



Consultation Paper on Draft Banking (Capital) Rules ("Capital Rules").

The Law Society has the following comments on the Capital Rules:

The Capital Rules govern the calculation of capital adequacy ratio ("CAR") in line with the requirements of Basel II. The consultation paper prescribes the different approaches, models and formulae for calculating CAR and their application to locally incorporated authorized institutions. The Capital Rules are largely technical and their practical implications have to be assessed in light of the business activities and operations of the individual authorized institutions. Authorized institutions and their auditors are well positioned to review those aspects of the Capital Rules.

As regards the legal aspects and drafting of the Capital Rules, we have the following comments:

1. General

On the basis that the Capital Rules apply to authorized institutions incorporated in Hong Kong, the Capital Rules should be clarified to that effect.

2. Section 1.2 - Interpretation

"securities firm"

This definition should be clarified as to whether it includes a banking or deposit-taking institution that conducts securities business (e.g. a registered institution as defined in the Securities and Futures Ordinance, or an equivalent institution overseas).

3. Section 2.4 - Minimum requirements for approval to use BSC approach

An authorized institution applying to use the BSC approach to calculate its credit risk for non-securitization exposures is required to satisfy the HKMA that, among other things, there is no cause to believe that use of the BSC approach would not adequately identify, assess and reflect such credit risk taking into account the nature of its business.

It will be useful to clarify the requirements to facilitate compliance by authorized institutions. If the details are not specified in the Capital Rules, they should at least be set out in a guidance note or Supervisory Policy Manual. This comment applies to requirements of similar nature where an authorized institution is required to satisfy the HKMA of certain standards or things but straight-forward evidence is unlikely to be available.

4. Section 2.9 - Exemption for exposures

An authorized institution which uses the IRB approach to calculate its credit risk for non-securitization exposures may apply to the HKMA to have such exposures exempted from inclusion in the relevant calculation. The authorized institution is required to satisfy prescribed substantive criteria in order to be eligible for exemption. On top of that, section 2.9(5) gives the HKMA the power to refuse to grant exemption if it is satisfied that the authorized institution can use the IRB approach to calculate its credit risk for the relevant exposures *without incurring significant cost or expending significant resources*.

We question the regulatory rationale of section 2.9(5) if exemption will not prejudice the authorized institution's calculation of credit risk and the effectiveness of the IRB approach.

5. Section 2.10 - Revocation of exemption under section 2.9

The HKMA is empowered to revoke the exemption granted under section 2.9 if the authorized institution fails to satisfy the exemption criteria at any time after exemption is granted. According to section 2.10(1)(c), the HKMA may also require the authorized institution to submit a remedial plan to the satisfaction of the HKMA and implement the plan. If the HKMA so requires, the authorized institution must submit and implement the plan. However, notwithstanding that the authorized institution has done so, section 2.10(3) provides that the HKMA is still entitled to exercise its power to revoke the exemption.

We are of the view that section 2.10(3) should be qualified to the effect that the HKMA will not exercise its power to revoke the exemption unless the authorized institution fails to implement the remedial plan or the anticipated effect of the remedial plan is not achieved. Otherwise, the authorized institution should be given the option of accepting revocation of the exemption without pursuing remedial action.

6. Section 4.8 - Public sector entity exposures

Section 4.8(2) provides for the allocation of risk-weight to a public sector entity by reference to the credit quality grade applicable to the sovereign of the place of incorporation of that entity.

Section 4.8(2)(c) specifically refers to a credit quality grade 5 allocated to a sovereign on the basis of an ECAI issuer rating assigned to the sovereign which will translate into a

risk-weight of 100%. Given that both a credit quality grade 5 and a credit quality grade 4 on a sovereign based on an ECAI issuer rating will translate into the same risk-weight of 100%, please clarify whether section 4.8(2)(c) should refer to both credit quality grades 4 and 5.

The Law Society of Hong Kong
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