18 December 2020

BY E-MAIL

Banking Policy Department
Hong Kong Monetary Authority
Two International Finance Centre,
8 Finance Street, Central,
Hong Kong

Dear Mr Ho,

Consultation paper on the Implementation of the Basel III Final Reform Package (CP 20.2)

The Asia Securities Industry & Financial Markets Association (**"ASIFMA"**)[1] and the International Swaps and Derivatives Association, Inc. (**"ISDA"**)[2] (together, the **"Associations"**) on behalf of their members welcome this opportunity to comment on the Hong Kong Monetary Authority's (**"HKMA"**) consultation paper on the proposed implementation of the Basel III final reform package (**"Consultation"**)[3] published in November 2020. In general, the industry supports finalisation of the Basel Committee on Banking Supervision's (**"BCBS"**) post-crisis reforms, noting that financial stability and the banking sector's ability to withstand shock has greatly improved because of reforms to date.

This has been demonstrated by the sector's ability to withstand the COVID-19 pandemic thus far, although we recognise that the financial and economic effects of the pandemic have yet to be fully realised. We would like to highlight that as these discussions continue to evolve globally, the comments provided by the Associations in this response to the Consultation should not be considered as a final statement on the reforms. The Associations will continue to assess the final Basel III framework over the coming months, and form our positions more fully.

Our high-level comments to the Consultation are set out below in the *General comments and policy considerations* section, which is followed by specific comments to points raised in the Consultation in the *Specific comments* section. Other relevant comments addressing aspects of the Basel III framework that are not within the scope of this Consultation are provided in the *Other Comments* section as we believe these will be generally helpful for the HKMA as international discussions continue.

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1 ASIFMA is an independent, regional trade association with over 140 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

2 Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

3 https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/CP20_02_Implementation_of_the_Basel_III_Final_Reform_Package.pdf, HKMA, Consultation Paper on the Implementation of the Basel III Final REFORM Package.

General comments and policy considerations

Timing and Alignment

The industry is grateful for the evident coordination between regulators and standard setting bodies such as BCBS, and for the decision to defer the implementation of the Basel III final reform package one year to 1 January 2023 in order to provide banks and regulators with additional operational capacity to respond to the impact of the COVID-19 pandemic.

With the pandemic ongoing and its impact on economies worldwide developing, we acknowledge there could be potential challenges to financial stability, and that raises possibility for further delay to be considered at the BCBS level. If such a decision is made, we would encourage HKMA to adjust its timeline in order to support a level playing field for market participants and minimise unintended consequences of market fragmentation.

Quantitative Impact Study (QIS)

We note HKMA undertook its local QIS in 2019, prior to the COVID-19 pandemic, and therefore not reflecting its impact on capital levels and liquidity. Should the HKMA foresee that the COVID-19 pandemic could have a material impact on banks' balance sheets, a refresh of the existing impact analysis could be warranted, notwithstanding that we fully support the international workstreams of the Basel Committee and Financial Stability Board (**"FSB"**) to review the cumulative impact of the changes to the financial regulatory framework. A comprehensive re-running of the entire existing QIS would be a resource intensive exercise for locally incorporated Authorised Institutions (**"AIs"**), and we believe that it may not be necessary, favouring instead a pragmatic approach, which would layer adjustments on top of existing QIS results. This could be both insightful and efficient for both the regulator and the firms involved.

We suggest consideration also be given in this exercise to reviewing specific impacts which are a result of a lack of availability of ratings for corporates. It is not clear from the QIS analysis feedback in the paper the extent to which this poses a particular challenge in the Hong Kong context, but this is a problem in other jurisdictions with potential implications for bank financing, which may be exacerbated in the current climate.

National Discretion

We recognise that the HKMA has proposed not to exercise certain national discretion elements, while we note that most other jurisdictions are intending or expected to make full use of Basel's flexibilities. However, the industry suggests that some national discretions are warranted under certain circumstances, and we recommend that consideration be given to exercise such discretions to support the risk sensitivity of the overall framework and avoid unintended consequences.

a. Exposures to banks – use of external ratings:

As noted in paragraph 25, we note that the HKMA is considering the necessity to exercise national discretion to allow the use of external ratings which incorporate assumptions of implicit government support for up to a period of five years, subject to any practical difficulties the industry may identify. The industry is supportive of HKMA exercising this national discretion on the basis that:

1. It is uncertain as to whether it would be feasible for external credit assessment institutions (**"ECAI"**) to start producing credit assessments without implicit government support;

2. The five-year transition period could help alleviate implementation risks and enable AIs to assess regulatory impact; and
3. We note, from the Monetary Authority of Singapore (**"MAS"**)'s consultation paper[4] and policy advice from the European Banking Authority (**"EBA"**), their plans to exercise such discretion, and as such, respectfully request the HKMA to consider the benefits of alignment from an international and cross-border perspective, in addition to the above points.

b. Finished property:

We note that in paragraph 44, the HKMA, for simplicity, intends not to exercise the national discretion to apply the same risk-weighting treatment as qualifying RRE exposures to loans to individuals that are secured by residential property under construction or land upon which residential property would be constructed. We do not think that this national discretion would introduce material complexity to the implementation of the overall framework, and other jurisdictions have indicated they plan to and/or are expected to use this option.

c. Off-balance sheet items:

We note HKMA's proposal in paragraph 47 not to exercise provision for national discretion in relation to off-balance sheet items, as provided if certain conditions are met, due to concerns of complexity if the HKMA is to elaborate on its supervisory interpretation of these conditions.

We believe that AIs could leverage on existing credit processes to demonstrate that the conditions for exemptions are met. Overall, we note that there are several other areas of implementation of the final Basel III framework that are more complex than this specific exemption. In addition, other regulators have indicated their intention to exercise national discretion on this item (e.g. the Monetary Authority of Singapore, Korea FSS) or expected to exercise it (e.g. EU, UK).

d. Leverage ratio – exemption of central bank reserves:

We note HKMA's proposal in paragraph 115 not to allow flexibility for AI's to exempt central bank reserves from the leverage exposure measure. However, we consider that such discretion may be warranted under certain circumstances and consideration should be given for these to be exercised in order to balance risk sensitivity, simplicity, and comparability.

Specific Concerns

a. Credit risk:

There are several areas of the revised Basel credit risk framework which would require clarifications of terminology and guidance on interpretation to support an effective and efficient local implementation while avoiding unintended consequences. Examples include: diligence requirements on external credit rating for banks and corporates exposures; categorisation of bank exposures; definition of the "movement of goods", granularity criterion on retail exposures; currency mismatch

[4] https://www.mas.gov.sg/-/media/MAS/resource/publications/consult_papers/2019/Consultation-Paper-on-Proposed-Implementation-of-the-Final-Basel-III-Reforms.pdf, MAS, Consultation paper on the proposed implementation of the final Basel III reforms in Singapore.

multiplier to unhedged retail exposures; supervisory expectations on mandatory move from Advanced to Foundation model approach; revenue threshold for large corporate; IRB coverage ratio. We would encourage the HKMA to engage the industry on those areas before finalising the local requirements.

There are also areas of the final Basel III framework which should be recalibrated, ideally at the international level. This includes, for instance, the increase of the PD floor to all asset classes except sovereigns from 0.03% to 0.05%, including for financial institutions which are already subject to a conservative multiplier of 1.25x under the current framework. Another issue is the 10% CCF floor on off balance sheet items or the 50% CCF applicable to low-risk trade finance off balance sheet items such as bonds and guarantees.

b. Minimum haircut floors for securities financing transactions ("SFTs"):

While the minimum haircut framework introduced by the Financial Stability Board ("FSB") seeks to limit leverage and, more specifically*, "to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage*[5]*"*, it does not sufficiently distinguish between those SFTs that are financings (and, thus, increase leverage) and those that are for another purpose.

Many SFTs are undertaken, not to provide financing, but rather to source a specific security, with the haircut being provided to the lender rather than borrower of the security. Unless revised, the SFT haircuts framework could increase SFT RWAs substantially, with significant impact coming from securities borrowing. If banks and other liquidity providers cannot access "locked away" securities held by end investors for market making through securities borrowing transactions, it would have detrimental impacts on the functioning of the HK capital markets, and secondary markets in particular.

The Associations would like to highlight that while it is appropriate to impose some penalty and there should be strong incentives for maintaining minimum haircuts, overly punitive capital charges such as those introduced by the minimum haircut framework cast an unneeded overlay on the SFT market by ignoring the risk-mitigating benefits of the remaining collateral, and we request the HKMA consider this concern in reaching a conclusion on the haircut floor as outlined in paragraph 70 of the Consultation.

c. Operational Risk

On Operational Risk, the Basel III Final Reform Package replaces all approaches with the new Standardised Measurement Approach ("**SMA**"). Our main concern with the SMA is the lack of forward-looking elements that would future proof banks form upcoming operational risks. The variable element of the formula (Internal Loss Multiplier – "**ILM**") further erodes confidence, due to the fact that it puts the emphasis of Operational Risk capital requirements on past incidents, which will have been long resolved, following bank and supervisory action. In line with other jurisdictions such as Australia, we encourage HKMA to exercise the discretion available in the Basel text and set the ILM to 1.

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5 https://www.fsb.org/wp-content/uploads/r_141013a.pdf, FSB, Strengthening Oversight and Regulation of Shadow Banking, Page 4.

d. *Output floor:*

The Associations are concerned that the accelerated phase-in arrangement of the output floor as proposed by HKMA in paragraph 105 of the Consultation will disadvantage locally-incorporated AIs compared to banks incorporated in other jurisdictions globally. Such an accelerated implementation could potentially reduce the ability of banks to lend to the real economy, disadvantaging the Hong Kong economy considerably. It should also be noted the accelerated phase-in arrangement has been proposed based on data from the QIS conducted in 2019. As noted in the Quantitative Impact Study section of this response, the Associations are supportive of a targeted refresh of the QIS, which would provide a clearer impact of the COVID-19 pandemic on capital levels and liquidity.

It should also be ensured that the Output Floor only captures capital requirements from the Basel III standards, in particular Pillar 1 and Basel buffers. That will ensure comparability of the outcome with international banks and will not disadvantage Hong Kong banks.

e. *Leverage ratio:*

The Associations are supportive of HKMA's proposals to align the revisions to the leverage ratio framework with the Basel III final package as they apply to measurement of derivative exposures, revisions to the specific treatment for written credit derivatives, treatment of regular-way purchases and sales of financial assets, credit conversion factors for off-balance sheet items, and the leverage ratio buffer for global G-SIBs.

However, as highlighted in the National Discretion section of this response, we request that HKMA allow AI's the flexibility to exempt central bank reserves from the leverage exposure measure.

Other Comments

a. *Market risk framework ("FRTB"):*

The Associations are grateful to the HKMA for the opportunity to respond to the consultation paper on FRTB published on 28 June, 2019[6]. We are also grateful for the subsequent announcement on 30 March, 2020 indicating a delay in the implementation of FRTB due to COVID-19[7].

The Associations wish to reiterate that it is important that international standards such as FRTB are applied consistently across jurisdictions, enabling banks to operate on a global level-playing field whilst also reflecting the specific financial and economic circumstances of Hong Kong and the Asia Pacific region. The Associations request that the HKMA should continue to monitor the timeline for implementation of FRTB in the European Union and United States, and not front-run implementation compared to these and other key jurisdictions. There is the real risk of regulatory fragmentation, and consequently implementation challenges for globally active banks, if the HKMA finalises the FRTB framework ahead of these key jurisdictions. Furthermore, the recent

[6] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/consultations/CP19_01_Market_Risk.pdf, HKMA, Consultation paper on market risk (CP 19.01).
[7] https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200330e1.pdf, HKMA, Deferral of Basel III implementation and HKMA's supervisory actions in response to Covid-19.

COVID-19 stress period has highlighted areas of procyclicality in the existing market risk framework, and we recommend that the calibration of the FRTB framework is monitored and assessed at an international level to address areas of conservatism.

b. Credit valuation adjustment risk ("CVA") framework:

The Associations understand that proposals for the revisions to the CVA framework are not within the scope of the Consultation, and HKMA has published a separate consultation on CVA risk on 16 December, 2020[8] ("**CVA Consultation**"). The Associations welcome the opportunity to provide HKMA with detailed feedback on HKMA's proposals on revisions to the CVA framework, and intend to respond to the CVA Consultation separately.

However, the Associations would like to highlight that the BCBS published the targeted revisions to the credit valuation adjustment risk framework in July 2020[9] ("**Revised CVA Framework**"), which reflects some of the industry feedback[10]. The Associations are supportive of the HKMA proposals aligning with the Revised CVA Framework, including with respect to:

- SA-CVA multiplier - the Revised CVA Framework introduces a reduction in the SA-CVA multiplier from 1.25 to 1.
- BA-CVA scaler - the Revised CVA Framework also introduces a scaler of 0.65 for the overall BA-CVA requirement, to ensure there is an appropriate level of calibration between BA-CVA and SA-CVA approaches.
- Exclusion of certain SFTs and CCTs - the Revised CVA Framework also excludes certain SFTs and client cleared transactions ("**CCTs**") from CVA capital requirements, under specific circumstances. Losses incurred on SFTs and client cleared transactions due to a default already fully covered by the counterparty credit risk ("**CCR**") framework, and better alignment of the CVA and CCR rules will help to prevent a potential double count in capital charges.
- Reduction in MPOR for SFTs and CCTs - the reduction in the supervisory floor for the margin period of risk ("**MPOR**") in the Revised CVA Framework for certain SFTs and CCTs from ten to five business days ensures better alignment between regulatory CVA and accounting practices (although the MPOR of 10 business days for all other derivatives transactions remains unchanged).
- Index hedges - given the lack of liquidity in many single-name credit default swap contracts, firms typically use indices as a proxy to hedge their CVA risk at the portfolio level. The Revised CVA Framework replicate the market risk framework by introducing new index buckets in the counterparty credit spread risk class, the reference credit spread risk class and the equity risk class for SA-CVA. For credit and equity indices that satisfy certain liquidity and diversification conditions, firms will now have the ability to calculate CVA capital based on the index buckets rather than looking through to the underlying names.

[8] https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/CP20_03_CVA_Risk.pdf, HKMA, Consultation paper on CVA Risk (CP 20.03)
[9] https://www.bis.org/bcbs/publ/d507.pdf, BCBS, Targeted revisions to the credit valuation adjustment risk framework.
[10] https://www.isda.org/a/72oTE/ISDA_GFMA_IIF_CVA_Consultation_Response.pdf, ISDA/GFMA/IIF, Industry response - BCBS consultation - Credit Valuation Adjustment risk: targeted final revisions.

- Changes in Supervisory Risk Weights - align with the changes to supervisory risk weights in the Revised CVA framework for SA-CVA to align with the revised market risk framework.

However, the Revised CVA Framework did not consider some feedback provided by the industry, including:

- further granularity in the risk buckets for financial institutions to better reflect differences in the risk profile between different types of organizations (for example, pension funds and hedge funds); and
- further amendments to the index buckets, aggregation formula and a reduced MPOR for all derivatives to better reflect the economic risks of CVA and to incentivize prudent hedging practices.

We would be grateful if the HKMA would consider these additional points as part of the CVA Consultation, and the Associations will provide additional information on these areas as part of the consultation process.

Conclusion

We reiterate the industry's embrace of the objectives set out in the Basel post-crisis reforms in increasing global financial stability, and improvements made to Banks' abilities to withstand shocks due to the thoughtful implementation to date.

The Associations hope to continue the constructive ongoing dialogue between HKMA and market participants, and intend to follow our submission with additional technical details not covered in this response.

If you have further questions or would otherwise like to follow up, please contact Matthew Chan, Head of Policy and Regulatory Affairs at ASIFMA, at mchan@asifma.org or +852 2531 6560, and Rahul Advani, Head of Public Policy, Asia Pacific at ISDA, at radvani@isda.org or +65 6653 4171. We would also be happy to meet with you to discuss this letter if you deem it appropriate.

Sincerely,

Mark Austen
Chief Executive Officer
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