HVCRE) classification for specialised lending exposures. The second deviation was the allowance for residential mortgages to property-holding shell companies to be treated as retail exposures.
Overview of findings by Basel paragraph:	
Basel paragraph no	Paragraphs 218–228: Definition of corporate exposures
Reference in the domestic regulation	BCR §139(1) definition of "specialised lending"
Findings	Basel II paragraph 220 defines five sub-classes of specialised lending, including HVCRE. The BCR do not categorise assets into HVCRE as the HKMA considers that the criteria set out for the other specialised lending classes, taking into account local underwriting standards on mortgage loans secured by commercial real estate and on lending to finance property development, adequately capture the risks associated with HVCRE. Among other things, commercial property mortgage lending is subject to maximum loan-to-value (LTV) ratios (ranging from 20% to 40%) for borrowers who have proven eligible repayment sources and can satisfy prescribed requirements on debt-servicing ratios (DSRs) calculated both on a "normal" and "stressed" basis.
Materiality	Paragraphs 277 and 282 of the Basel Framework allow for discretion whereby supervisors could prescribe lower risk weights to specialised lending exposures provided they determine that banks' underwriting standards and other risk characteristics are substantially stronger than those specified in the slotting criteria. In this regard the HKMA indicated that underwriting standards on real estate lending are stringent in Hong Kong in terms of LTV, DSR and stressed DSR. Based on these factors, the deviation was found to be non-material. The HKMA indicated its intention to amend the BCR within 2015 to create a category and risk-weighting framework for HVCRE as it appears that ongoing work at the Basel Committee on the IRB Framework is unlikely to result in any removal of the HVCRE class.
Basel paragraph no	Paragraphs 231: Definition of retail exposures

Reference in the domestic regulation	BCR §144(3)
Findings	Basel II paragraph 231 states that residential mortgage loans are eligible for retail treatment "so long as the credit is extended to an individual". BCR §144(3) allows residential mortgages extended to property-holding shell companies to be classified as retail exposures, which does not meet the requirement for loans to be extended to individuals. The HKMA explained that the inclusion of mortgage loans to property-holding shell companies within retail treatment in the BCR was intended to better reflect the risks associated with such loans vis-a-vis those associated with residential mortgage loans to individuals. In particular, the eligibility criteria for retail treatment set out in the BCR also ensure that only those residential mortgage loans to property-holding shell companies that bear comparable risk characteristics to residential mortgage loans to individuals can qualify for retail treatment.
Materiality	The data indicate that this deviation is non-material as the impact on RWAs is: max 0.8%; avg 0.2%; and the impact on capital ratios is: max 6.3 bps; avg 1.6 bps. The HKMA noted ongoing work at the Basel Committee in respect of definitional issues relating to the IRB framework and will consider amending the BCR once any forthcoming changes to the IRB standard are finalised.

2.1.6. Securitisation framework

Section grade	Compliant
Summary	Two deviations were identified by the RCAP Team, neither of which are considered material. The HKMA envisages rectifying the two findings after the cut-off date.
Overview of findings by Basel paragraph:	
Basel paragraph no	Paragraph 541: Scope and definitions
Reference in the domestic regulation	BCR §2(1), BCR §246 and BCR §258.
Findings	Para 541 of Basel II states securitisation exposure can include – among other items – interest rate or currency swaps. The BCR do not include interest rate or currency swaps to be risk-weighted within the securitisation framework. BCR §2(1) defines a securitisation exposure as an exposure to a securitisation transaction and includes such an exposure arising from (a) the purchase or repurchase of securitisation issues; (b) the provision of credit protection or credit enhancement to any of the parties to the transaction; (c) the retention of one or more than one securitisation position; (d) the provision of a liquidity facility or servicer cash advance facility for the transaction; and (e) the obligation to acquire any investors' interest in the transaction if the transaction is subject to an early amortisation provision. BCR §227(1) defines a securitisation transaction as a transaction involving the tranching of credit risk associated with a pool of underlying exposures and in respect of which (a) there are no fewer than two different tranches; (b) payments to investors or other parties to the transaction depend on the performance of the underlying exposures; and (c) the subordination of tranches determines the distribution of losses during the life of the transaction. BCR §246 states where a bank has an exposure arising from its entering into an interest rate contract or exchange rate contract in a securitisation transaction, the

	bank shall calculate the risk-weighted amount of that exposure in accordance with a STC or a BSC[23] approach, as the case requires. (BCR §258 – similar requirement for an IRB approach).
Materiality	Based on collected data, the deviation is considered to have little or no impact, and the number of banks impacted by the deviation is small. In the judgment of the Assessment Team, the finding is considered to be non-material. The HKMA has indicated its intention to review this issue in the course of implementing the BCBS revised securitisation framework issued in December 2014.
Basel paragraph no	Paragraph 594: Maximum capital requirement
Reference in the domestic regulation	BCR §242.
Findings	Para 594 of Basel II stipulates for a bank which adopts the standardised approach for securitisation exposures and which is subject to the early amortisation treatment, the total capital charge for all of its positions will be subject to a maximum capital requirement (ie a "cap") equal to the greater of (i) that required for retained securitisation exposures, or (ii) the capital requirement that would apply had the exposures not been securitised. BCR §242 is wider than the Basel text. BCR §242(1): "Subject to subsection (2), the originating institution in a securitisation transaction shall not provide regulatory capital for the securitisation exposures held by the institution in the transaction in excess of the regulatory capital the institution would have been required to provide for the underlying exposures in the transaction if the underlying exposures had not been securitised through the transaction." BCR §242(1), which caps the capital requirement for securitisation exposures under the standardised approach, was modelled on the requirements set out in para 610 from Basel II in respect of the IRB approach to securitisation. However, Basel II does not cap the capital requirement for securitisation exposures under the standardised approach except where the bank concerned is subject to the early amortisation treatment. HKMA has confirmed that during the period between 30 June 2007 and 30 June 2014 no AIs using the standardised approach were an originator of securitisation transactions.
Materiality	Based on collected data, the deviation is considered to have little or no impact. In the judgment of the Assessment Team, the finding is considered to be non-material. The HKMA has indicated its intention to review this issue in the course of implementing the BCBS revised securitisation framework issued in December 2014.

2.1.7. Operational risk

Section grade	Compliant
Summary	The team identified one deviation, which was not found to be material.
Overview of findings by Basel paragraph:	
Basel paragraph no	Paragraph 663(f): The standardised approach – qualifying criteria
Reference in the domestic	BCR Schedule 4, §1(i)

[23] STC refers to the standardised approach to credit risk and BSC is a jurisdiction-specific "Basic Approach" to credit risk for use by very small (total assets of less than HKD 10 billion), simple non-internationally active AIs.

regulation	
Findings	Para 663(f) of Basel II requires the bank's operational risk assessment system must be subject to regular review by external auditors and/or supervisors. BCR Schedule 4, §1(i) states a bank's operational risk assessment system is subject to validation and regular independent reviews by external auditors or internal auditors. An independent review conducted by internal auditors is not in full alignment with the Basel text. However, para 2.1.3 of SPM OR-1 stipulates that the HKMA will have particular regard to (among other things) the adequacy and results of the AI's internal review and audit of operational risk.
Materiality	Materiality was not assessed quantitatively. The deviation is considered to have little or no impact. In the judgment of the Assessment Team, the finding is considered to be non-material. The HKMA has indicated its intention to review this issue in the course of implementing the BCBS revised standard on the Standardised Approach for Operational Risk once finalised.

2.1.8. Market risk: Standardised Measurement Method

Section grade	Compliant
Summary	The Assessment Team found that the allowance of netting net long or short FX positions against an AI's USD/HKD position where the AI's net open positions in USD and HKD are opposite positions diverges from paragraph 718(xLi) of Basel II. This has a material impact on two of the RCAP sample banks using the SMM to calculate general market risk for foreign exchange risk.
Overview of findings by Basel paragraph:	
Basel paragraph no	Paragraph 701(i)
Reference in the domestic regulation	BCR §17(1)
Findings	In addition to the standardised approach and the internal models approach prescribed in Basel II for market risk calculation, BCR §17(1)(c) also permits an AI to use, subject to the HKMA's approval under §20(2)(a), the approach used by the institution's parent bank ("parent bank approach").
Materiality	Thus far, no AI has been granted approval to use the parent bank approach and, future expectation for using the approach according to the HKMA is "unlikely" in recognition of the Basel Committee's increased emphasis on ensuring consistency in implementation of the Basel capital framework across jurisdictions. Hence, the finding is not material. We understand that the HKMA will review the need to retain the "parent bank approach" in the BCR, with a view to amending the BCR in 2015.
Basel paragraph no	Paragraph 711(i), bullet 1 and 2
Reference in the domestic regulation	BCR §287(4)(b)
Findings	Securities which are not issued by an MDB or PSE are allowed to be rated by fewer than two rating agencies. The HKMA explained that the solicitation of external credit ratings from two separate rating agencies on the same instrument has not been a widespread practice for local issuers. This is not uncommon in jurisdictions with less developed debt markets.
Materiality	A non-zero impact was observed for three of the RCAP sample banks that use the SMM to calculate specific interest rate risk. The finding was found not to be material – in terms of RWA, the maximum impact is 3%, and 0.1% for the system. In terms of capital ratios, the impact is below 0.1 basis points for individual SMM sample banks

	and for the system. The HKMA has indicated its intention to review this issue at the time of implementing the BCBS's revised standardised approach for market risk, following the results of the ongoing fundamental review of the trading book, and in the light of the use and penetration of ratings in local and regional markets at that time.
Basel paragraph no	Paragraph 718(xLi)
Reference in the domestic regulation	BCR §296(1)(a) and §296(2)(b)(ii)
Findings	BCRs §296(1)(a) and 296(2)(b)(ii) allow an AI to set off its net long or short FX positions against its USD/HKD position where the AI's net open positions in USD and HKD are opposite positions. The BCR provision reflects the operation of the LERS (Currency Board) in Hong Kong, which constrains volatility in the exchange rate between the USD and the HKD. Over the past 30 years, the average volatility has been 0.46%.
Materiality	The finding was found to be material for two of the RCAP sample banks that use the SMM to calculate general market risk for foreign exchange risk – in terms of RWA, the impact is above 5% (the maximum is at 7.1%), while the average impact is at 2.6%. The impact is, however, immaterial in terms of the SMM banks' capital ratios – the impact is at 3 basis points for one sample bank but is less than 1 basis point for the system.

2.1.9. Counterparty Credit Risk framework

Section grade	Compliant
Summary	Under the counterparty credit risk component, one deviation was identified which was non-material. The BCR do not require banks to hold regulatory capital in respect of an exchange rate contract which has an original maturity of not more than 14 calendar days.
Overview of findings by Basel paragraph:	
Basel paragraph no	Paragraph 92(i)
Reference in the domestic regulation	BCR §71
Findings	BCR §71(3) states that an AI is not required to hold regulatory capital in respect of an excluded exchange rate contract ie an exchange rate contract (except a contract the value of which is determined by reference to the value of, or any fluctuation in the value of, gold) which has an original maturity of not more than 14 calendar days; or a forward exchange rate contract entered into by the AI pursuant to a swap deposit arrangement with an obligor. It was argued by the HKMA that this special dispensation re exchange rate contracts was available under Basel I and has not been specifically disallowed under Basel II. The Assessment Team however, indicated that the specific exemption from capital requirements for an exchange rate contract of 14 days (or less) original maturity is not covered under the Basel II CCR framework. Accordingly, it is considered a deviation from the Basel standard.
Materiality	The data analysis suggests that this is currently not material. The HKMA indicated its intention to amend the BCR to address this issue within 2015.

2.2 Pillar 2

No deviations.

2.3 Pillar 3

Section grade	Largely compliant
Summary	Pillar3 was found to be generally compliant with the Basel standards. Five deviations were identified by the Assessment Team, four of which were minor. The main deviation relates to disclosure frequency, where the BDR do not require (i) quarterly disclosure of Tier 1 and Total capital adequacy ratios, and their components by large internationally active banks and other significant banks, (ii) semiannual disclosure of all risk exposures. However, mitigating factors are information coming in particular from disclosure requirements that are related to accounting information from financial reporting and listing rules. On an overall level the HKMA expects to revise the BDR in December 2016 as a result of the upcoming BCBS revision to the Pillar 3 framework.
Overview of findings by Basel paragraph:	
Basel paragraph no	Paragraph 818: Frequency
Reference in the domestic regulation	BDR §14. §13.11 of SPM CA-D-1.
Findings	The rules relating to the frequency of disclosure in Hong Kong are not fully in line with the Basel standards. The BDR do not require (i) quarterly disclosure of Tier 1 and Total capital adequacy ratios, and their components by large internationally active banks and other significant banks, (ii) semiannual disclosure of all risk exposures. Under the Basel framework (para 818 of Basel II), the disclosures in Pillar 3 should be made on a semi-annual basis, subject to some exceptions. Further "large internationally active banks and other significant banks (and their significant bank subsidiaries) must disclose their Tier 1 and total capital adequacy ratios, and their components, on a quarterly basis". Under the BDR, large internationally active banks and other significant banks are required to make semi-annual rather than quarterly disclosures on Tier 1 and total capital adequacy ratios, and their components, as well as for those elements relating to certain risks, eg currency risks, off-balance sheet exposures etc. Disclosures in relation to risk exposures in general (Tables 3 to 14 under Part 4 of Basel II, ie Pillar 3 quantitative disclosures other than scope of application and components of capital) are required as "additional disclosures" under the BDR to be made by AIs only on an annual basis instead of a semiannual basis. However, as some risk factors can change rapidly, SPM CA-D-1 encourages AIs to make more frequent disclosures than under the BDR provided these additional disclosures would improve the transparency of the bank's risk profile and risk management. The latter is complemented by the obligations for medium and large sized listed banks, which are bound by the obligations set out in the listing rules that require to disclose price-sensitive information to the public as soon as possible (formally incorporated as a statutory requirement since 1 January 2013). The HKMA intends to revise the BDR in December 2016 in line with the BCBS revision of the Pillar 3 framework.
Materiality	The impact of the deviation is non-quantifiable. However, a lower disclosure frequency may compromise the operation of market discipline, since the participants would be responding to information which being outdated. As a mitigating factor, medium and large sized listed banks are bound by the obligations set out in the listing rules, which, require them since 1 January 2013 to disclose price-sensitive information to the public as soon as possible. Also, the capital ratios of banks in Hong Kong tend not to be unduly volatile from quarter-to-quarter, owing to limited recognition of property revaluation gains as regulatory capital and to the fact that securitisation and other activities that tend to contribute more to volatility in the balance sheet capital ratio are relatively limited in scale in Hong Kong. Hence, the team's judgment suggests that the deviation has only limitedimpact.

Basel paragraph no	Paragraph 825: Table 5 (b, first bullet) Credit risk: Quantitative disclosure
Reference in the domestic regulation	BDR §57.
Findings	Table 5 (b, first bullet) of Basel II provides disclosure "For exposure amounts after risk mitigation subject to the standardised approach, amount of a bank's outstandings (rated and unrated) in each risk bucket as well as those that are deducted;" The BDR do not require disclosure of outstanding amounts subject to the standardised approach to credit risk by "each risk bucket" (eg 0%, 10% 20% etc). However, according to SPM CA-D-1 §3.2.3, AIs are encouraged to make more detailed or granular disclosures than are required under the BDR. For instance, AIs might break down their sector disclosures into more detailed subcategories, while those using the standardised approach to calculate their regulatory capital for credit risk in respect of their non-securitisation exposures might disclose the composition of relevant portfolios with more granularity than required under the BDR.
Materiality	Materiality was not assessed quantitatively. In the judgment of the Assessment Team, the finding is considered to be non-material.
Basel paragraph no	Paragraph 826: Table 8 (b) Counterparty Credit risk: Quantitative disclosure
Reference in the domestic regulation	BDR §§58(3) and 80(3).
Findings	Table 8 (b) of Basel II provides disclosure for "Gross positive fair value of contracts, netting benefits, netted current credit exposure, collateral held (including type, eg cash, government securities etc), and net derivatives credit exposure. Also report measures for exposure at default, or exposure amount, under the IMM, SM or CEM, whichever is applicable. The notional value of credit derivative hedges and the distribution of current credit exposure by types of credit exposure." The BDR do not require disclosure of netting benefits, but address disclosure of major classes of exposures by counterparty type, in BDR §58(2) and §80(2). In addition BDR §58(3) and §80(3) require disclosure of the gross total positive fair value of the relevant transactions (defined to include securities financing transactions and derivatives contracts booked in the banking book or trading book) that are not securities financing transactions as well as the default risk exposures, after taking into account the effect of any valid bilateral netting agreements, for the relevant transactions that are not securities financing transactions; the default risk exposures, after taking into account the effect of any valid bilateral netting agreements, for the relevant transactions that are securities financing transactions; the default risk exposures, after taking into account the effect of any valid cross-product netting agreements, for the relevant transactions.
Materiality	Although the disclosure requirements under BDR are "post-" netting, in practice disclosures made by banks already contained information on "pre-", "netting effect" and "post-" positions. Materiality was not assessed quantitatively. In the judgment of the Assessment Team, the finding is considered to be non-material.
Basel paragraph no	Paragraph 826: Table 9 (g and o) Securitisation: Quantitative disclosure
Reference in the domestic regulation	BDR §§60(1)(l)-(m) and 82(1)(l)-(m)
Findings	Information on securitisation exposures is required separately for banking book items and trading book items. Table 9 (g and o) of Basel II.5 provides disclosure of "The total amount of outstanding exposures securitised by the bank and defined under the securitisation framework (broken down into traditional/synthetic) by exposure type, separately for securitisations of third-party exposures for which the bank acts only as sponsor", divided into banking book and trading book information. The BDR require disclosure for such information, but do not separate the information relating to the banking book and the trading book.

Materiality	Materiality was not assessed quantitatively. However, as a mitigating factor, the following items are shown separately for exposures booked in the AI's banking book and trading book: • the BDR require AIs to disclose the amount of outstanding exposures that the AI holds with the intention of transferring them into securitisation transactions, broken down by exposure type. • the BDR require AIs to disclose a summary of the securitisation transactions the institution has entered into during the annual reporting period, including (i) the amount of underlying exposures that have been securitised, broken down by exposure type; and (ii) the amount of recognised gain or loss on sale of underlying exposures that have been securitised, broken down by exposure type. • the BDR require AIs to disclose the total outstanding amount of the AI's on-balance sheet securitisation exposures, broken down by exposure type. • the BDR require AIs to disclose the total outstanding amount of the institution's off-balance sheet securitisation exposures, broken down by exposure type. The deviation is considered to be of little or no impact. In the judgment of the Assessment Team, the finding is considered to be non-material.
Basel paragraph no	Paragraph 826: Table 9(r) Securitisation: Quantitative disclosure
Reference in the domestic regulation	BDR §§60(1)(y), 82(1)(y)
Findings	Footnote 229 of Basel II.5 requires that securitisation transactions (including underlying exposures originally on the bank's balance sheet and underlying exposures acquired by the bank from third-party entities) in which the originating bank does not retain any securitisation exposure should be shown separately but need only be reported for the year of inception. Table 9(r) of Basel II.5 provides disclosure of "aggregate amount of exposures securitised by the bank for which the bank has retained some exposures and which is subject to the market risk approach (broken down into traditional/synthetic), by exposure type." BDR §60(1)(p) and § 82(1)(p) require an AI to disclose a summary of securitisation transactions the AI has entered into during the reporting period, and including the amount of underlying exposures that have been securitised and shown separately for exposures in the banking book and trading book. BDR §60(1)(y) and § 82(1)(y) require disclosure of the total amount of underlying exposures in securitisation transactions in relation to which the AI has retained some securitisation exposures. However, the BDR do not require separate disclosure for securitisation transaction activities in which the originating bank does not retain any securitisation exposures for the year of inception.
Materiality	Materiality was not assessed quantitatively. Based on collected data, the deviation is considered to be of little or no impact. In the judgment of the Assessment Team, the finding is considered to be non-material.

Pillar 3 additional remuneration and capital disclosure requirements

Basel paragraph no	Paragraph 6: Frequency of reporting
Reference in the domestic regulation	BDR §14.
Findings	Para 6 of "Composition of capital disclosure requirements" under Pillar 3 of the Basel framework requires large banks to make certain minimum disclosures with respect to certain defined key capital ratios and elements on a quarterly basis, regardless of the frequency of financial statement publication. The disclosure of key capital ratios/elements for these banks will continue to be required under Basel III (the revisions as of June 2012). The BDR do not require quarterly disclosure of key capital ratios and elements by large banks. The issue is related to the findings in respect of para 818 of Basel II and hence is not counted as a separate finding.
Materiality	See above under item Paragraph 818: Frequency.

2.4 List of observations

Scope of application

Basel paragraph no	Basel II paragraph 24
Reference in the domestic regulation	BCR §27
Observations	Basel II paragraph 24 states that majority-owned or -controlled banking entities, securities entities and other financial entities should generally be fully consolidated. BCR §27 (2) requires an AI to calculate its capital adequacy ratio on a consolidated basis in respect of a subsidiary of the AI (other than insurance or securities subsidiary) where (a) more than 50% of the total assets or total income of the subsidiary relate to or arise from the carrying out of one or more than one relevant financial activity; or (b) the HKMA is satisfied that after taking into account the nature of the business undertaken by the subsidiary, the AI should consolidate the entity in calculating its capital adequacy ratio. The HKMA clarified that these criteria were introduced only to address the issue of determining whether a majority-owned or -controlled entity is a financial entity when the entity engages in both financial and non-financial activities. The Assessment Team recognises the flexibility provided by paragraph 24's use of "generally". Moreover, the BCR state that an AI's investments in an unconsolidated subsidiary would either be deducted or risk-weighted at 1250%. Thus any potential adverse impact on the AI's capital ratios and RWAs of categorising an entity as a non-financial entity by reference to the criteria devised by the HKMA for this purpose should not be material.

Definition of capital

Basel paragraph no	Basel III paragraphs 67–68
Reference in the domestic regulation	BCR §43(1)(a) and (b)
Observations	Basel III paragraph 67 requires that goodwill and all other intangibles must be deducted in the calculation of Common Equity Tier 1, including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of consolidation. The Assessment Team

	observes that the underlined sentence is not included in the BCR, but notes that the BCR definition of goodwill is found to be compliant with IFRS.
Basel paragraph no	Basel III paragraph 90
Reference in the domestic regulation	BCR §68A(2) (STC), §183(6) (IRB), §43(1)(n)
Observations	See findings with respect to paragraphs 35–36 in the Scope of application section.

Credit risk: Standardised Approach

Basel paragraph no	Paragraphs 72–73: Claims secured by residential property
Reference in the domestic regulation	BCR §65
Observations	Paragraph 72 of Basel II requires that lending fully secured by mortgages on residential property that is, or will be, occupied by the borrower, or that is rented, will be risk-weighted at 35%. However, BCR §65(1)(c) is broader insofar as it recognises that the property may be used as the residence of a licensee of the borrower. The HKMA clarified that it is not uncommon in Hong Kong for family members to provide flats for other family members, or for purchasers to buy a flat in a company name and then live in the flat as licensee where the person is a director of the company. The inclusion of a "licensee" reflects local circumstances. The Assessment Team observes that this is a jurisdiction-specific aspect of the BCR, and that the Basel standard also provides for a concessional risk weight for rented residential property.
Basel paragraph no	Paragraphs 109–118 as amended by revised framework: overarching issues
Reference in the domestic regulation	None.
Observations	Paragraph 116 of Basel II stipulates that Pillar 3 requirements must be observed in order for banks to obtain capital relief with respect to any credit risk mitigation techniques. This requirement is not included in either the BCR or in BDR. The HKMA explained that failure to comply with the disclosure requirements under the BDR is an offence and upon conviction every director, chief executive or manager of the AI is liable to a fine, and this serves to deter AIs from violating the Pillar 3 requirements.

Credit risk: Internal Ratings-Based Approach

Basel paragraph no	***Paragraph 230: Definition of bank exposures***
Reference in the domestic regulation	BCR §2(1) (Definition of "securities firm")
Observations	(The following statements set out in the assessment of the standardised approach for credit risk are recapped below due to cross-referencing under the IRB approach to the treatment under the standardised approach. They are listed as observations for IRB so as to not double-count regulatory deviations). BCR §60 requires that claims on securities firms should be risk-weighted similarly to claims on banks. However, the eligibility criteria mentioned in paragraph 65 (including footnote 27) of Basel II for so risk-weighting such claims are not required to be fully met with respect to claims on licensed corporations supervised by the Securities and Futures Commission of Hong Kong ie for applying risk weights similarly to claims on banks instead of claims on corporates. The HKMA acknowledged the deviation and indicated that it proposed to revisit this issue in the course of implementing the BCBS's revised standard on the Standardised Approach for Credit Risk once the new standard has been finalised and in the light of how this issue is addressed in the new standard.

Basel paragraph no	Paragraphs 286–307 as amended by the revised framework: Loss-given-default (LGD)
Reference in the domestic regulation	BCR §139(1) and §2(1) various definitions; BCR §160; §161; §209(3); §10B(1); §203; §210(1); §211; §213; §214(1); §215; §216; §217; §218
Observations	(The following statements set out in the assessment of the standardised approach for credit risk are recapped below due to cross-referencing under the IRB approach to the treatment under the standardised approach. They are listed as observations for IRB so as to not double-count regulatory deviations). Paragraph 145(d) of Basel II prescribes criteria for recognition of unrated debt securities issued by banks as collateral. BCR §79(1)(m), however, includes unrated debt securities issued by securities firms also, in addition to banks, to be recognised as eligible collateral. The HKMA agreed with the findings and indicted its intention to amend the BCR to address this issue within 2015.
Basel paragraph no	Paragraphs 422–433 as amended by revised framework: Rating system operations
Reference in the domestic regulation	BCR §226A definition of "specific wrong-way risk"; §148; §154; §155; §160(1); §161(3); §174; §175; §193; §203(1b) Schedule 2 §1
Observations	Basel paragraph 424 requires that rating assignments and periodic reviews must be completed or approved by a party that does not directly stand to benefit from the extension of credit (eg bonuses not linked to credit sales). BCR §155(a) requires that the rating process is "independent" of the staff and management responsible for originating such exposures. This slight difference in wording between the BCR and the Basel text may be open to interpretation by AIs; however, the HKMA explained that the risk of misinterpretation is negligible as the concept of independence has been widely adopted in prudential standards and risk management guidelines issued by the HKMA over time and is therefore well understood and, in practice, the supervisory assessment of the independence of rating approval staff considers potential benefits from the extension of credit, as well as other factors. As such, the definition of "independent" within the BCR for this purpose is wider than required by the Basel standard.
Basel paragraph no	Paragraphs 452–460: Definition of default; re-ageing; treatment of overdrafts; definition of loss for all asset classes
Reference in the domestic regulation	BCR §139(1) definition of "re-ageing"; §149; §148(c), §161(2)(b) and §178(2)(b)
Observations	The BCR do not specify "credit obligation on non-accrual status" as an indicator of unlikely to pay, on the basis that under IAS39, the concept of "interest in suspense" no longer exists. The Assessment Team agreed that interest in suspense does not exist under IAS39 and, in their judgment, the other items prescribed by the HKMA as indicators of unlikely to pay were sufficient to cover any instance where non-accrual might arise.
Basel paragraph no	Paragraphs 521–522: Requirements for the recognition of other collateral
Reference in the domestic regulation	BCR §207
Observations	The BCR do not specify in the case of inventories (eg raw materials, work-in-progress, finished goods, dealers' inventories of autos) and equipment, that the periodic revaluation process must include physical inspection of the collateral. Rather, the BCR require it "where practicable". The SPM CR-G-7 on Collateral and Guarantees provides supervisory guidance on the risk management of collateral and guarantees, which is used to ensure appropriate revaluations in line with regulatory expectations.

Operational risk

Basel paragraph no	Paragraphs 646–647: The measurement methodologies
Reference in the domestic regulation	BCR §24
Observations	Paragraph 646 of Basel II encourages banks to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. Based on para 647 of Basel II, internationally active banks and banks with significant operational risk exposures (for example, specialised processing banks) are expected to use an approach that is more sophisticated than the Basic Indicator Approach (BIA) and that is appropriate for the risk profile of the institution. There is no equivalent reference in the BCR which provides explicit encouragement for banks to move along the spectrum of approaches. However, para 1.4.1 of SPM OR-1 stipulates that a bank is expected to develop an operational risk management framework commensurate with its size, complexity and risk profile. Given that the AMA is not applicable, the Standardised Approach and ASA would be the eligible approaches. Nevertheless, two of the seven largest banks use the BIA.

Annexes

Annex 1: RCAP Assessment Team and Review Team

Assessment Team Leader:

Mr Arthur Lindo	Federal Reserve Board, United States

Assessment Team Members:

Mr Jacob Hostrup Andersen	Danish Financial Supervisory Authority, Denmark
Mr Chris Clark	Prudential Regulation Authority, UK
Mr Stefan Hohl	Bank for International Settlements, Financial Stability Institute
Mr Rajnish Kumar	Reserve Bank of India, India
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Mr Page Conkling	Federal Reserve Board, United States
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Review Team Members:[24]

Mr Karl Cordewener	Basel Committee Secretariat
Mr Matthias Güldner	SIG member, BaFin, Germany
Mr Sebastijan Hrovatin	SIG member; European Commission, EU
Mr Nkosana Mashiya	SIG member, South Africa Reserve Bank, South Africa

[24] The Review Team is distinct from the Assessment Team, and provides an additional level of quality assurance for the report's findings and conclusions. The Assessment Team has also benefited from the feedback of the RCAP Peer Review Board. The Assessment Team has also coordinated closely with Mr Udaibir Das, Head of Basel III Implementation at the Basel Committee Secretariat.

Annex 2: Implementation of the Basel framework as of cut-off date

Overview of adoption of capital standards

Table 4

Basel III Regulation	Date of issuance by BCBS	Transposed in HKMA rule	Date of implementation in Hong Kong	Status
Basel II				
Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	June 2006	Banking (Capital) Rules Banking (Disclosure) Rules SPM CA-D-1 SPM CA-G-3 SPM CA-G-5 FAQ(MR) FAQ(IRB)	1 January 2007 1 January 2007 30 May 2007 31 January 2007[25] 1 January 2007[26] 25 May 2007 25 May 2007	4
Basel 2.5				
Enhancements to the Basel framework Guidelines for computing capital for incremental risk in the trading book Revisions to the Basel II market risk framework	July 2009	Banking (Capital) (Amendment) Rules 2011 Banking (Disclosure) (Amendment) Rules 2011 SPM CA-G-5 SPM CA-G-3	1 January 2012 1 January 2012 4 June 2010 11 October 2012	4
Basel III				
Basel III: A global regulatory framework for more resilient banks and banking systems – revised version	June 2011 (Consolidated version)	Banking (Amendment) Ordinance 2012	1 January 2013 (provisions related to capital and disclosure standards)	4
		Banking (Capital) (Amendment) Rules 2012	1 January 2013 (to implement revisions to minimum capital ratios, definition of capital and risk coverage)	
		Banking (Capital) (Amendment) Rules 2013	30 June 2013 (to align with FAQs on CCR and CCPs issued by the BCBS in Q4 2012)	

[25] SPM CA-G-3 was further revised on 11 October 2012 to elaborate on the revised market risk capital framework as set out in Basel 2.5 (which was incorporated into the BCR from 1 January 2012) and related FAQs issued by the Basel Committee.

[26] SPM CA-G-5 was further revised on 4 June 2010 and 28 December 2012 to reflect Basel 2.5 and Basel III standards respectively as they relate to Pillar 2.

		SPM CA-G-5	28 December 2012	
Pillar 3 disclosure requirements for remuneration	July 2011	Banking (Disclosure) (Amendment) Rules 2013 SPM CG-5 §3, supplemented by circular letter on "Disclosure on remuneration"	30 June 2013 19 March 2010 (SPM CG-5) 23 November 2011 (Circular letter)	4
Treatment of trade finance under the Basel capital framework	October 2011	Banking (Capital) (Amendment) Rules 2012	1 January 2013	4
Composition of capital disclosure requirements	June 2012	Banking (Disclosure) (Amendment) Rules 2013 Capital Disclosure Guidance	30 June 2013 19 August 2013	4
Capital requirements for bank exposures to central counterparties	July 2012	Banking (Capital) (Amendment) Rules 2012 Banking (Capital) (Amendment) Rules 2013	1 January 2013 30 June 2013 (to align with FAQs on CCR and CCPs issued by the BCBS in Q4 2012)	4

Number and colour code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. For rules which are due for implementation as on 30 June 2012**,** the following colour code is used: Green = implementation completed; Yellow = implementation in process; Red = no implementation.

A further set of Banking (Capital) Amendment Rules 2014 came into effect from midnight on the cut-off date to implement the capital buffers (including the HLA requirements for G-SIBs and D-SIBs), with effect from 1 January 2015.

Annex 3: List of capital standards under the Basel framework used for the assessment

(i) International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), June 2006

(ii) Enhancements to the Basel II framework, July 2009

(iii) Guidelines for computing capital for incremental risk in the trading book, July 2009

(iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", Basel Committee press release, 13 January 2011

(v) Revisions to the Basel II market risk framework: Updated as of 31 December 2010, February 2011

(vi) Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)

(vii) Pillar 3 disclosure requirements for remuneration, July 2011

(viii) Treatment of trade finance under the Basel capital framework, October 2011

(ix) Interpretive issues with respect to the revisions to the market risk framework, November 2011

(x) Basel III definition of capital – Frequently asked questions, December 2011

(xi) Composition of capital disclosure requirements: Rules text, June 2012

(xii) Capital requirements for bank exposures to central counterparties, July 2012

(xiii) Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee, July 2012

(xiv) Basel III counterparty credit risk – Frequently asked questions, November 2011, July 2012, November 2012

Annex 4: Local regulations issued by HKMA for implementing Basel capital standards

Overview of issuance dates of important HKMA capital rules — Table 5

Domestic regulations	Name of the document, version and date
Domestic regulations implementing Basel II	Please refer to Annex 2
Domestic regulations implementing Basel 2.5	Please refer to Annex 2
Domestic regulations implementing Basel III	Please refer to Annex 2

Hierarchy of Hong Kong laws and regulatory instruments — Table 6

Level of rules (in legal terms)	Type
Primary legislation	Enacted by the Legislative Council
Subsidiary legislation/rules	Enacted by the Legislative Council
Codes of practice	Issued by HKMA
Statutory guidelines	Issued by HKMA
Other guidance	Issued by HKMA

Annex 5: Details of the RCAP assessment process

A. Off-site evaluation

(i) Completion of a RCAP questionnaire (self-assessment) by the HKMA

(ii) Evaluation of the RCAP questionnaire by the RCAP Assessment Team

(iii) Independent comparison and evaluation of the domestic regulations issued by the HKMA with corresponding Basel III standards issued by the BCBS

(iv) Identification of observations

(v) Refinement of the list of observations based on clarifications provided by the HKMA

(vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment

(vii) Forwarding of the list of observations to the HKMA

B. On-site assessment

(viii) Discussion of individual observations with the HKMA

(ix) Meeting with selected Hong Kong banks, three audit firms and three credit rating agencies

(x) Discussion with the HKMA and revision of findings to reflect additional information received

(xi) Assignment of component grades and overall grade

(xii) Submission of the detailed findings to the HKMA with grades

(xiii) Receipt of comments on the detailed findings from the HKMA

C. Review and finalisation of the RCAP report

(xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to the HKMA for comments

(xv) Review of the HKMA's comments by the RCAP Assessment Team

(xvi) Reporting of findings to SIG by the team leader

(xvii) Review and clearance of the draft report by the RCAP Review Team and Peer Review Board

Annex 6: List of items rectified by HKMA during the RCAP assessment

The changes were published by 31 December 2014.

Basel paragraph	Reference to HKMA document and paragraph	Brief description of the correction
Scope of application		
1. Basel II paragraph 16, footnote 3	BCR §2(1) definition of "trading book" and §281 definition of "two-way market"; FAQ (MR) on §2: A.2(b), (d) and (e)	The missing references in the BCR definition of "trading book" to certain types of exposures mentioned in footnote 3 to Basel II paragraph 16 has been published via the revision of an existing FAQ.
2. Basel II, paragraph 24	BCR §31, BCR §33	The following point applies to the Scope of application section generally. BCR §33(3) requires that, when risk-weighting of exposures for an overseas subsidiary of an AI, the risk weights prescribed by the host country regulator may be applied instead of those in the BCR. However, adopting this approach is subject to AIs demonstrating that the use of the host country's standards would not materially prejudice the calculation of the AIs' capital adequacy ratio. The HKMA clarified that use of the host country rules is an exception subject to its prior approval under BCR §33(2), and that currently, only one AI has been granted such approval. The Assessment Team considers that where one bank has received such approval (and thus is an exception rather than a rule), and because such dispensation is subject to the prior regulatory approval of HKMA, the deviation is not material. The HKMA has rectified this divergence from the Basel text by clarifying in its supervisory guidance (SPM module "Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions" (CA-G-1)) that only when an overseas subsidiary is subject to Basel III equivalent standards, implemented by the host-country regulator, will approval under BCR §33(3) be considered.
Credit risk: Standardised Approach		
3. Basel II, paras 82–89: Off-balance sheet items	BCR §71, §74(1)	BCR §71(1), Table 10 item 9(c): the unconditional cancellable condition provision permitting a 0% CCF does not include the "without prior notice" language included in Basel paragraph 83. The HKMA noted that the "without prior notice" requirement is included in the completion instructions ("CIs") for Form MA(BS)3(IIIb) of the Return of Capital Adequacy Ratio (see page 28 of the CIs re item 9a) and hence AIs are bound to observe it. Nevertheless, the HKMA issued an FAQ to clarify the conditions for applying a 0% CCF.
4. Basel II, paras 173–177	BCR §2(1) BCR §96(5), BCR §96(1)–(4)	BCR §2(1), which defines a valid bilateral netting contract, does not include explicit reference in respect of repo style transactions to netting of gains and losses on the value of any collateral posted and prompt liquidation or setoff of

		collateral upon the event of default. The HKMA issued an FAQ to clarify these criteria for valid bilateral netting agreements.
5. Basel II, para 188	BCR §2(1)	The definition of "valid bilateral netting agreement" provided in the BCR does not include the requirements of Basel II paragraph 188(c) (ie a bank "monitors and controls its roll-off risks"). The HKMA believes that the condition is subsumed within the criterion for the definition of "valid bilateral netting agreement" that the transactions covered by the netting agreement be managed on a net basis. Nevertheless, the HKMA issued an FAQ to explain this criterion for valid bilateral netting agreements.
Credit risk: Internal Ratings-Based Approach		
6. Basel II, paras 235–238: Definition of equity exposures	BCR §145 as read with §139(1) definition of "corporate"	Paragraph 235 of Basel II defines "equity exposures" as including "both direct and indirect ownership interests … in the assets and income of a commercial enterprise or of a financial institution that is not consolidated or deducted …". BCR §145(1) originally did not capture the "financial institution" element in the Basel text, as it made reference to a "corporate" but this term was defined under BCR §139(1) to exclude "a public sector entity, bank or securities firm". An amendment has been made to the BCR to redefine "corporate" for the purposes of BCR §145.
7. Basel II, paras 331–338: Risk Components	BCR §170; §177; §217; §210; §215; §203; §179; §180; §180A; §181; §182 BCR §139(1) (Definition of "exposure at default") BCR §2(1) (Definition of "valid bilateral netting agreement")	The definition of "valid bilateral netting agreement" provided in the BCR does not explicitly include the requirements of paragraph 188(c) of Basel II (ie where a bank "monitors and controls its roll-off risks"). The HKMA issued an FAQ to explain this criterion for valid bilateral netting agreements (see item 5 above).
8. Basel II, paras 438–445: Corporate governance and oversight and Use of internal ratings	BCR Schedule 2 §2; SPM CA-G-4 §§4, 5.5, 6.2	The BCR permit the HKMA to consider a shorter use test period of two years (one year for FIRB), rather than three years, prior to an AI's qualification for IRB use. Of the eight AIs (counted on a legal entity basis) that have the HKMA's approval to use the IRB approach for credit risk, six AIs had a use test period of shorter than three years. However, all IRB AIs now have more than three years of IRB experience and future IRB applicants will be required to evidence a period of use of more than three years. The HKMA issued an FAQ to set out that the period that the HKMA will consider reasonable for the purposes of BCR Schedule 2 §2 will be three years henceforward.
9. Basel II, paras 491–499: Requirements specific to estimating PD and LGD (or EL) for qualified purchased receivables	BCR §200	The minimum operational requirements for the risk quantification of qualifying purchased receivables set out in Basel text paras 493 to 499 are not specifically captured in the Hong Kong regulations. The HKMA issued an FAQ setting out the minimum operational requirements it will expect in line with the Basel standard.
10. Basel II, paras 511–520: Requirements for recognition of financial receivables	BCR §205	Para 511 of Basel II specifies that recognised financial receivables do not include receivables associated with securitisations, sub-participations or credit derivatives, while para 519 excludes receivables from affiliates of the borrower (including subsidiaries and employees). BCR §205(2), however, originally only captured exclusions in respect of securitisation transactions. An amendment has been made to the BCR, via the BCAR 2014, to exclude financial receivables derived from all of securitisation transactions, sub-participations, credit derivative contracts and affiliates of

		the borrower (including subsidiaries and other group companies and employees).
Credit risk: Securitisation Framework		
11. Basel II, para 550	BCR §227(1)	The definition of excess spread. Basel states that excess spread is generally defined as gross finance charge collections and other income received by the trust or special purpose entity minus certificate interest, servicing fees, charge-offs, and other senior trust or SPE expenses. The BCR originally defined excess spread, in relation to a securitisation transaction, as future interest and other income derived by the SPE in the transaction from the underlying exposures in the transaction in excess of the transaction costs specified in the documentation for the transaction, expressed as a percentage of the underlying exposures. It was unclear if transaction cost covers charge-offs. An amendment has been made to the BCR, via the BCAR 2014, to redefine "excess spread" in BCR §227 to align with the definition in the Basel standard.
12. Basel II, para 584	BCR §§235, 261(1) and 269(1)	Basel II states when a bank other than the originator provides credit protection to a securitisation exposure, it must calculate a capital requirement on the covered exposure as if it were an investor in that securitisation. The original reference to "securitisation issue" in the BCR instead of "securitisation exposures" meant the scope of application was narrower (eg credit protection provided to liquidity facilities will not be captured). Amendments have been made to the BCR, via the BCAR 2014, to replace the term "securitisation issue" with the term "securitisation exposure" in each of BCR §§235, 261 and 269.
13. Basel II, para 586	BCR §§232A(1), 247, 265, 278 and 279	Basel states that SPEs cannot be recognised as eligible guarantors and provide credit protection. The BCR did not reflect that SPEs could not be recognised as eligible guarantors and provide credit protection. An amendment has been made, via the BCAR 2014, to BCR §232A to exclude guarantees for which the guarantor is an SPE or credit derivative contracts for which the protection seller is an SPE, from recognition as eligible guarantees and credit protection.
14. Basel II, para 608	BCR §15(3)	In situations where there is no specific IRB treatment for the underlying asset type, investing banks with approval to use the IRB approach must apply the Ratings-Based Approach (RBA) in the securitisation framework, according to Basel. The BCR originally required in such situation investing IRB AIs to use the standardised approach in the securitisation framework. An amendment has been made, via the BCAR 2014, to BCR §15 to provide that investing AIs must use the RBA in situations where there is no specific IRB treatment for the underlying asset type.
Market risk: Standardised Measurement Method		
15. Paragraph 718(xv)	BCR §290(a)	The provision of an alternative treatment for the calculation of large swap books is allowed in the BCR without the preconditions set in Basel. The BCR would allow in general use of different methodologies with prior consent of the HKMA. There is no current impact, as the HKMA has not yet received an application to use a different methodology for the calculation of large swap books. The HKMA issued an FAQ setting out the conditions (reflecting those in the Basel standard) under which the HKMA will allow use of a different methodology under BCR §290 for calculation of capital charges for large swap books.
16. Paragraph 718(xxxviii)	BCR §295(2) and (3)	The BCR do not explicitly require satisfaction of the three conditions set out in Basel II for recognising an FX position as a structural position. The HKMA expects as a matter of practice, however, that an AI will demonstrate its compliance

		with the three conditions as part of its justification for an FX position to be allowed to be considered as a structural position. The HKMA issued an FAQ setting out the conditions (reflecting those in the Basel standard) for recognition of an FX position as a structural position.
Pillar 3		
17. Basel II, Table 4 (b) average gross exposures	BDR §§57 and 78.	The requirement to disclose average gross exposures is not incorporated under the BDR. The BDR do not require disclosure of average gross exposures, where the period-end position is not representative of the risk positions of the AI. The HKMA issued supervisory guidance in the form of an FAQ to include reference to disclosure of average gross exposures.

Annex 7: Assessment of the binding nature of regulatory instruments issued by HKMA

The following table summarises HKMA's self-assessment of the seven criteria used by the RCAP to determine the eligibility of HKMA's regulatory instruments for the RCAP. The Assessment Team concluded that the regulatory instruments issued and used by HKMA (as set out in Table 5 of Annex 4) are eligible for the RCAP assessment.

Criterion	Assessment (by HKMA)
(i) The instruments used are part of a well defined, clear and transparent hierarchy and regulatory framework	The Banking Ordinance (BO) provides a comprehensive framework for the setting and enforcing of minimum prudential standards for AIs, including capital, liquidity and disclosure requirements as well as (among other things) ownership, governance, internal controls, provisioning and large exposures. Specifically in relation to capital, liquidity and disclosure requirements, the BO grants (or will provide from 1 January 2015 in the case of liquidity) the Monetary Authority (HKMA) with the power to issue rules which, without limit to generality, "may give effect to banking supervisory standards… issued by the Basel Committee". The HKMA has used these provisions to issue the Banking (Capital) Rules (BCR) and the Banking (Disclosure) Rules (BDR) and will use the power to issue the Banking (Liquidity) Rules (BLR) to take effect from 1 January 2015. These rules have the status of subsidiary legislation. The BO also provides for the HKMA to issue guidance indicating the manner in which the HKMA proposes to exercise its functions under the BO and Codes of Practice for the purpose of providing guidance in respect of any relevant provisions in the BCR, BDR and BLR. The HKMA's Supervisory Policy Manual (SPM) sets out the HKMA's supervisory policies and practices; the minimum standards that AIs are expected to attain in order to satisfy the requirements of the BO (which by definition will include the rules made under it); and recommendations on best practices that AIs should aim to achieve. Modules within the SPM fall into three broad categories: • statutory guidelines issued under the BO – these set out the minimum standards with which AIs are expected to comply to satisfy the requirements of the BO. In addition to minimum standards, statutory guidelines may also embody best practices or advisory standards; • non-statutory guidelines issued as guidance notes – these are best practice guides setting out the HKMA's recommendations to AIs in respect of the standards they should aim to achieve, subject to the AIs' size, complexity and scope of activities, and • non-statutory guidelines issued as technical notes – these are usually technical in nature and are for the purpose of clarifying the HKMA's interpretation of regulatory and reporting matters A number of SPM modules complement the application of the BCR and BDR (and in future the BLR) and are referred to, where relevant, in the self-evaluation. The power to issue Codes of Practice is relatively new, having been introduced in 2013. It is likely that the HKMA will make use of the power to issue a Code of Practice, to supplement the BLR, in relation to the detailed mechanics of calculating total net cash outflows for the LCR. The HKMA is not, however, restricted to issuing guidance in the form of SPM modules or Codes of Practice and can issue guidance in other forms including supervisory circular letters and FAQs. Further, as under the BO, the HKMA can require AIs to submit information to the HKMA in such manner as the HKMA may require, the requirements for AIs to calculate capital and liquidity ratios in accordance with the completion instructions accompanying the relevant Banking

		Returns also has the practical effect of "prescribing" the calculation methodology. The HKMA will monitor AIs' compliance with issued guidance as part of its regular supervision.
(ii)	They are public and freely available	The BO and the BCR, BDR and BLR are available on the website of the Department of Justice (as is all current legislation in Hong Kong). The HKMA publishes SPM modules and other circulars, FAQs and Banking Returns on its website. Codes of Practice will be gazetted in the Government Gazette and a copy maintained on the HKMA website.
(iii)	They are viewed as binding by banks as well as by the supervisors	The BO and the BCR, BDR and (from 1 January 2015) the BLR, as primary and subsidiary legislation respectively, are binding in Hong Kong and failure to comply may constitute a criminal offence. Any failure to adhere to any of the guidelines issued by the HKMA, whether statutory or non-statutory, may call into question whether the AI concerned continues to satisfy the ongoing authorisation criteria under the BO. In addition, where such failure is in respect of any statutory guideline, it may constitute a contravention of the relevant provision or requirement of the BO. Accordingly, severe sanctions may potentially result from any failure to adhere to a guideline. In the recent FSAP of Hong Kong, the assessors for the Basel Core Principles for Effective Banking Supervision noted in their report that they had "confirmed with all firms and professionals with whom they met that the SPM, Guidelines and Circulars are perceived and treated as enforceable rules by AIs" (assessment of Core Principle 1 Essential Criterion 3).
(iv)	They would generally be legally upheld if challenged	The BO and the BCR, BDR and (from 1 January 2015) the BLR as primary and secondary legislation respectively would be upheld in the courts. The SPM and other guidelines, in setting out minimum standards and the HKMA's interpretation of regulatory requirements and its functions under the BO (including the rules made under it) are tied into the ongoing authorisation criteria and the HKMA's powers under the BO. Accordingly (although to date there has been no legal challenge as to the enforceability of the SPM or other guidance) failure to comply may result in the use by the HKMA of its powers under the BO and the use of these powers would be binding. Codes of Practice are given specific evidentiary value by the BO (§97N). This means that, whilst failure to observe a provision of a Code does not, per se, render the AI liable to civil/criminal proceedings, it is the case that failure to observe the Code will, if relevant to something which the HKMA has to prove in order to establish a contravention of a prescribed requirement, be taken as proving that thing unless a Review Tribunal is satisfied that the prescribed requirement was satisfied otherwise than by compliance with the Code.
(v)	They are supported by precedents of enforceability	If an AI fails to comply with the BO, BCR, BDR and (from 1 January 2015) the BLR, the HKMA has a range of measures which it can deploy. These include, in relation to capital and liquidity shortfalls, issuing a notice requiring the AI to take the remedial action specified in the notice and, if the AI fails to comply, its chief executive, every director and every manager of the AI commits an offence (§97E and §97J BO). (As yet it has not been necessary to initiate any prosecution under these provisions.) Prior to reaching this point, however, the HKMA may also address perceived weaknesses through the Pillar 2 Supervisory Review Process and the CAMEL rating system and through its general risk-based supervisory approach. There are precedent cases, for example, when an AI has received a lower CAMEL rating due to perceived capital/liquidity weaknesses. In addition to the signalling effects to the AI concerned, a CAMEL rating downgrade also increases the level of a locally incorporated AI's contribution to Hong Kong's deposit protection scheme.
(vi)	They are properly communicated and consequences of failure to comply are properly understood and carry a similar practical effect as for the primary law or regulation	Industry consultation will be conducted prior to the gazetting of legislation or prior to the issuance of SPM modules/Codes of Practice. Thereafter, as noted above, the contents are easily accessible and the HKMA may, if any areas of confusion arise, issue FAQs in short order to clarify. The adverse consequences of failure to comply are understood by the local banking industry as evidenced by the observation of the FSAP assessors referred to under (iii) above.
(vii)	The instrument is expressed	All legislation and regulatory/supervisory instruments are written in clear, precise

in clear language that complies with the Basel provision in substance and spirit	language and are generally issued in both English and Chinese. While the protocols of legislative drafting may mean that it is not always possible for local laws to track the Basel language exactly, the actual language used is designed to reflect the HKMA's understanding of both the substance and the spirit of the Basel standard.

Annex 8: Key financial indicators of the Hong Kong banking system

Overview of the banking sector of the jurisdiction

This table will inform the Assessment Team about the domestic banking sector and the importance of certain Basel components for the banking sector.

(Amount in millions of local currency)

	Size of banking sector	
1	Total assets of all AIs operating in the jurisdiction[27]	17,397,412
2	Total assets of all major locally incorporated banks[28]	9,694,509[29]
3	Total assets of locally incorporated AIs to which capital standards under Basel framework are applied	11,071,534
	Number of banks	
4	Number of AIs operating in the jurisdiction	202
5	Number of major locally incorporated banks	10 banks included in the RCAP sample (seven if reported on a consolidated legal entity basis)
6	Number of AIs required to implement Basel standards (according to domestic rules)	57[30]
7	Number of Global Systemically Important Banks (G-SIBs)	0
8	Number of Domestic Systemically Important Banks (D-SIBs)	To be determined
	Implementation of advanced approaches of capital standards under the Basel framework	
9	Number of banks on IRB approach for credit risk	8[31]
10	Number of banks on IMA for market risk	6[32]
11	Number of banks on AMA approaches for operational risk	Not yet implemented in HK
12	Number of banks on IMM for counterparty credit risk	0

[27] The amount of "total assets" is extracted from the HKMA Monthly Statistical Bulletin (as at March 2014).

[28] These refer to the seven RCAP sample banks which are major locally incorporated banks in Hong Kong.

[29] The amount of "total assets" is extracted from the two prudential returns "MA(BS)1 – Assets and Liabilities (Hong Kong Office)" (ie. including the local branches of the AIs) and "MA(BS)1B – Assets and Liabilities (Combined)" (ie including local and foreign branches of the AIs), whichever is applicable. The total asset numbers are based on those reported by AIs on an unconsolidated legal entity basis (consolidated positions not available).

[30] The HKMA rules apply to all locally incorporated AIs, but not to the 145 branches (= 202 – 57).

[31] The figure represents the number of banks on IRB approach for credit risk on an unconsolidated legal entity basis. When counted on a consolidated legal entity basis, the number of banks/banking groups is five.

[32] The figure represents the number of banks on IMA for market risk on an unconsolidated legal entity basis. When counted on a consolidated legal entity basis, the number of banks/banking groups is three.

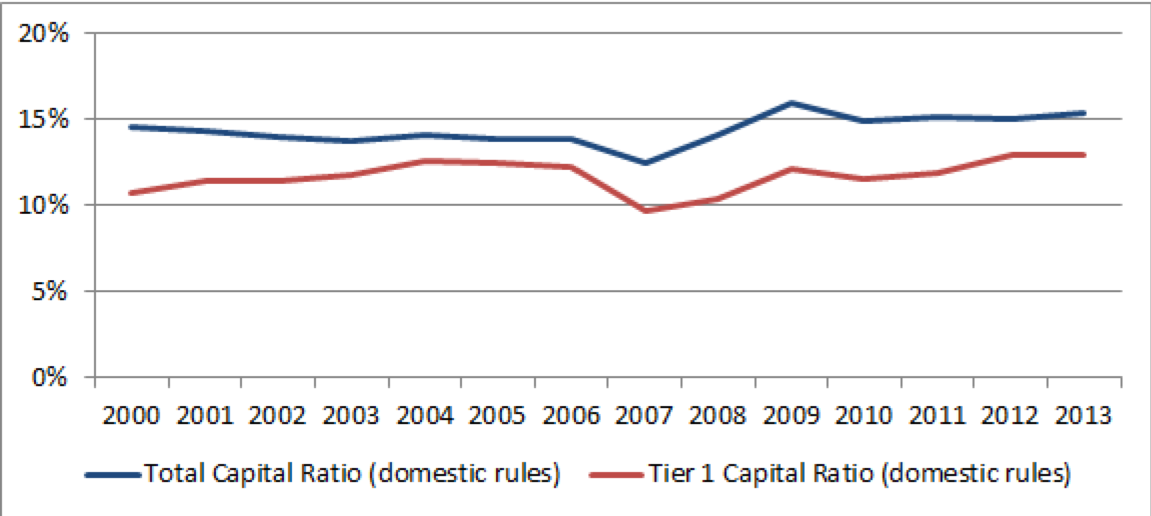
	Capital adequacy (major locally incorporated banks)	
13	**Total capital**	782,401
14	Total Tier 1 capital	649,228
15	Total CET1 capital	645,678
16	Total risk-weighted assets	5,080,382
17	RWAs for credit risk (per cent of total RWAs)	4,447,990 (86.6%)
18	RWAs for market risk (per cent of total RWAs)	242,055 (4.7%)
19	RWAs for operational risk (per cent of total RWAs)	448,192 (8.7%)
20	Total off-balance sheet bank assets	1,507,903
21	Capital Adequacy Ratio (weighted average)	15.4% (Note 1)
22	Tier 1 Ratio (weighted average)	12.8% (Note 1)
23	CET1 Ratio (weighted average)	12.7% (Note 1)
	Source: HKMA, 31 March 2014	

Note: Weights for items 21 to 23 will be the total assets of each bank.

Note 1: Weighted average of relevant capital ratios is computed in each case by dividing the aggregate capital of the banks in the relevant tier by their aggregate risk-weighted assets.

Note 2: Total assets exclude off-balance sheet positions.

Evolution of capital ratios of Hong Kong's seven largest banks (RCAP sample)	
Weighted average, in percent	Figure 1



Source: HKMA.

Annex 9: Materiality assessment

The assessment findings (deviations from the Basel minimum) were examined for the materiality of their impact on the capital ratios of the RCAP sample banks in Hong Kong. Both quantifiable and non-quantifiable findings were assessed. The impact of all quantifiable findings for each bank in the RCAP sample was quantified, where data were available. In cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data were available to quantify a finding, the Assessment Team relied only on expert judgment.

Following this approach, an attempt was made to determine whether the findings are "not material", "material" or "potentially material", as shown below.

Given the 17 rectifications that were made during the assessment process (Annex 6), 26 findings remain, of which 25 are classified as non-material and 1 as material. More details of the rationale underlying the materiality analysis are provided in the detailed assessment in Section 2.

Number of assessment findings by component — Table 8

Component	Non-material	Potentially material	Material
Scope of application	2	0	0
Transitional arrangements	0	0	0
Definition of capital	1	0	0
Capital buffers	0	0	0
Pillar 1			
Credit risk: Standardised Approach	9	0	0
Credit risk: IRB Approach	2	0	0
Credit risk: Securitisation	2	0	0
Counterparty credit risk	1	0	0
Market risk: Standardised Measurement Method	2	0	1
Market risk: IMA	0	0	0
OR: Basic Indicator Approach/SA	1	0	0
OR: AMA	N/A	N/A	N/A
Pillar 2	0	0	0
Pillar 3	5	0	0

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps). See Section 2 for further information.

Annex 10: Areas where HKMA's rules are stricter than the Basel minimum standards

In several places, the HKMA has adopted a stricter approach than the minimum standards prescribed by Basel or has simplified or generalised an approach. The following list, prepared with input from the HKMA, provides an overview of the areas where the BCR and the regulatory capital framework in Hong Kong are considered stricter than the Basel minimum standards. These areas have not been taken into account as mitigants for the overall assessment of compliance.

Definition of capital

In the calculation of the capital base, certain items that the Basel III standard would allow to be recognised in Common Equity Tier 1 capital (CET1) can only be recognised in Tier 2 capital. Unrealised gains on property revaluation can only be recognised in Tier 2 subject to a 55% haircut. Shares issued through capitalising any part of reserves or retained earnings attributable to fair value gains arising from revaluation of land and buildings can only be recognised in Tier 2 subject to a 55% haircut, and retained earnings earmarked for a regulatory reserve which the HKMA requires AIs to hold (broadly to reflect a general provision against expected loss) are excluded from CET1 and included in Tier 2 (in aggregate with collective provisions) subject to the respective criteria and limits for recognition of eligible provisions prescribed under Basel II for the standardised approach (1.25% of standardised credit RWA) and the IRB approach (0.6% of IRB credit RWA) for credit risk. Deferred tax assets and mortgage servicing rights are deducted in full from CET1 (without the benefit of the Basel III thresholds) and credit exposures to connected companies that are not assumed in the ordinary course of business are deducted from CET1 (this latter provision is an anti-avoidance device designed to capture investments recharacterised as loans).

Capital buffers

1. Basel III paragraph 150

The BCR require that, during the transitional period for the countercyclical buffer, AIs should follow the buffer requirement as announced by an overseas jurisdiction (up to 2.5%) whether or not that requirement is set within the Basel transitional levels, unless the HKMA announces a different ratio.

Credit Risk Standardised Approach

2. Basel II paragraph 59: Claims on multilateral development banks (MDBs)

The BCR require that claims on other MDBs (ie those MDBs which do not qualify for 0% risk weights) be risk-weighted similarly to claims on corporates (as opposed to claims on banks as under the Basel text).

3. Basel II paragraphs 75–78: Past-due loans

The BCR require application of a flat 150% risk-weight to the unsecured portion of past-due loans irrespective of the level of specific provisions, instead of differential risk-weighting depending upon the level of specific provisions made.

4. Basel II paragraphs 119–144: Overview of credit risk mitigation techniques

The BCR require AIs to use only the simple approach under credit risk mitigation techniques for past-due exposures in the banking book instead of allowing banks to use either the simple approach or comprehensive approach.

5. Basel II paragraphs 189–201: Guarantees and credit derivatives

Under the credit risk mitigation framework, the BCR prescribe certain additional requirements for guarantors/protection sellers to be recognised as eligible mitigants, such as there being no exchange controls, or if there are exchange controls, approval has been obtained for the funds to be remitted freely in the event that the credit protection provider is called upon to make payment to the AIs. Further, there is a requirement that the credit protection provider has no recourse to the AI for any losses suffered.

Credit risk: Internal Ratings-Based approach

6. Basel III paragraph 256–262

The BCR allowed a phased roll-out only during the Basel II transitional period (2007–09). Since then, any AI that wishes to adopt an IRB approach must do so in full from day one.

7. Basel III paragraph 286–307

The BCR narrowed the scope of recognition of CRM under the double-default framework to preclude its use when the underlying obligation is a loan to a small business that is subject to retail treatment.

8. Basel III paragraph 327–330

All residential mortgage loans secured on Hong Kong properties and granted by an IRB AI after 22 February 2013 are subject to a 15% risk-weight floor.

9. Basel III paragraph 340–358

Guarantees are not allowed to be recognised for CRM for equity exposures subject to the IMM under the market-based approach.

10. Basel II Paragraphs 452–460

The BCR prohibit the use of "re-ageing" for the definition of default.

Credit risk: Securitisation framework

11. Basel II paragraph 554–555

The BCR set a number of additional applicable operational requirements for the recognition of risk transference and for synthetic securitisations in order to determine whether the assets have been transferred in the form of a "clean sale" or a similar effect has been synthetically achieved through the use of derivatives. Among those additional requirements are the following: (i) obtaining a tax adjudication or opinion on whether any direct or indirect tax obligations arise as a result of any transfer of interests in underlying exposures and related collateral under the transaction; (ii) the documentation for the transaction accurately reflects the economic substance; (iii) the documentation for the transaction does not contain any clause that directly or indirectly makes any representation or provides any warranty as to the future credit performance of the underlying exposures and that obliges the AI to repurchase

any of the underlying exposures; (iv) where the AI or a member of its group of companies has underwritten any securitisation issues in the transaction this has been done on an arm's-length basis; (v) subject to underwriting, the AI has not committed itself to purchasing any of the securitisation issues prior to their initial issue by the SPE; (vi) where under the transaction there is an interest rate contract or exchange rate contract between the AI and the SPE which issued the securitisation issues for the purposes of enabling the SPE to hedge interest rate risk or foreign exchange risk, the contract was entered into at market rates.

12. Basel II paragraph 642

Basel allows wider treatment of credit risk mitigation for securitisation exposures than the BCR. The BCR do not accept "eligible IRB collateral" (eg financial receivables, real estate, physical assets), which are applicable under the CRM techniques of the FIRB.

Market risk: Standardised Measurement Method

13. Basel Paragraph 718(xxv)

The BCR do not adopt the Basel preferential treatment for specific risk prescribed for banks' positions in an index contract comprising a diversified portfolio of equities (with specific risk capital charge of 2% on the net position). Such equities positions are subject to the regular treatment of an 8% specific risk capital charge on gross positions as set out in BCR §293.

14. Basel Paragraph 718(xxvi) and 718(xxvii)

The BCR do not adopt the Basel preferential treatment for specific risk prescribed for banks' equities positions which are the subjects of specified futures-related arbitrage strategies (with minimum specific capital risk of 2% of the gross value of the positions on each side, ie 4% in total). Such equities positions are subject to the regular treatment of an 8% specific risk capital charge on gross positions as set out in BCR §293.

15. Basel Paragraph 718(xxviii)

The BCR do not allow offsetting of an AI's equities positions across markets as permitted under para 718(xxviii). BCR §292(1)(a) requires separate calculation of market risk capital charge for equities positions for each exchange where the equities or equity-related derivative contracts are listed or traded. The BCR treatment may generate higher capital requirements.

16. Basel Paragraph 718(xxxix)

This paragraph of the Basel framework specifies two types of FX positions that can be treated as structural positions for capital purposes and thus be exempted from market risk calculations. The BCR do not sanction exemption of the second type of FX position, ie "other long-term participations denominated in foreign currencies which are reported in the published accounts at historic cost", from the market risk capital framework.

17. Basel Paragraph 718(xLvii)

In BCR §297(2)(a) and (b), only the offsetting provisions in commodities as set out in the first two sentences of the Basel paragraph have been adopted. Other forms or methods of offsetting (eg across different subcategories or based on correlations as described in the rest of the Basel paragraph) are not allowed. Hong Kong's approach is more conservative.

Annex 11: List of approaches not allowed by HKMA's regulatory framework

The following list provides an overview of approaches that the HKMA has not made available to AIs through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as "not applicable" for the assessment.

Credit risk: Standardised Approach

- Own-estimated haircut under the comprehensive approach for CRM techniques
- VaR model approach for securities financing transactions other than repo-style transactions

Credit risk: Securitisation framework

- Internal Assessment Approach (IAA) relevant for unrated securitisation exposures pertaining to ABCP programmes. Instead the Supervisory Formula (SF) is applicable. (Basel II, paragraphs 619–622)

Operational risk

- Advanced Measurement Approaches

Counterparty credit risk

- Standardised method
- Internal model to calculate a maturity under the internal model method
- Own estimates of alpha under the internal model method

Market risk: Standardised Measurement Method

- Maturity Ladder approach

Annex 12: List of issues for follow-up RCAP assessments

The Assessment Team identified one issue listed below for follow-up and for the future RCAP assessments:

1. Envisaged changes after the cut-off date

Annex 13: Areas for further guidance from the Basel Committee

Recognition of bilateral netting

Paragraph 96(ii) of Annex IV requires that the national supervisor, after consultation when necessary with other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions. Further, footnote 250 explains that thus, if any of these supervisors is dissatisfied about enforceability under its laws, the netting contract or agreement will not meet this condition and neither counterparty could obtain supervisory benefit.

The HKMA indicated that AIs must obtain written legal opinions on the enforceability of the netting agreements in order to be able to recognise the netting benefit. The same approach is also adopted by other regulatory authorities as the primary means of ensuring the enforceability of netting agreements. The HKMA also observed that so far it had not received any enquiry from any other regulatory authorities about its opinion on the enforceability of netting under Hong Kong law. Also, the HKMA noted that it is practically difficult, in terms of resources, for the HKMA to verify the legal certainty of enforceability in respect of every host jurisdiction associated with AIs' derivatives transactions.

The Assessment Team believes that it is important for home jurisdictions to ensure that host-jurisdictions have adequate laws and rules recognising closeout netting and that the laws/rules are enforceable and as such it should not be left for the banks alone to verify the legal enforceability and legal certainty of netting arrangements for OTC derivatives and SFTs. However, given the submissions made by the HKMA, more specifically, with respect to other Basel member jurisdictions, the Assessment Team would seek guidance from the Basel Committee in this matter.

Annex 4: Counterparty credit risk: scope of application

Paragraph 4, Footnote 238 in respect of scope of application under Annex 4 inter alia suggests that transactions for which the probability of default is defined on a pooled basis are not included in this treatment of CCR. The BCR on counterparty credit risk do not include the requirement of this footnote. It is suggested by HKMA that neither footnote 238 nor any other Basel II paragraph indicates the appropriate capital treatment of the CCR exposure from excluded transactions and therefore inclusion of footnote 238 in the domestic rules or policy manual may lead to an interpretation that AIs are not required to hold any capital against the CCR associated with these transactions. The HKMA further indicated that, by not including the wording of footnote 238 in the BCR, the HKMA is in effect subjecting transactions (which would otherwise be captured by the footnote) to the Annex 4 requirements. This would in fact be a super-equivalent approach if the intended effect of the footnote was really to exclude the transactions from counterparty risk capital requirements (by virtue of their not having an identified counterparty as required under paragraph 4 of Annex 4).

The Assessment Team is of the view that paragraph 335 of IRB credit risk mentions that for EAD computation for retail off-balance sheet items, banks must use their own estimates of CCFs, provided that the minimum requirements in paragraphs 474–477 and 479 are satisfied.

The Assessment Team believes that Annex 4 prescribes only the exposure measure for the counterparty credit risk for derivatives and SFTs. Further, it is quite usual for banks to use pooled PD for regulatory retail portfolios under the IRB approach for credit risk. Also, that paragraph 335 provides for the method of EAD computation for regulatory retail portfolios. However, the absence of any explicit reference to paragraph 335 in paragraph 4 or footnote 238 in Annex 4 leaves scope for a different

interpretation. Accordingly, the Assessment Team would like to raise the issue of application of footnote 238 for examination and clarification to the Basel Committee.

Standardised CVA risk capital charge

For standardised CVA risk capital charge calculations for OTC derivatives, the BCR require AIs to use a flat weight of 1% for unrated counterparties. The HKMA has observed that the use of a 1% capital charge corresponds to the treatment of unrated claims on banks and corporate counterparties. For unrated corporate counterparties, this capital charge may not, however, be appropriate keeping in view the fact that the Standardised Credit Valuation Adjustment (SCVA) framework foresees a 1% charge for BBB-rated and a 2% charge for BB-rated counterparties. While there is no tangible benchmark in the international standards, and the BCR are consistent with those in Switzerland, it is noted that Canada uses a 2% weight. We recommend that the Committee provide additional guidance on this matter.

Annex 14: HKMA's summary of its Pillar 2 supervisory review process[33]

The HKMA has implemented Pillar 2 in Hong Kong through the conduct of the supervisory review process ("SRP") on all locally incorporated AIs,[34] as an integral part of its capital adequacy framework and risk-based supervisory process. Guided by the four key principles for supervisory review in the 2006 Basel II document,[35] the HKMA has developed the SRP framework to serve the following objectives:

(i) facilitate supervisory monitoring of the capital adequacy of AIs to support the risks inherent in their business activities (including risks not captured or adequately captured under Pillar 1);

(ii) encourage AIs to enhance their risk management techniques for monitoring and controlling such risks; and

(iii) provide the impetus for AIs to maintain, and strengthen where necessary, active capital planning and management practices, including the effectiveness of their capital adequacy assessment process ("CAAP").

The HKMA's approach to conducting the SRP, including the criteria and standards used for evaluating an AI's capital adequacy and the effectiveness of its CAAP, is set out in the Supervisory Policy Manual module on "Supervisory Review Process" (CA-G-5).

Application of the four key principles of supervisory review

The manner in which the HKMA applies the four principles for supervisory review in its SRP framework is briefly described below.

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Under Paragraph 6 of the Seventh Schedule to the Banking Ordinance ("BO"), AIs are obliged to satisfy the Monetary Authority ("MA") that they maintain, on and after authorisation, adequate financial resources (whether actual or contingent) for the nature and scale of their operations. AIs are thus expected to ensure they can assess their own capital adequacy through conducting internal capital assessments under their CAAP.

Supervisory standards on CAAP are detailed in CA-G-5 (§4). In general, an AI's CAAP should be comprehensive, risk-based and forward-looking, with risk management policies and systems (supplemented by comprehensive stress testing to assess the effects of economic cycles and external vulnerabilities) to identify, measure and control its material risks[36] and a process to relate its internal capital to such risks. There should also be adequate capital planning and monitoring processes and

[33] The information contained in this Annex has been provided by HKMA.

[34] These include AIs that are internationally active, those with sizeable and/or sophisticated operations, and those with localised and less complex business activities.

[35] This refers to Part 3 (the Second Pillar) of the June 2006 *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version).*

[36] These include the eight inherent risks covered under the MA's risk-based supervisory framework (ie credit, market, operational, legal, interest rate, liquidity, strategic and reputation risks) and the interactions of these risks under both normal and stressed conditions.

procedures to ensure that its capital targets are attained, as well as a process of internal controls, independent reviews and audits to ensure the overall integrity of the CAAP. Under the SRP framework, AIs are required to submit their CAAP document to the HKMA for review, at least annually.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

To ascertain the adequacy of financial resources maintained by individual AIs (as required under Paragraph 6 of the Seventh Schedule to the BO), the HKMA conducts the SRP on them, including a review of their CAAP, at least annually. The SRP involves an assessment of:

(i) an AI's overall risk profile, including the inherent risks associated with the AI's business, structure and operations. This review is informed by the HKMA's ongoing risk-based supervisory process;

(ii) the extent to which such inherent risks are covered, or adequately covered, by the Pillar 1 capital requirements, having regard to the assessment framework and relevant risk and control factors set out in CA-G-5 (§3);

(iii) the adequacy of the AI's systems and controls for controlling such inherent risks, having regard to its compliance with relevant supervisory standards and guidelines issued by the HKMA;

(iv) the effectiveness of the AI's CAAP to identify additional capital needs (ie on top of minimum regulatory capital requirements). In particular, the assumptions, methodology, coverage and outcome of the CAAP will be assessed, taking into account the CAAP standards set out in CA-G-5 (§4);

(v) the AI's capital strength (in terms of quality of capital held, access to additional capital and capability to withstand economic cycles and other external risk factors); and

(vi) the AI's corporate governance arrangements and any other specific factors which may increase or mitigate its risks.

To facilitate the conduct of the SRP, the HKMA has developed a set of scorecards for the assessment of risk factors that are commonly applicable to AIs (please see Annex C of CA-G-5 for details). Other techniques and tools, such as quantitative and qualitative assessments, statistical and sensitivity analyses, stress and scenario tests, and peer group comparisons, are also employed as appropriate.

Based on the results of the SRP, the HKMA forms a view as to whether an AI needs to observe additional capital requirements (in the form of a Pillar 2 add-on that is commensurate with the AI's overall risk profile) and/or comply with other supervisory measures (eg requiring the AI to reduce risk exposures, strengthen risk management controls, or increase provisions or reserves etc) that the HKMA may impose on the AI as appropriate to address any weaknesses identified. There are a range of powers (under the BO or otherwise) that the HKMA may use for such purposes (please refer to Principles 3 and 4 below for more details).

The results of the SRP on an AI will also feed into the HKMA's assessment of the AI's CAMEL ratings (which in turn may affect the amount of premium to be paid under Hong Kong's Deposit Protection Scheme in the case of a locally incorporated bank) and the MA's supervisory plan for the AI.

The monitoring of an AI's capital adequacy, including the AI's compliance with various regulatory capital requirements applicable to it, is an ongoing process. The HKMA updates the AI's risk profile regularly, taking into account its progress in addressing any supervisory concerns raised or other events which may significantly affect the AI's ability to maintain adequate capital resources.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

As the HKMA expects AIs to maintain adequate capital to support their inherent risks (some of which may not be covered or adequately covered under Pillar 1),[37] this means that in most cases the MA considers it necessary for an AI to maintain additional capital (eg as a result of the SRP assessment) over and above the Pillar 1 levels specified in §§3A and 3B of the BCR. The MA is empowered under §97F of the BO to impose a capital add-on on an AI if the MA considers it prudent to do so, taking into account the risks associated with the AI.

In practice, the MA has imposed a Pillar 2 add-on, as a constituent part of AIs' minimum capital requirements (ie a "hard" minimum), on every locally incorporated AI, the magnitude of which is based on the outcome of the SRP assessment.[38] This recognises the importance that AIs maintain adequate capital for both Pillar 1 and Pillar 2 risks at all times. The Pillar 2 add-on is allocated across the CET1 capital ratio, Tier 1 capital ratio and Total capital ratio of an AI on a proportionate basis that reflects the prevailing split of these components in the "Pillar 1" capital. To cater for any potential overlap between the Basel III capital buffers (ie the capital conservation buffer and the countercyclical capital buffer) and the Pillar 2 add-on when the former are implemented in 2016, the HKMA has devised a method for identifying such overlap, and allowing such overlap to be absorbed in the capital buffers (please see subsection 3.4 of CA-G-5 for details).

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

The HKMA monitors the levels and trends of individual AIs' capital positions on an ongoing basis, through the collection of regular banking returns from AIs. If adverse trends are noted (eg significant deterioration in capital levels), the HKMA will institute prompt follow-up actions with the AIs concerned. As an early warning device, AIs are required to observe non-statutory trigger ratios set by the HKMA at levels above their respective minimum CARs (ie Pillar 1 plus Pillar 2 add-on). The trigger ratios are intended to provide a cushion to reduce the risk of an AI breaching its minimum CARs and to provide the HKMA with an early warning signal of deterioration in the AI's capital adequacy. The HKMA will continue using this tool to monitor AIs' capital adequacy until 31 December 2015. When the capital buffers commence operation on 1 January 2016, the use of trigger ratios is intended to be discontinued. Nevertheless, AIs will still be expected to ensure that they have comparable internal targets or monitoring tools so that timely discussion with the HKMA can be undertaken if their capital levels fall close to the buffer zone.

The HKMA's monitoring of AIs' capital adequacy, and ability to intervene at an early stage, are further reinforced by §97D(1) and §97E(2) of the BO which respectively require an AI to (i) notify the MA immediately regarding a matter prescribed in the BCR (and, in this regard, §3D of the BCR requires an AI to notify the MA immediately of any failure to maintain the minimum CARs prescribed under §97F (ie Pillar 1 and Pillar 2)); and (ii) take any remedial actions, as specified by the MA, to comply with the capital requirement.

[37] For example, the Pillar 1 capital requirements do not cover credit concentration risk, interest rate risk in the banking book, liquidity risk, strategic risk, and reputation risk and may not be sufficient to capture all credit, market and operational risks faced by AIs having regard to their specific risk profiles.

[38] A minimum ratio requirement (Pillar 1 plus Pillar 2 add-on) is imposed on an AI in respect of the CETI ratio, Tier 1 capital ratio, and Total capital ratio.

Failure of an AI to meet the statutory capital requirements may also call into question whether the AI continues to satisfy the minimum authorisation criterion stipulated in paragraph 6 of the Seventh Schedule to the BO. In addition, any non-compliance with §97D(3) or §97E(4) of the BO is a criminal offence that may render every director, chief executive and manager of the AI concerned liable to fines or imprisonment.

Specific issues addressed under the SRP

Having regard to specific issues identified in the 2006 Basel II document that banks and supervisors should particularly focus on when carrying out the SRP, as well as the supplemental Pillar 2 guidance subsequently issued by the BCBS (taking into account lessons drawn from the Global Financial Crisis), the HKMA has included relevant guidance in CA-G-5 to address:

(i) assessment of specific risk factors under the SRP (eg credit concentration risk, residual operational (and legal) risk, interest rate risk in the banking book, liquidity risk, strategic risk, and reputation risk (Annex B);

(ii) supervisory requirements relevant to the conduct of stress tests for assessing the need for additional capital to absorb losses should severe stress events occur (Annex D);

(iii) supervisory expectations on how AIs should assess and manage specific risks arising from securitisation exposures (Annex E);

(iv) supervisory requirements for the assessment and management of risk concentrations (Annex F);

(v) issues associated with high-cost credit protection transactions and how AIs should analyse such transactions for the purpose of credit risk mitigation or credit risk transfer (Annex G); and

(vi) supervisory assessment of AIs' counterparty credit risk and associated risk management systems (Annex H).