

HKMA's key responses on the soft consultation on market and CVA risk

On 11 May 2023, the Hong Kong Monetary Authority (HKMA) provided responses to the comments from the Hong Kong Association of Banks (HKAB) on the HKMA's proposed amendments to the Banking (Capital) Rules for the implementation of the revised market risk and CVA risk frameworks and the related two new Supervisory Policy Manual modules (SPMs) MR-1 and MR-2. The HKMA aims to issue the draft amendment rules and the two SPMs for statutory consultation with the industry in August 2023. We have distilled the key takeaways from the HKMA's responses below, together with our analysis of what the key updates will mean for Authorised Institutions (AIs).

1. Clarification on HKMA regulatory timeline and relevant regulatory application requirement

- All approval requests should be submitted in written format with supporting documents, to the HKMA after the amendment rules become enacted. AIs can start the discussion with the HKMA on different applications.
- No approval is required for all items in the reporting-only period as long as an AI is able to fulfill the application requirements based on its self-assessment.
- Exemption application on Structural FX (S-FX) positions is based on the S-FX risk management policy instead of the application on S-FX positions specifically.

Our take: To ensure the application can be completed before the full capital requirement effective date, AIs that intent to apply for HKMA approval should start to engage their case officer to discuss the application and commence to prepare relevant application materials. The submission of application will start once the relevant amendment rules become enacted.

	#	Application items	Submission timeline
Market risk	1	Deviation from presumptive list	Late second half of 2023
	2	S-FX position exemption	
	3	Internal risk transfer (IRT) desk set up	
	4	Items in relation to standardised approach (e.g. FX base currency approach, and use of IRB approach for rating mapping, alternative formulation of sensitivities, etc.)	
	5	Items in relation to internal models approach (e.g. use of IMA, and trading desk, etc.)	
CVA risk	6	Items in relation to CVA risk capital charge (e.g. use of SA-CVA, etc.)	Third quarter of 2023

It is expected that the AIs that have obtained S-FX positions approval for existing capital reporting need to re-submit the exemption application. For the AIs that intent to apply the application of S-FX exemption, they need to obtain the HKMA approval based on the criteria as specified in SPM MR-1 paragraph 1.3.3.

2. More detailed classification on trading book and banking book boundary

- The booking treatment of certain financial instruments are clarified by the HKMA:
 - Derivatives used for liquidity and balance sheet management (e.g. funding swap) should be assigned to the trading book at its initial recognition, except obtaining HKMA's approval on application of presumptive list or IRT of GIRR
 - Interest rate swap should be part of the presumptive list of the trading book even though the Fair Value Option under HKFRS 9 is applied to the instrument.
 - Financial Assets: The embedded derivative in relation to a banking book financial asset does not fall into the presumptive list.
 - Financial Liabilities: The embedded derivative in relation to a financial liability (e.g. capital instrument) that issued out of the banking book (e.g. callable subordinated notes and convertible bonds) and the value of such embedded derivative depends on any credit spread or equity risk factors, it falls under the presumptive list.
- For the instruments that failed in hedge effectiveness test are early terminated or closed-out before the maturity date, AIs need to confirm the date of discharging the capital surcharge with the HKMA.

Our take: AIs should develop the bifurcation methodology to calculate the market risk capital charge on embedded derivative that is from an instrument issued out of the banking book and relates to credit or equity risk.

3. More specific definition on back-to-back transaction

- The definition of back-to-back transaction has been clarified, in which all the terms of a pair of back-to-back transactions should be identical and the total notional amounts of back-to-back transaction should be exactly matched with each other.
- It is acceptable to treat a pair of back-to-back transactions as one instrument given that the net sensitivity of back-to-back transactions is always zero from the market risk perspective.
- In case the hedge of the back-to-back transaction is broken in any circumstance, the AI must be ready to calculate the respective sensitivities for its market risk capital charge.

Our take: Back-to-back transactions can be excluded from the calculation of market risk capital charge. AIs are recommended to set up a monitoring framework on back-to-back transactions to notice any case of the hedge of a back-to-back transaction is broken and a procedure to include this kind of transactions in the market risk capital charge calculation.



4. Confirmation on regulatory reporting frequency

- AIs are required to report the market and CVA risk capital charges for capital purposes in the return MA(BS)3A on a monthly basis and the total market risk and CVA risk RWA figures in the return MA(BS)3 on a quarterly basis.

Our take: It is expected that there is a dual reporting period for current and new market risk and CVA frameworks. We expect that the date of reporting-only period and the effective date of full implementation of capital charges frameworks will be confirmed by the HKMA in the subsequent consultation response of MA(BS)3A amendment.

5. Other clarifications

The clarification and supplementary information provided in the HKMA's responses get the market and CVA risk capital requirements more align with the Basel standards and the FAQs in Basel standard. Other clarifications in addition to the abovementioned include:

Market risk – Maximum open position (MOP) calculation for S-FX

- The amount of MOP to be excluded should be determined by only one selected capital ratio measure but separately calculated for different reporting basis.
- Only the FX risk of structural currency should be excluded in determining the amount of MOP.
- The sensitivity of the adjusted total risk-weighted amount with respect to the movement of the structural currency against the reporting currency is considered in the MOP calculation.
- Capital investment in HK subsidiaries dominated in foreign currency is not automatically qualified as S-FX position.
- Additional Tier 1 bonds issued by an AI dominated in foreign currency that leading to net long FX position in that foreign currency can be recognised as S-FX position.

Market risk – Standardised approach

Sensitivities based method (SBM)

- Where there is no ECAI issuer rating, AIs that use the IRB approach to calculate their credit risk may, subject to the HKMA approval, map the internal rating to one of the ECAI ratings to determine the delta risk weight.
- The determination of market capitalisation of equity is required to update at least on a monthly basis.
- Floating rate bonds with 0% floor applied on reference rate are subject to vega risk capital charge.

Default risk charge (DRC)

- Only the credit risk mitigation requirement as stated in the section 98 of the Rules applies in determining whether the exposure of guaranteed bond is an exposure to the underlying obligor or that to the guarantor.
- For exposures to Chinese policy banks, the default risk weights would be based on the ECAI issuer rating, unless it would be allocated as 0% risk weight under the standardised (credit risk) approach.
- The domestic public sector entities will not be allocated as 0% risk weight under the standardised (credit risk) approach.
- An additional table for type B ECAIs including Indian rating agencies will be provided for SA-DRC calculation for non-securitisation exposures.

Market risk – IMA

- For an AI intends to adopt the IMA, the minimum level of an AI's aggregate market risk capital charge based on the positions held in trading desks is lowered to 10% from 30%.
- AIs with multiple backtesting exceptions produced in a trading desk are allowed to continue to use the IMA only if the condition of "the most extraordinary circumstances with systemic relevance" is met.
- Key components of the internal models documentation include but not limited to the scope of application, methodology, assumptions, limitations, data sources, instructions for model users and procedures of model validation.
- AIs are allowed to use an alternative base currency under the IMA approach as long as the FX risk between HKD and the base currency is appropriately captured in the internal models.

CVA risk

- Switching from the approach of 100% of capital charge for CCR to basic CVA approach to align with global implementation of the group is allowed with no HKMA approval required if the CVA risk is not materially contributes to the overall risk of the AI.
- SFTs that are fair-valued for accounting purpose are assumed to have immaterial CVA risk by default unless AIs are notified in writing by the HKMA on the contrary.

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