RESPONSE TO FEEDBACK RECEIVED – CONSULTATION ON PROPOSALS FOR THE IMPLEMENTATION OF BASEL II IN SINGAPORE – PHASE 3

1. General Comments

1.1 In June 2006, MAS invited Singapore-incorporated banks to comment on draft rules and guidelines relating to the calculation of capital requirements for equity and securitisation exposures under Basel II.

1.2 We thank all respondents for their comments. MAS has considered carefully the feedback received, and where it agrees with the comments, has incorporated them into the revised draft guidance. The comments that are of wider interest and MAS' responses are set out below.

2. Definition of Equity Exposure

2.1 One respondent requested more guidance on how to distinguish whether an instrument should be treated as debt or equity for the purposes of calculating regulatory capital requirements. Another respondent asked whether preference shares should be treated as equity exposure although it is deemed as debt in accounting. Yet another respondent sought clarification on whether investments in real estate investment trusts ("REITs"), unit trusts and money market funds will be treated as equity exposure.

MAS’ Response

2.2 For determining the appropriate risk charges under the capital rules, an instrument that meets the definition of an equity exposure as set out in Sub-division 1 of Division 5 of Part VII of the Notice should be classified as an equity exposure. It would not be possible to provide comprehensive guidance on whether a specific instrument should be treated as debt or equity. Nevertheless, as an example, MAS would generally regard perpetual instruments that are irredeemable or redeemable only at the issuer’s option as equity exposures. Some such instruments are convertible preference shares, irredeemable perpetual preference shares and perpetual preference shares that are redeemable only at the issuer's option. Perpetual preference shares redeemable at the holder's option and term preference shares would be treated as debt. This example has been included in the revised draft rules.

2.3 All investments in collective investment schemes, e.g. REITs, unit trusts and money market funds, will normally be treated as equity exposures unless the Reporting Bank, if required by the Authority, is able to demonstrate that a look-through approach is appropriate. This has been clarified in the revised draft rules.

3. Calculation of Risk-Weighted Assets (“RWA”) for Options and Warrants

3.1 MAS proposed that a Reporting Bank shall exclude any equity exposure held in the trading book from its calculation of Equity RWA. One respondent sought clarification as to whether a Reporting Bank is required to compute credit RWA for options and warrants held in the trading book and if so, the methodology to be used. The respondent also asked whether credit RWA for options and warrants held in the banking book should be computed based on the current exposure method or as provided under the proposed equity rules. Some respondents sought guidance on the measurement of exposure value for derivatives.

MAS' Response

3.2 For equity derivative exposures in the trading book, a Reporting Bank must compute:

(a) Market RWA for the equity position risk using the approaches set out in Part VIII of the Notice; and

(b) Credit RWA for the counterparty credit risk arising from such OTC derivative transactions. The relevant exposure amount is derived using the current exposure method (or if the Reporting Bank chooses, the standardised or internal models methods).

3.3 For equity derivative exposures in the banking book, a Reporting bank must compute:

(a) Credit RWA for the equity exposure as provided for in sub-divisions 4 and 5 of Division 5 of Part VII of the Notice. The relevant exposure amount should be the fair value of the equity derivative if no hedge is involved, except for any equity exposure where the Reporting Bank has elected not to recognise the revaluation gains as Upper Tier 2 Capital pursuant to paragraph 6.2.1(e) of Division 2 of Part VI, in which case the relevant exposure amount should be equal to the historical cost of that investment less provision for impairment; and

(b) Credit RWA for the counterparty credit risk as per paragraph 3.2(b) above.

4. Calculation of Credit RWA for Equity Exposures which are Partially Deducted from Tier 1 Capital and Tier 2 Capital

4.1 MAS proposed that a Reporting Bank shall exclude any equity exposure that is included in Deductions from Tier 1 Capital and

Deductions from Tier 2 Capital from its calculation of Credit RWA for equity exposures. One respondent sought clarification on the capital treatment for equity exposures which are partially deducted.

MAS' Response

4.2 Credit RWA for equity exposures should be computed based on the portion of equity holdings that has not been included in Deductions from Tier 1 Capital and Deductions from Tier 2 Capital (excluding PE/VC investments). In determining whether it meets the materiality threshold for exclusion from using the IRBA for equity exposures, a Reporting Bank should compare the risk-weighted portion of its equity holdings (excluding PE/VC investments) against its Eligible Total Capital (as defined in Part VI of the Notice).

5. Methods for calculating Credit RWA for Equity Exposures

5.1 MAS proposed that a Reporting Bank may use different methods for different portfolios of equity investments. One respondent asked if MAS would allow a Reporting Bank to use the Simple Risk Weight Method for its "pure" equity exposures and the PD/LGD method for its investment in the Tier 1 Capital of banks that are structured in the form of debt.

MAS' Response

5.2 Reporting Banks are allowed to use different methods for different portfolios of equity investments. However, Reporting Banks should, if required by the Authority, be able to demonstrate that their choices are made consistently and address the risks faced by their equity portfolio and not determined by capital arbitrage considerations.

6. Simple Risk Weight Method – Hedging

6.1 MAS proposed that short cash positions and derivative instruments held in the banking book are permitted to offset long positions in the same individual stocks provided that these instruments have been explicitly designated as hedges of specific equity holdings and that they have remaining maturities of at least one year. One respondent proposed that the Authority consider accommodating hedges which may be short-term because of their nature e.g. options. The respondent also asked whether equity-linked derivatives can be used as hedges for equity-index linked instruments. In addition, the respondent sought clarification on the Authority's expectations on hedge documentation and monitoring of hedge effectiveness.

MAS' Response

6.2 MAS maintains that, for hedging purpose, instruments should have remaining maturities of at least one year which is in line with Basel's requirement. MAS expects Reporting Banks to, if required by MAS, be able to demonstrate how equity-index linked instruments will provide an effective hedge. Reporting Banks should be guided by accounting standard FRS 39.88(a), which sets out the requirements for hedge documentation and monitoring of hedge effectiveness over time. In addition, MAS expects Reporting Banks to conduct a review of the effectiveness of the hedge at least quarterly.

7. Use of Internal Models Method ("IMM")

7.1 MAS proposed that a Reporting Bank shall not use the IMM to calculate the credit risk-weighted exposure amount of its equity exposures (other than PE/VC investments) unless it has received supervisory permission to use the IMA to calculate Market RWA. One respondent asked whether separate approval, from the Internal Models Approach ("IMA") for market risk, would be required for the use of the IMM for banking book equities.

MAS' Response

7.2 Reporting Banks are required to seek separate approval from the Authority to use the IMM for banking book equities. Reporting Banks may adopt the IMM for banking book equities for regulatory capital purposes only if it has obtained the Authority's approval for the adoption of IMA for market risks.

8. Measurement of E or EAD for Equity Exposures and PE/VC investments

8.1 MAS proposed that E or EAD, whichever is applicable, for any equity investments, should be equal to the fair value of that investment presented in the balance sheet except:

(a) for any equity investment held at cost, E or EAD, whichever is applicable, should be equal to the cost of that investment presented in the balance sheet (i.e. cost less impairment); and

(b) for any AFS equity investment, E or EAD, whichever is applicable, should be equal to the fair value of that AFS equity investment gross of any unrealised fair value gains or losses on revaluation of that AFS equity investment to be included in Deductions from Tier 1 Capital pursuant to paragraph 6.1.1(b) of Division 1 of Part VI, if the Reporting Bank has elected not to recognise the revaluation gains as Upper Tier 2 Capital pursuant to paragraph 6.2.1(e) of Division 2 of Part VI.

8.2 One respondent sought clarification on whether Reporting Banks are allowed to measure E or EAD using the cost of investment for the purpose of credit RWA calculation, notwithstanding the IFRS 39 accounting requirement to apply fair valuation. The respondent also asked if the cost of investment should be used for the purpose of

comparing against the materiality threshold as set out in the guidelines on IRBA rollout.

MAS' Response

8.3 If Reporting Banks elect not to recognise revaluation gains as Upper Tier 2 Capital, then E or EAD should be the cost of investment. Similarly, the cost of investment can be used to compute the equity materiality threshold notwithstanding the accounting treatment under FRS 39.

9. Scope of application of the Securitisation Framework

9.1 Several respondents sought clarity on the requirement for a Reporting Bank that acts as an originator or a sponsor to transfer all of the securitised exposures and any securitisation exposures that it retains to the banking book if they were previously held in the trading book.

9.2 One respondent also sought confirmation that derivative-related activity similar to bespoke tranches which are related to pools of credit, e.g. CDS-based credit indices, would not be considered securitisation transactions. Such products are benchmark credit products used for hedging and trading by major commercial banks and these activities should not be subject to the Basel II securitisation framework.

MAS' Response

9.3 MAS will remove the requirement for the transfer of securitised exposures and any retained securitisation exposures to the banking book. In its place, MAS will require that a Reporting Bank comply with the conditions in Annex 7AD before it can exclude the securitised exposures from its regulatory capital calculations in the case of a traditional securitisation or recognise the credit protection in the case of

a synthetic securitisation, regardless of whether the securitised exposures were held in the banking book or the trading book.

9.4 The securitisation framework set out in Division 6 of Part VII, with the exception of the clean sale requirements, applies only to securitisation exposures included in the banking book. Where a Reporting Bank invests in CDS-based credit indices or other such products and these exposures meet the criteria for inclusion in the trading book, the applicable rules concerning such exposures in the trading book would apply. For avoidance of doubt, exposures in the trading book that fall within the definition of a "securitisation exposure" and that would otherwise be included in Deductions from Tier 1 Capital and Deductions from Tier 2 Capital under the securitisation framework set out in Division 6 of Part VII would be subject to a specific risk capital charge that is no less than the charge set forth in the securitisation framework (i.e. 1,250%).

10. Risk weights under the Standardised Approach for Securitisation ("SA(SE)")

10.1 Several respondents requested that MAS consider allowing a Reporting Bank to apply a 350% risk weight to exposures with a credit quality grade of 9, 10 or 11 where it is a third party investor, instead of requiring that these exposures be deducted.

MAS' Response

10.2 MAS agrees and will allow a Reporting Bank that is an investing bank to apply a 350% risk weight to securitisation exposures with a credit quality grade of 9, 10 or 11.

11. Clean sale

11.1 One respondent proposed that the requirement for a Reporting Bank to hold not more than 20 per cent of the aggregate original amount of all securities issued by the SPE as a condition for clean sale be deleted as:

(a) the holding of securities in itself does not impinge on the transfer of credit risk or evidence implicit support;

(b) the requirement is not in Basel II;

(c) the requirement is not risk-sensitive; and

(d) a Reporting Bank would already be subject to capital requirements for securitisation exposures that it retains or repurchases.

MAS' Response

11.2 Although Basel II does not prescribe a limit, it requires as a condition for clean sale that significant credit risk associated with the securitised exposures must be transferred to third parties. To provide clarity, we have specified that a Reporting Bank should hold no more than 20 per cent of the aggregate original amount of securities issued by the SPE if this condition is to be met. However, to make this condition more risk sensitive, we will not apply this limit in instances where the securities held by the Reporting Bank have a credit quality grade of 1.

12. Credit conversion factors (CCFs) for off-balance sheet items

12.1 Several respondents requested that MAS consider allowing a Reporting Bank to apply the Basel II CCFs to general market disruption

eligible liquidity facilities and eligible servicer cash advance facilities. One respondent also proposed that MAS allow a Reporting Bank to apply the CCF for eligible servicer cash advance facilities without having to obtain MAS' consent prior to the transaction.

MAS' Response

12.2 MAS agrees and will allow a Reporting Bank to apply the Basel II CCFs to general market disruption eligible liquidity facilities and eligible servicer cash advance facilities. In place of the requirement to obtain MAS' consent for the application of the CCF for eligible servicer cash advance facilities, we will require a Reporting Bank to notify MAS if it intends to provide such cash advance facilities and when there is a drawdown.

13. Supervisory Formula ("SF")

13.1 One respondent asked if a Reporting Bank could be exempt from the requirement to split an exposure into a senior portion above K_{IRB} and a junior portion for the purpose of calculating the capital charge under the SF where $L \leq K_{IRB}$, subject to the same approach being applied to all applicable transactions.

MAS' Response

13.2 We note that the volume of securitisation exposures currently held by Reporting Banks may not be sufficient to warrant the enhancements necessary to split an exposure into a senior and a junior portion. In view of this, we will allow a Reporting Bank the option of adopting the more conservative approach of including the entire exposure in Deductions from Tier 1 Capital and Deductions from Tier 2 Capital where $L \leq K_{IRB.}$ We will however, continue to provide Reporting Banks with the option of using the more sophisticated approach if they are able to do so.

14. Definition of “Securitisation Exposure”

14.1 Several respondents commented that exposures to interest rate and currency swaps with a securitisation SPE should be excluded from the definition of a “securitisation exposure”. The respondents proposed that the capital requirements for such exposures could be calculated as part of market RWA or taken into account under Pillar 2 (e.g. under interest rate risk in the banking book) instead.

MAS’ Response

14.2 MAS will provide a Reporting Bank with the flexibility to deal with interest rate and currency swaps in securitisation transactions either as (a) securitisation exposures or (b) through market risk and Pillar 2, based on whether these swaps are intended to tranche the underlying credit risk exposures or are incidental to the securitisation transaction (e.g. to swap cashflows into different currencies to meet investors' demand) respectively. Notwithstanding this, where such swaps are used by a Reporting Bank to absorb losses incurred by the SPE or to provide recourse to investors, they would be viewed as a form of implicit support under the securitisation framework and should be included in Deductions from Tier 1 Capital and Deductions from Tier 2 Capital.

MONETARY AUTHORITY OF SINGAPORE
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