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Exposure Limits

HONG KONG MONETARY AUTHORITY
香港金融管理局

Contents

I INTRODUCTION

1 Purpose

1 This consultation paper sets out the Hong Kong Monetary Authority's (HKMA) proposals for updating the current regulations on Exposure Limits (i.e. on large exposures and concentration risks) in Part XV of the Banking Ordinance (BO).

2 The HKMA invites comments on the proposals in this paper by 23 May 2016.

3 Following the close of this consultation, the HKMA will further refine its proposals taking into account the feedback received. We intend, through a Banking (Amendment) Ordinance to replace Part XV of the BO with a power for the HKMA to make rules (broadly similar to the approach adopted in respect of capital and liquidity requirements) and to include the detailed provisions relating to the calculation of large exposure and concentration limits into the rules made under this power. The rules would be intended to take the form of subsidiary legislation and would hence be subject to negative vetting by the Legislative Council.

4 In order to better assess the impact of the proposals on the banking sector in Hong Kong, we also intend to conduct a local Quantitative Impact Study (QIS) over the summer of 2016. Authorized Institutions (AIs) will be approached separately regarding their participation in the QIS. Relevant Supervisory Policy Manual (SPM) modules will also be revised as necessary to reflect the new regulatory framework introduced by the rules. Industry Associations will be consulted on the new rules and revised SPM modules before they enter into effect.

2 Background

5 In April 2014 the Basel Committee on Banking Supervision (BCBS) issued a "Supervisory framework for measuring and controlling large exposures"[1] to replace the existing standards[2] which were originally published in 1991. The new framework is designed to provide for the enhanced measurement of exposures in a manner which better reflects a bank's economic loss when a counterparty defaults. The new framework is also more comprehensive than the 1991 principles in terms of

[1] http://www.bis.org/publ/bcbs283.pdf
[2] http://www.bis.org/publ/bcbsc121.pdf

coverage and provides more detailed guidance in relation to the treatment of exposures arising from specific instruments.

6 Consisting of a comprehensive Pillar 1 minimum standard for internationally active banks, the new framework is designed to function as a simple backstop to the risk-based capital standards, avoiding the complexity of models or bank-specific assumptions.

7 The HKMA proposes to implement the new BCBS framework locally, building on the proposals set out in this paper, from 1 January 2018. This essentially involves the replacement of section 81 BO. Taking this opportunity, we have however also undertaken a comprehensive review of all of the provisions in Part XV which houses regulations on concentration risks more generally (in addition to the large exposures provisions in section 81) and which has been in effect for many years. The purpose of the review was to consider whether, and how best, to update all of the various provisions in Part XV BO in the light of the changes brought about by the new BCBS framework and of market and other regulatory developments in recent years. Our detailed proposals for implementing the new BCBS large exposures framework locally are set out in sections II and III, while the results of the review of the remainder of Part XV BO and the consequent proposed amendments are discussed in section IV of this consultation paper.

8 As noted above, given that the regulations under Part XV BO are generally of quite a technical nature, driven by international standards and interrelated, we are minded to seek a rule making power and include the revised requirements in a set of "Exposure Limits Rules". The inclusion of technical regulations, derived from international standards, into subsidiary legislation in the form of rules should facilitate future updating in line with any subsequent changes in the underlying international standards. This is particularly relevant in this case given that the BCBS has yet to reach a final position on the treatment of exposures to (i) banks (for interbank exposures), (ii) securities financing transactions and (iii) qualifying central counterparties (QCCPs) (as defined in section 226V(1) BCR) and intends to address these issues in 2016. The relevant final standards in these areas will need to be incorporated into the local rules in due course.

9 The new BCBS framework limits exposures to most single counterparties and to groups of linked counterparties (that is counterparties linked to each other through a control relationship or economic interdependence) to 25% of a bank's Tier 1 capital. A stricter 15% limit is required for exposures between global systemically important banks (G-SIBs). Exposures to sovereigns, intra-group counterparties and, as noted above, QCCPs are presently not within the scope of the framework. There are also

no limits and (in contrast to the 1991 principles), no recommendations on geographical or sectoral concentrations.

10 The framework is designed to limit exposures to individual counterparties in case of their default. The probability of such a default is not taken into account for the purposes of the framework.

11 For most positions, the exposures are calculated in exactly the same way as for the regulatory capital standards. Exceptions to this principle include exposures in relation to options and credit risk mitigation (CRM). While the capital standards partially rely on approximating option price behaviour under certain price shock assumptions for the underlying, the large exposures framework is based on the assumption of a jump-to-default for which the delta-gamma approximation commonly used for capital requirement calculations cannot deliver meaningful results.

12 For most CRM transactions, the amount of the protected exposure to the original reference obligor is subject to a compulsory "shifting" to the CRM provider. The implicit assumption behind this treatment is a multiple default scenario in which (i) all the obligors on whom credit protection from a specific CRM provider was bought default together and (ii), at the same time, the credit protection provider itself also defaults.

13 Unlike the 1991 principles, the new BCBS framework provides detailed guidance on the calculation of exposure measures. This extends to the treatment of specific exposure types such as exposures connected with sovereigns (e.g. public sector entities), interbank positions, covered bonds, collective investment undertakings (CIUs), securitisation vehicles and other structures.

3 Implementation Timeline

14 According to the BCBS timeline, all aspects of the new large exposures framework should be implemented in BCBS member jurisdictions in full by 1 January 2019. We propose to implement the new framework locally earlier from 1 January 2018. This is driven by the following considerations:

- The existing regulations under section 81 BO are now outdated. Given the increase in activities in the local OTC derivatives market in recent years, there is a need to expand the scope of exposures covered by the statutory limit sooner rather than later to fully capture the counterparty credit risk exposures arising from OTC derivatives.

- The new large exposures standards are more effective (in the sense that the exposure definition is now more closely aligned with the actual loss if the relevant counterparty defaults), comprehensive and detailed with additional standards provided for specific types of exposure. It will therefore be beneficial from the perspective of prudential supervision to implement the new standards earlier rather than waiting until the BCBS deadline.
- In implementing the new framework, the opportunity can also be taken to update other provisions currently in Part XV BO (i.e. harmonising the definition of exposures across all large exposure and concentration limit provisions and aligning provisions with market developments).

II APPLICATION

4 Scope

15 The new BCBS large exposures framework is applicable to all internationally active banks. National supervisors may however extend the framework to a wider range of banks.

16 To be consistent with the philosophy underlying the current regulation in section 81 BO, we propose that the new framework should generally be applicable to all locally incorporated AIs. As an exception to this general principle, however, the HKMA is inclined to offer an alternative treatment for use by AIs that are not considered to be "internationally active"[3] in respect of CRM exposures (see paragraph 57). The industry is also welcome to suggest alternative treatments in respect of other aspects of the new framework in its application to non-internationally active AIs, if applying the framework is considered unduly burdensome or disproportionate for these AIs. However any such alternative treatment should not represent a markedly less stringent treatment than that proposed in the new BCBS framework.

5 Limits

5.1 *Standard Limit*

17 The HKMA proposes to adopt the "standard" large exposure limit in the new BCBS framework. Hence a locally incorporated AI's exposures to a single counterparty (or a single group of linked counterparties) must not exceed 25% of its Tier 1 capital. In comparison to the existing large exposures regulations, specific treatments will be prescribed (reflecting those in the new BCBS framework) for the measurement of different types of exposure and these are explained in further detail in section III. On the other side of the equation, the measure of the capital base to which the new limit makes reference will change from total capital (as now in Part XV BO) to the narrower Tier 1 capital measure.

[3] A locally incorporated AI that is not designated as a domestic systemically important bank may regard itself as non-internationally active for this purpose.

18 Following the same principle applicable to linked counterparties, exposures to a group of linked investments that share a common risk factor will also be required to be subject to the limit (see section 6.2).

5.2 *Limit for Inter-G-SIB Exposures*

19 Concerns about interconnectedness and contagion between G-SIBs have led the BCBS to set a tighter limit on exposures between G-SIBs in the new framework. In line with this, a locally incorporated AI that is designated as a G-SIB will be required to observe an additional limit for its exposures to another G-SIB. This limit will be equal to 15% of the AI's Tier 1 capital. The HKMA intends to apply the limit at the consolidated G-SIB entity level but not to individual subsidiaries of G-SIBs.

20 The tighter 15% limit also applies to groups of linked counterparties as described in section 6.1, if one or several counterparties involved in the group of linked counterparties are G-SIBs.

21 When an AI becomes designated as a G-SIB it, and other G-SIBs with exposures to it, must apply the 15% limit within twelve months. This reflects the timeframe generally permitted for a new G-SIB to satisfy the higher loss absorbency requirements becoming applicable to it as a G-SIB and is in line with the new BCBS large exposures framework. However, the HKMA also proposes to retain a degree of flexibility to require compliance with the lower limit within a shorter period time (but in any event not less than six months) where the HKMA considers the level of exposures to a new G-SIB as detrimental to financial stability.

6 Linked Exposures

6.1 *Grouping of Linked Counterparties*

22 Two or more natural or legal persons will constitute a group of linked counterparties[4] if one of the counterparties has control directly or indirectly over one or more of the others or if there is an economic interdependence between them. Given that there is already a degree of latitude incorporated into the criteria defining

[4] Differing from the terminology used in the BCBS framework, we use the term "linked counterparties" (instead of "connected counterparties") here in order to avoid confusion with the term "connected parties" which is used for parties connected to an AI, rather than connected among themselves, in the context of section 83 BO.

linked counterparties, the HKMA would not propose to grant individual exemptions in respect of such groupings notwithstanding that the new BCBS framework would accommodate this additional flexibility.

23 One counterparty is regarded as having control over another counterparty if:

a. it owns more than 50% of the voting rights in the other counterparty;
b. it has control of a majority of the voting rights in the other counterparty pursuant to an agreement with other shareholders;
c. it has the right to appoint or remove a majority of the members of the other counterparty's board of directors or management committee, or a majority of the members in the other counterparty's board of directors or management committee have been appointed solely as a result of the first counterparty exercising its voting rights;
d. it has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of the other counterparty (i.e. through consent rights over key decisions).

24 If an AI's exposure to an individual counterparty, counterparty A, exceeds 5% of the AI's Tier 1 capital, the AI should also regard any other counterparty of the AI that meets any of the criteria below, vis-à-vis counterparty A, as belonging to the same group of linked counterparties as counterparty A:

- 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other counterparty;
- one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable in respect of that exposure in any other manner (e.g. by the giving of an indemnity), and the exposure is so significant that the guarantor/indemnifier is likely to default if a claim occurs;
- the majority of one counterparty's product/output is sold to the other counterparty, and the other counterparty cannot easily be replaced by other customers;
- the expected source of funds to repay each loan which one counterparty makes to the other is the same and the counterparty does not have another source of income from which the loan may be fully repaid;
- it is likely that the financial problems of one counterparty would cause difficulties for the other counterparty in terms of full and timely repayment of liabilities;
- the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other; or

- when two or more counterparties rely on the same source for the majority of their funding and, in the event of the common funding provider's default, an alternative provider cannot be found.

6.2 *Grouping of Linked Investments*

25 As noted in paragraph 18, exposures to a group of linked investments that share a common risk factor will also be required to be subject to the standard limit. For this purpose the following investments are regarded as a group of linked investments:

a. two or more investment funds which are managed by the same fund manager, except where the custodian of the fund assets is a separate legal entity;
b. two or more asset-backed commercial paper issues (ABCP) in respect of which the liquidity provider is the same;
c. two or more ABCP issues of which the sponsor is the same;
d. two or more investments in respect of which the credit protection provider (i.e. the seller of protection) by means of credit default swap (CDS) / guarantee is the same.

26 The above list contains the major common risk factors presently known to regulators. To cater for the emergence of additional common risk factors which are significant to the local market in the future, the HKMA proposes to retain the flexibility to add to the list.

27 As mentioned in paragraph 17, the standard limit applies to a group of linked investments. If the third party that constitutes a common risk factor to a group of linked investments is a credit protection provider, an AI will also be required to add its exposures arising from the group of linked investments associated with that third party to its other exposures (such as loans) to that third party for the purposes of compliance with the large exposure limits.

7 Regulatory Reporting

28 The sum of all of an AI's exposures to an individual counterparty or to counterparties with linked exposures, as defined in section 6, will be considered a *large exposure* for regulatory reporting purposes if it equals or exceeds 10% of the AI's Tier 1 capital. The value of the exposure would be measured as described in section III.

29 AIs will be required to report to the HKMA the exposure values both before and after application of any CRM techniques.

30 AIs must report:

(i) all exposures with values, measured as described in section III, that equal or exceed 10% of the AI's Tier 1 capital (i.e. all large exposures);

(ii) all other exposures with values, measured as described in section III, without the effect of CRM being taken into account, that equal or exceed 10% of the AI's Tier 1 capital;

(iii) all exempted exposures (see section 12) with values that equal or exceed 10% of the AI's Tier 1 capital;

(iv) their largest 20 exposures to counterparties as measured in line with section III and included in the scope of application, irrespective of the values of these exposures relative to the AI's Tier 1 capital.

III EXPOSURE MEASURES

8 Principles

8.1 *Scope of Exposures*

31 Generally, all exposures subject to regulatory capital requirements will also be subject to the large exposures regime. This includes both on- and off-balance sheet exposures either in the banking or the trading book as well as counterparty credit risk exposures captured under the risk-based capital framework.

32 Certain exposures might be excluded from the scope of the regime. Please see sections 12.2 (interbank exposures), 12.5 (exposures to central counterparties) and 12.7 (other exposures currently exempted under section 81 BO) for further discussion on this.

33 An exposure to a counterparty that is deducted from capital will not be subject to the large exposure limit. Exposures attracting a 1,250% risk weight however are generally within scope.

8.2 *Definition of Exposure Value*

34 We propose that exposure values should be net of specific provisions and value adjustments. AIs that would prefer measuring exposures gross of specific provisions and value adjustments[5] would be able to do so if they notify the HKMA in advance and provide their justifications for doing so.

35 The exposure value for on-balance sheet exposures in the banking book will be the current accounting value of the exposure. This is in line with the current definition of value under section 79 BO.

36 The exposure value for "traditional" off-balance sheet items, i.e. those specified in the Specification of Factors (Financial Exposure of Authorized Institution) Notice 2007 (Cap 155P)[6] will be the credit exposure equivalent obtained by multiplying the nominal value of the exposure by the credit conversion factors (CCFs). Under section

[5] Valuation adjustment refers to those provided for in section 4.5 of the Supervisory Policy Manual module CA-G-10 on Financial Instrument Fair Value Practices and credit valuation adjustment as defined in section 2 BCR.

[6] http://www.legislation.gov.hk/blis_pdf.nsf/6799165D2FEE3FA94825755E0033E532/825F7EEC336C132B482575EE00465D44/$FILE/CAP_155P_e_b5.pdf

81 BO, currently the applicable CCFs are standardised at 100%. In contrast, under the new framework the applicable CCFs will be those currently used in the standardised approach for credit risk under the risk-based capital framework (STC approach), with a floor of 10%. Therefore, CCFs under the new framework may be less than 100%.

37 Further details on the determination of the exposure value for exposures in the trading book are set out in section 10.

38 The exposure value for instruments that give rise to counterparty credit risk and are not securities financing transactions (SFT) will be the exposure at default according to the new BCBS standardised approach for counterparty credit risk (SA-CCR)[7] or the Modified Current Exposure Method (Modified CEM) according to section III of CP 15.01.[8] The HKMA consulted the industry associations on 13 October 2015 on its plans to implement SA-CCR locally from 1 January 2017.[9]

39 For a derivative transaction (other than credit derivatives[10]), in addition to the exposure to a counterparty according to paragraph 38, AIs also need to take into account exposures to the issuer of the underlying reference obligation. This value corresponds to the loss resulting in case of a default of the underlying instrument's issuer. Net negative losses must be ignored in this context.

40 For example, if an AI purchases a call option on equity A from counterparty X, the AI will need to take into account both an exposure to A—equal to the option's banking book value—and an exposure to counterparty X, quantified based on the SA-CCR or, if applicable, the Modified CEM. If, as another example, an AI holds a long future position on equity B purchased from counterparty Y, it will need to consider an exposure to B in the amount of the value lost if B defaults and an exposure to counterparty Y quantified in the manner described in paragraph 36.

41 In relation to SFTs, the BCBS is currently reviewing its standardised approach for credit risk under the regulatory capital framework, including the comprehensive approach used for the measurement of SFT exposures. The HKMA would intend to adopt the BCBS's revised comprehensive approach and supervisory haircuts—or an equivalent non-internal model method—once finalised and agreed on the international level. Until then, it is proposed that AIs should use the same method they use for the calculation of their risk-based capital requirements against SFTs.

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[7] http://www.bis.org/publ/bcbs279.pdf

[8] See footnote 9.

[9] http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/basel-3/Consultation_paper_CP_15_01.pdf

[10] For the treatment of credit derivatives see section 9.

42 The exposure value of an AI's investment in a structure with underlying assets (i.e. index positions, securitizations, hedge funds or investment funds) would be calculated in the manner described in paragraphs 96−99. The amount invested in a particular structure may be assigned to the structure itself (defined as a distinct counterparty), to the counterparties corresponding to the underlying assets, or to the "unknown client" (see paragraph 99).

43 The value of a group of linked investments is the aggregate value of the respective investments.

9 Credit Risk Mitigation (CRM)

9.1 *Eligibility*

44 Under section 81 BO, an exposure is not generally allowed to be reduced by the value of any relevant CRM. There are a few exceptions for a limited scope of CRM techniques when the HKMA's explicit approval is obtained. For example, the financial exposure of an AI shall not include any financial exposure to the extent to which it is secured by a cash deposit or securities issued by a central government, subject to the HKMA's approval. A fundamental change under the new framework is that CRM techniques recognised under the STC approach will generally be recognised to reduce a relevant exposure for the purpose of determining compliance with the large exposure limits.

45 This means that, locally, eligible CRM techniques for the purposes of determining large exposures will include recognised guarantees, recognised credit derivative contracts and recognised collateral under the STC approach in the Banking (Capital) Rules (BCR). The minimum requirements and eligibility criteria for these CRM techniques are set out in sections 98−99 and 77 BCR respectively. However for the purposes of the large exposures framework, real property is excluded from eligible CRM techniques (and will not reduce relevant exposure values in the context of exposure limits) notwithstanding its recognition as eligible collateral under section 79(1)(p) BCR.

46 In addition, for exposures in the trading book, credit derivative contracts will only be regarded as acceptable CRM if the additional requirements described in paragraphs 74−76 are satisfied.

47 Other forms of collateral that are only recognised under the internal-ratings based (IRB) approach in accordance with sections 205−208 BCR (receivables, commercial and residential real estate and other collateral) will not be eligible to reduce exposure values for large exposures purposes.

48 An AI would be required to recognise an eligible CRM technique in the calculation of an exposure whenever it has used this technique to calculate its risk-based capital requirements for the same exposure (except in relation to real property), and provided the CRM meets the conditions for recognition under the large exposures framework.

49 In accordance with the provisions set out in section 103(2)(a) and (b) BCR, hedges with maturity mismatches will only be recognised when their original maturities are equal to, or greater than, one year and the residual maturity of a hedge is not less than three months.

50 If there is a maturity mismatch in respect of credit risk mitigants (collateral, on-balance sheet netting, guarantees and credit derivatives) recognised in the calculation of the risk-based capital requirement, the adjustment of the value of the credit protection for the purpose of calculating large exposures is determined by using the same approach as in the STC approach (cf. section 103(1) BCR). When an AI has in place a valid bilateral netting agreement (as defined in section 2 BCR) for loans and deposits, it may calculate the exposure values for large exposures purposes on the basis of net credit exposures.

51 An AI would be required to reduce the value of an exposure to the original counterparty by the amount of the eligible CRM recognised for risk-based capital requirements purposes. This recognised amount equals:

a. the value of the protected portion in the case of unfunded credit protection (i.e. recognised guarantees or recognised credit derivative contracts);
b. the value of the portion of the exposure collateralised, calculated by reference to the market value of the recognised collateral for exposures in the banking book (whether past due or not) where the AI uses the simple approach[11] in its treatment of recognised collateral for the purposes of calculating credit risk capital requirements according to section 78(2)(a) or section 78(2)(b) BCR;

[11] Simple approach refers to the approach for using recognised collateral in credit risk mitigation set out in Division 6, Part 4 of the BCR.

c. the value of the collateral adjusted after applying the required haircuts following the comprehensive approach[12] for

   (i) exposures which are not past due in the banking book where the AI uses the comprehensive approach in its treatment of recognised collateral for the purposes of calculating credit risk capital requirements according to section 78(2)(a) BCR;
   (ii) trading book exposures of all AIs according to section 78(2)(c) BCR.

52 The haircuts used to reduce the collateral amount as described in paragraph 51(c) are the supervisory haircuts specified in schedule 7 BCR. Internally modelled haircuts cannot be used.

9.2 *Exposure to CRM Providers*

53 Under section 81 BO, currently where an AI's exposure is guaranteed, the AI must recognise an exposure to both the counterparty (section 81(2)(a) BO) and the guarantor (section 81(8)(c) BO). For example, if an AI granted a loan of HKD 1m to counterparty A and repayment of the full amount of the loan is guaranteed by B, the AI should record an exposure of HKD 1m to each of A and B (assuming that A and B do not belong to the same group).

54 Also, under the current framework, an AI is generally not required to recognise an exposure to any collateral provided to the AI in respect of an exposure.

55 The position under the new BCBS framework is somewhat different. Under the new framework, for transactions that involve eligible CRM, the protected exposure to the original reference obligor is subject to a compulsory "shifting" to the CRM provider. The HKMA proposes to adopt the approach in the new framework. Accordingly, an AI will be obliged to recognise eligible CRM for the purpose of calculating the large exposures measures and limits, and to the extent that an exposure is reduced by recognition of CRM the AI will be obliged to recognise an exposure to the CRM provider. Save as discussed in paragraph 78 (in relation to credit protection in the form of CDS in the trading book), the amount assigned to the CRM provider is the amount by which the exposure to the original counterparty is reduced.

56 Using the example in paragraph 53, under the new framework the AI should record an exposure of zero to A and an exposure of HKD 1m to B, if the guarantee

[12] Comprehensive approach refers to the approach for using recognised collateral in credit risk mitigation set out in Division 7, Part 4 of the BCR.

concerned is recognised as eligible CRM. Taking another example, if the loan granted to A were to be fully secured by collateral in the form of shares which are recognised as eligible CRM, the AI should record an exposure of zero to A and an exposure of HKD 1m to the company that issues the shares.

57 The HKMA would like to seek industry views on whether for large exposures purposes non-internationally active AIs[13] should be provided with the option to choose whether they prefer to (i) ignore the effect of eligible CRM and recognise the full exposure as exposure to the original obligor, as if it were unprotected, or (ii) shift the protected exposure to the CRM provider in the manner envisaged by the new BCBS framework for internationally active banks. The choice would have to be applied homogenously for the entire portfolio of an AI.

10 Trading Book Exposure Values

58 This section provides some elaboration on the determination of the exposure value of instruments held in the trading book. It should be noted that paragraph 38 regarding measurement of counterparty credit risk also applies to instruments held in the trading book.

59 Trading book exposures associated with a single counterparty will be required to be added to banking book exposures for that counterparty, resulting in an aggregate exposure subject to the large exposure limits.

60 Trading book exposures which are not associated with a counterparty—i.e. commodities or currencies—will not be subject to large exposure limits under the new framework. However AIs will be expected as part of their ongoing risk management to prudently manage exposure concentrations in commodities or currencies or other assets.

61 The exposure values for most trading book exposures follow the principles adopted for the calculation of the risk-based capital requirements. However options and credit derivatives that represent sold protection are treated differently for the purposes of the large exposures regime.

62 The exposure value of "plain vanilla" debt instruments and equities will be the accounting value of the exposure, i.e. the market value of the respective instruments.

[13] See footnote 3 on page 8.

63 Instruments such as swaps, futures and forwards will be converted into individual legs or positions as set out in the BCR.[14] Only transaction legs representing exposures within the scope of the large exposures regime will need to be taken into account. For example, a future on stock A is decomposed into a long position in stock A and a short position in a risk-free interest rate exposure in the respective funding currency. The former will be subject to the large exposures regime, the latter will not. However, in the case that the market value of the future is positive from the perspective of the AI, this positive market value results in an exposure to the counterparty of the future.

64 In the case of credit derivatives that represent sold protection, the exposure to a referenced name will be the amount due in the case that the referenced name triggers the instrument, minus the absolute value of the credit protection.[15] For credit-linked notes, the protection seller needs to consider positions both in the note of the note issuer and in the underlying reference obligation of the note. For positions hedged by credit derivatives, see paragraphs 74−77.

65 For nth-to-default swaps, the HKMA proposes that for a protection seller each basket position (or group of linked basket positions as described in section 6) would have to be considered as an exposure with a value equal to the nominal amount of the instrument multiplied by m:

$$m = \max(\frac{1}{n}, \min(1, 1.6 - 0.2n)\,;$$

where n stands for the number of positions in the basket that need to default to trigger the payment by the protection seller. A group of linked basket positions would need to be considered as one position for that purpose. Long positions in an nth-to-default swap would not be recognised as a credit risk mitigant and would be excluded from the exposure calculation.

66 An alternative approach to the proposal in paragraph 65 would be to consider a risk exposure in the full nominal amount of the instrument to each basket position (or group of linked basket positions).

[14] Section 289(2)(c) BCR for the instruments with respect to bonds or interest rates and section 292(1)(c), (d), (e) and (f) BCR for the instruments with respect to equities. It is not necessary to convert the instruments with respect to foreign currencies or commodities because, as mentioned in paragraph 60, exposures in commodities and currencies are not subject to large exposure limits.

[15] In the case that the market value of the credit derivative is positive from the perspective of the protection seller, such a positive market value would also have to be added to the exposure of the protection seller to the protection buyer (counterparty credit risk, cf. paragraph 38). Such a situation could typically occur if the present value of already agreed, but not yet paid, periodic premiums exceeds the absolute market value of the credit protection.

67 The measure of the exposure value of options under the new large exposures framework differs from the exposure value used for risk-based capital requirements. For the purposes of the large exposures regime the exposure value must be based on the change in option price that would result from a default in respect of the instrument underlying the option.

68 The exposure value for a simple long position in a call option would therefore be its market value and for a short position in a put option it would be equal to the strike price of the option minus its market value. In the case of short positions in a call or long positions in put options, a default of the underlying would lead to a profit (i.e. a negative exposure) instead of a loss, resulting in a negative exposure equivalent to the option's market value in the former case and equal to minus the strike price of the option plus its market value in the latter case.

69 Exposures resulting from call and put options can be summarised as follows:

Position	Call	Put
Long	V	−S + V
Short	−V	S – V

Table 1

where V stands for the option's market value and S for its strike price. A negative exposure results in cases where the default of the underlying leads to a profit.

70 The resulting positions will in all cases be aggregated with those from other exposures. After aggregation, negative net exposures must be set to zero.

71 Exposure values of AIs' investments in index positions, securitisations, hedge funds or investment funds in the trading book and the banking book alike will be required to be calculated in line with section 12.4.

11 Offsetting Long and Short Positions in the Trading Book

72 Long and short positions in the same issue may be offset for the purpose of calculating large exposures. Issues are defined as the same if the issuer, coupon, currency and maturity are identical. Consequently, AIs may take a net position in a

specific issue for the purpose of calculating their exposure to a particular counterparty.

73 Positions in different issues relating to the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of equal seniority.

74 Similarly, for positions hedged by credit derivatives, the hedge may be recognised provided that in respect of the underlying reference obligation of the hedge and the position hedged, the short position is junior, or of equal seniority, to the long position.

75 In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, “equity”, “subordinated debt” and “senior debt”). This categorisation, if used, would have to be applied consistently across an AI’s entire portfolio.

76 The bucketing described in paragraph 75 will be optional. AIs may elect instead not to allocate securities to different seniority buckets for reasons of simplicity. Absent the bucketing however, no offsetting of long and short positions in different issues relating to the same counterparty could be recognised.

77 In addition, in the case of positions hedged by credit derivatives, any reduction in exposure to the original counterparty will correspond to a new exposure to the credit protection provider, following the principles underlying the substitution approach described in paragraph 55, except in the specific case described in paragraph 78.

78 When the credit protection takes the form of a CDS and either the CDS provider or the reference entity of the CDS is not a financial entity, the amount to be assigned to the credit protection provider is not the amount by which the exposure to the original counterparty is reduced but, instead, the counterparty credit risk exposure value calculated according to the SA-CCR or, if applicable, to the Modified CEM. For this purpose under the new BCBS large exposures framework financial entities comprise:

(i) regulated financial institutions, defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to, prudentially regulated insurance companies, broker/dealers, banks, thrifts and futures commission merchants; and

(ii) unregulated financial institutions, defined as legal entities whose main business includes: the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitisation, investments, financial custody, central counterparty services, proprietary trading and other financial services activities identified by supervisors.

The HKMA proposes to rely on the definition of a financial sector entity in section 35 BCR in this context, as it is in line with the description used in the BCBS framework.

79 Netting across the banking and trading books will not be permitted.

80 When the result of the offsetting is a net short position with a single counterparty, this net exposure need not be considered as an exposure for large exposure purposes.

12 Treatment of Specific Exposure Types

81 This section covers exposures for which a specific treatment has been deemed necessary under the new framework. The HKMA's proposed treatment of these types of exposure is discussed below. Any exposure type not included in this part will be subject in all respects to the large exposure limits under the new rules.

12.1 *Exposures to Sovereigns*

82 Under the new BCBS framework, exposures to sovereigns and their central banks are exempted from the scope of the large exposures regime. This exemption also applies to public sector entities treated as sovereigns under the risk-based capital requirements. Accordingly, under the framework, any portion of an exposure guaranteed by, or secured by financial instruments issued by, sovereigns would be similarly excluded from the scope of the framework to the extent that the eligibility criteria for recognition of the CRM are met.

83 The HKMA considers that risks associated with sovereign exposures should not be ignored in the context of a large exposures regime. We would therefore propose that for Hong Kong's new large exposures regime exposures to sovereigns and their central banks, as well as to public sector entities treated as sovereigns according to the risk-based capital requirements, should (rather than being exempted across the

board) be made subject to some specifically tailored treatment. This could take the form of one or several higher "hard" limits (one or possibly several limits by reference to currency or jurisdiction) or of one or several "indicative" limits that could be exceeded under certain circumstances (i.e. on a "comply or explain" basis), subject to prompt reporting requirements. We would welcome any initial views from the industry on these suggested approaches or on other approaches that might incorporate an appropriate degree of flexibility whilst addressing the perceived risks.

84 The treatment of exposures to sovereigns, their central banks and public sector entities would extend to exposures guaranteed by, or secured by financial instruments issued by, these counterparties to the extent that the eligibility criteria for recognition of the CRM are met.

85 Synthetic positions in sovereign exposures as they typically result from the decomposition of futures, forward contracts or interest rate swaps will not be considered part of any exposure subject to a limit. Such synthetic positions would not be affected by the default of their hypothetical issuer.

86 Where two (or more) entities that are outside the scope of the sovereign treatment are controlled by, or economically dependent on, an entity that falls within the scope of the sovereign treatment, and are otherwise not connected, those entities need not be deemed to constitute a group of linked counterparties.

87 However, as noted in paragraph 30(iii), an AI must report sovereign exposures, even if they fall within the scope of the sovereign treatment, if the exposures meet the criteria for definition as a large exposure (see paragraph 28).

88 In addition, if an AI has an exposure to a sovereign entity which is hedged by a credit derivative, the AI will have to recognise an exposure to the counterparty providing the credit protection in accordance with the proposed provisions described in paragraphs 55 and 78, notwithstanding that the original exposure is subject to the sovereign treatment.

12.2 *Interbank Exposures*

89 Interbank exposures are currently exempted from the existing statutory large exposure limit under section 81 BO but they will generally fall within the scope of the new BCBS framework. However, even under the new framework, in order to avoid disturbing payment and settlement processes, intraday interbank exposures will be

exempted, both for reporting purposes and for the application of the large exposure limits.

90 The HKMA would intend to adopt a similar approach in the local Exposure Limits rules but with an additional flexibility for the HKMA to also relax longer-term interbank exposure limits in stressed circumstances if this is needed on a temporary basis to ensure stability in the interbank market.

91 The BCBS is undertaking further studies to consider whether any specific treatment is required for a limited range of interbank exposures in order to minimise adverse consequences for the implementation of monetary policy. The BCBS is expected to issue further guidance in 2016 in this area and the HKMA will consider whether and how to incorporate any such guidance into the local regime once it is available.

12.3 *Covered Bond Exposures*

92 Covered bonds for the purpose of the new BCBS framework are bonds issued by a bank or mortgage institution which are subject by law to special public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the entire period for which the bonds are outstanding, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal of, and payment of the accrued interest on, the bonds.

93 A covered bond satisfying the conditions set out in paragraph 94 may be assigned an exposure value of no less than 20% of the nominal value of the bank's holding of that covered bond. We are minded to adopt a similarly accommodative treatment for covered bonds in our local implementation and, given that the BCBS framework refers to an exposure value of *no less* than 20%, we are inclined to consider that a discounted factor of 30% might be sufficiently prudent for this specific exposure class. This means that an AI holding a "qualified" covered bond would record an exposure to the issuer of the bond for an amount equal to 30% of the nominal value of the bank's holding of that covered bond. We would welcome industry's comments on the appropriateness of this discount factor. Other covered bonds which do not meet the qualifying eligibility criteria described below must be assigned an exposure value equal to 100% of the nominal value of the bank's holding of such covered bonds.

94 To be eligible to be assigned an exposure value of less than 100%, a covered bond must satisfy all the following conditions:

(i) it must meet the general definition in paragraph 92;

(ii) the pool of underlying assets must exclusively consist of:

- claims on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks; and/or
- claims secured by mortgages on residential real estate that would qualify for a 35% or lower risk weight under section 65(1) BCR and have a loan-to-value ratio of 80% or lower;

(iii) the nominal value of the pool of assets assigned to the covered bonds by the issuer should exceed the nominal outstanding value of the bonds by at least 10%. The value of the pool of assets for this purpose does not need to be that required by the applicable legislative framework. However, if the applicable legislative framework does not stipulate a requirement of at least 10% "headroom" within the cover pool, the issuing bank needs to publicly disclose on a regular basis that their cover pool meets the 10% requirement in practice. In addition to the primary assets mentioned in item (ii) above, the additional pool collateral may include substituted assets (cash or short-term liquid and high quality assets held in substitution for the primary assets to top up the cover pool for management purposes) and derivatives entered into for the purposes of hedging the risks arising in the covered bond programme.

95 In order to calculate the required maximum loan-to-value for residential real estate referred to in paragraph 94(ii) above, the operational requirements set out in section 206(i) and (j) BCR regarding the objective market value of collateral and the frequency of revaluation would have to be adopted. The conditions set out in paragraph 94 must be satisfied at the inception of the covered bond and throughout its remaining maturity.

12.4 *CIUs, Securitisations, Indices and Other Structures*

96 The new BCBS large exposures framework provides for banks to take account of an exposure even when some form of "structure" lies between the bank and the exposure, that is, even when the bank invests in a structure through an entity which itself has exposures to assets within the structure ("underlying assets"). Such structures include funds, securitisations, indices and other structures with underlying assets. The HKMA would propose to follow this approach locally. Accordingly, AIs would be required to assign an exposure value in respect of an amount invested in a

particular structure to a specific counterparty in line with the approach described below.

97 An AI may assign the exposure amount to the structure itself, defined as a distinct counterparty, if an AI can demonstrate that the AI's exposure amount to each underlying asset of the structure is smaller than 0.25% of the AI's Tier 1 capital, considering only those exposures to underlying assets that result from the investment in the structure itself and using the exposure value calculated in the manner described in paragraphs 102 and 103.[16] In this case, an AI would not be required to "look through" the structure to identify the underlying assets.

98 An AI must however "look through" the structure in relation to any underlying asset for which the exposure value is equal to or above 0.25% of the AI's Tier 1 capital. In this case, the counterparty corresponding to the underlying asset must be identified so that the underlying exposure can be added to any other direct or indirect exposure to the same counterparty. Where in relation to a given structure an AI's exposures to the underlying assets of the structure is in the case of some assets less than 0.25% of the AI's Tier 1 capital and in other cases is equal to, or greater than, 0.25%, the AI's exposure amount to the underlying assets that are below 0.25% of the AI's Tier 1 capital may be assigned to the structure itself (i.e. partial look-through is permitted).

99 If an AI is unable to identify the underlying assets of a structure:

- where the total amount of its exposure does not exceed 0.25% of its Tier 1 capital, the AI would be required to assign the total exposure amount of its investment to the structure;
- otherwise, it would be required to assign the total exposure amount to the *"unknown client"*. The AI would then aggregate all unknown exposures as if they related to a single counterparty (the "unknown client"), to which the large exposure limit would apply.

100 When the look-through approach (LTA) is not required, an AI must nevertheless be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not—e.g. that the AI has not circumvented the large exposure limit by investing in several individually immaterial transactions with identical underlying assets.

[16] By definition, this required test will be passed if the AI's whole investment in a structure is below 0.25% of its Tier 1 capital.

101 If the LTA need not be applied, an AI's exposure to the structure would be the nominal amount it invests in the structure.

102 For a structure where all investors rank pari passu (e.g. a collective investment scheme): when the LTA is required, the exposure value assigned to a counterparty is equal to the pro rata share of the AI's holding in the whole structure multiplied by the value of the underlying assets in the structure. Thus, an AI holding a 1% share of a structure that invests in 20 assets each with a value of 5 must assign an exposure of 0.05 to each of the counterparties corresponding to the assets. An exposure to a counterparty must be added to any other direct or indirect exposure the AI has to that counterparty.

103 For a structure with different seniority levels among investors (e.g. securitisation): when an LTA is required, the exposure value to a counterparty is measured for each tranche within the structure, assuming a pro rata distribution of losses amongst investors in a single tranche. To compute the exposure value to the underlying asset, an AI would be required to:

- first, consider the lower of (i) the value of the tranche in which the AI invests and (ii) the nominal value of each underlying asset included in the underlying portfolio of assets; and
- second, apply the pro rata share of the AI's investment in the tranche to the value determined in the first step.

104 AIs would be required to identify third parties (such as originators, fund managers, liquidity providers and credit protection providers) that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. Such a third party could be a risk factor for more than one structure in which an AI invests as the default of the third party may potentially impact the value of structures related to it, independent from how the underlying asset values in the structure develop (see section 6.2 for the treatment of such exposures).

12.5 *Exposures to Central Counterparties*

105 The HKMA proposes to exempt exposures to QCCPs from the scope of the local large exposures regime initially. The BCBS intends to consider the appropriateness of setting a limit for exposures to QCCPs during 2016. The HKMA will consider any further guidance from the BCBS once it becomes available and whether, and if so how best, to incorporate it into the Exposure Limits rules.

106 Exposures to non-QCCPs will be covered by the new large exposures regime from its inception. AIs will be required to measure their exposure to a non-QCCP as a sum of both the clearing exposures described in paragraph 107 and the non-clearing exposures described in paragraph 108, and the overall exposure to a non-QCCP will be subject to the general large exposure limit of 25% of the Tier 1 capital. The concept of linked counterparties described in section 6 does not apply in the context of exposures to CCPs that are specifically related to clearing activities.

107 AIs must identify and aggregate exposures to a CCP related to clearing activities. Exposures related to clearing activities are listed in the table below together with the corresponding exposure value:

Exposure type	**Exposure value**
Trade exposures	Must be calculated using the exposure measures as described in the earlier sections of this consultation paper for the respective type of exposures (e.g. using the SA-CCR for derivative exposures).
Segregated initial margin	Zero[17]
Non-segregated initial margin	Nominal amount of initial margin posted
Pre-funded default fund contributions	Nominal amount of the funded contribution[18]
Unfunded default fund contributions	Zero
Equity stakes	Nominal amount[19]

Table 2

[17] When the initial margin (IM) posted is bankruptcy-remote from the CCP—in the sense that it is segregated from the CCP's own accounts, e.g. when the IM is held by a third-party custodian—this amount cannot be lost by the AI if the CCP defaults; therefore, the IM posted by the AI can be exempted from the large exposure limit.

[18] The exposure value of prefunded default fund contributions may need to be revised if in future the large exposures regime extends to exposures to QCCPs and not only to non-QCCPs. See also paragraph 105.

[19] If equity stakes are deducted from the level of capital on which the large exposure limit is based, such exposures must be excluded from the definition of an exposure to a CCP. See also paragraph 33.

108 Regarding exposures relating to clearing services (i.e. where the AI acts as a clearing member or is a client of a clearing member), the AI must determine the counterparty to which exposures must be assigned by applying the provisions of the risk-based capital requirements.[20]

109 Other types of exposure that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities, guarantees etc., would be measured in line with the provisions in section III, as for any other type of counterparty. These exposures will be added together and subjected to the large exposure limit.

12.6 *Exposures to Intra-group Counterparties*

110 The new BCBS framework excludes intra-group exposures from the large exposure limits. Whilst the HKMA proposes to follow a similar approach as far as the 25% and 15% Tier 1 capital limits are concerned, the HKMA considers that intra-group exposure may be a source of significant risk to an AI and therefore proposes to require AIs to set internal risk limits on their intra-group exposures. If the HKMA considers an AI's internal intragroup exposure limits are not commensurate with its risk profile or circumstances, the HKMA may require the AI to observe different limits.

12.7 *Other Exposures Currently Exempted under Section 81 BO*

111 The new BCBS framework does not provide exemptions for certain exposures which are currently exempted under section 81 BO, namely:

(i) subsection 6(c): exposures acquired by purchase of bills of exchange in relation to international trade;
(ii) subsection 6(d): exposures against any bills or documents referred to in the preceding item;
(iii) subsection 6(h): (1) exposures in the form of share capital or debt securities held as security for facilities granted by the AI or (2) exposures in the form of share capital or debt security acquired in the course of satisfaction of debts due to an AI, where such exposures have not been held for more than 18 months (or such further period as approved by the Monetary Authority) after their acquisition by the AI;

[20] See sections 226X, 226Z, 226ZA, 226ZB and 226ZD BCR.

(iv) subsection 6(i) and 6(j): exposures acquired incidental to underwriting or subunderwriting contracts;

(v) subsection 6(k): exposures in relation to any indemnity given by an AI to a person in relation to a share transfer involving the AI's subsidiary;

(vi) subsection (5): exposures to a trustee;

112 Given that there would appear to be effective risks related to these exposures, we see value in imposing some limits on them in line with the approach adopted in the BCBS framework. The industry is invited to comment on whether and the extent to which removing the above exemptions would cause significant impact on AIs' ordinary banking business operations. We are also planning to consider this potential impact in the upcoming QIS (cf. paragraph 4).

113 In developing local rules, we will keep in view potential amendments of the BCBS framework within 2016 (cf. paragraph 8).

IV OTHER PART XV BO AMENDMENTS

13 Overview

114 In addition to the large exposures provisions in section 81 BO, certain other provisions in Part XV BO also require revision in order to keep pace with latest market developments and international practices. These are provisions relating to: (i) granting advances against the security of an AI’s own shares (currently in section 80 BO); (ii) limitation on exposures to connected parties (currently in section 83 BO); and (iii) limitation on holding of shares by AIs (currently in section 87 BO). Some corresponding changes to the other provisions in Part XV BO will also be required to ensure consistency. The proposed revisions are discussed below.

14 Advances against Security of an AI’s Own Shares

115 Currently, pursuant to section 80 BO, an AI is prohibited from granting advances against the security of shares issued by the AI itself, or (except with the approval of the HKMA) against those issued by its holding company, its subsidiary or any subsidiary of its holding company. Section 80 BO was introduced to prevent the “manufacture” of capital (e.g. by issuing shares and then returning the proceeds received from the subscriber of such shares through granting that subscriber a loan secured by the shares concerned), and to mitigate the risk associated with the taking of shares issued by related companies of the AI as loan collateral.

116 To better reflect the original policy intention, the HKMA proposes to revise the relevant provisions, such that AIs will be prohibited from granting advances against the security of not only shares, but also all other instruments falling within the definition of CET1 capital instruments, Additional Tier 1 capital instruments and Tier 2 capital instruments under the BCR, that are issued by the AI itself, its holding company, its subsidiary or any subsidiary of its holding company.

15 Limitation on Exposures to Connected Parties

15.1 *Scope of Connected Parties*

117 To align the local regulatory framework with "Principle 20: Transactions with related parties" of the Core Principles for Effective Banking Supervision[21] issued by the BCBS, a revised SPM module CR-G-9 "Exposures to Connected Parties"[22] was issued by the HKMA in November 2015. Among other changes, the scope of connected parties set out in the SPM module for AIs' internal risk management purposes was expanded.[23]

118 When the industry was consulted on the revisions to the SPM module CR-G-9, there was a suggestion that corresponding changes in respect of the scope of connected parties should be made for the purposes of the statutory limitations. There are pros and cons of doing so. The alignment of the scope of connected parties may help streamline compliance efforts, as AIs would not have to monitor exposures to connected parties on different bases for internal risk management and statutory limitations purposes. However, such alignment would also significantly increase the ambit of the statutory prohibition and its attendant legal consequences. The HKMA is therefore open to consider other views if there is sufficient justification for maintaining separate risk management and statutory approaches and for not expanding the scope of connected parties for the purposes of the statutory limitations correspondingly.

119 If ultimately the scope of connected parties is to be the same for both internal risk management and statutory limitation purposes, consideration will be given to providing an exclusion for those "additional connected parties" that are AIs or banks incorporated outside Hong Kong as approved by the Monetary Authority under the proposed new Exposure Limits rules, in a manner similar to the current provisions in sections 83(4)(e) and 83(4)(g) BO. This follows the current practice to exempt bank risk under section 83 BO.

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[21] www.bis.org/publ/bcbs230.pdf

[22] www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-9.pdf

[23] Compared to the previous version of the SPM (which followed the current provisions in section 83 BO), the "additional connected parties" for internal risk management purposes are: (i) the AI's senior management and key staff (including chief executive and managers) and the relatives of such persons; (ii) the AI's subsidiaries, affiliates and other entities (including their subsidiaries, affiliates and special purpose entities) over which the AI is able to exert control; and (iii) the controllers, minority shareholder controllers, directors, senior management and key staff (and the relatives of such persons) of the AI's subsidiaries, affiliates and other entities referred to in (ii).

15.2 *Definition and Measurement of Exposures*

120 For consistency and ease of compliance, we consider that there is a case for aligning the definition and measurement of “exposures” for the purposes of limiting both large exposures and exposures to connected parties. As such, AIs will not have to calculate different exposure values for different purposes, and data in respect of exposures to connected parties would be a sub-set of that already available for the purposes of monitoring compliance with large exposure limits.

121 In terms of the measurement of exposures, the BCBS framework provides for the reduction of exposure values by a wide range of eligible CRM techniques, but the taking of real property collateral is excluded. In order to reduce the potential implications of revising the definition of exposures for loans to connected parties that are individuals, the HKMA proposes that, in respect of the statutory limitation on exposures to connected parties, the new rules should provide for the exclusion of advances, loans and credit facilities granted to individuals that are secured by real property collateral. This would, however, require further adaptations of AIs’ internal control and monitoring systems accordingly.

15.3 *Adjustment of Connected Exposure Limits*

122 For consistency with the new BCBS framework, we propose to re-base the statutory limits in respect of (i) aggregate exposures to all connected parties who are individuals and (ii) aggregate exposures to all connected parties (including individuals and non-individuals) as a ratio of Tier 1 capital instead of the total capital base of AIs. Moreover, taking into account the re-basing of these limits and the revisions to the definition of exposures, and subject to the quantitative impact study to be conducted, we also propose to correspondingly raise the respective limits to 10% and 20% of Tier 1 capital respectively.

123 Furthermore, subject to the approach to be taken regarding the exclusion from the limit of advances, loans and credit facilities granted to individuals that are secured by real property collateral, we will consider whether and how the existing statutory limit of HKD 1m on the aggregate exposures to a single connected individual should be adjusted.

16 Limitation on Holding of Shares by AIs

124 Currently, pursuant to section 87 BO, a locally incorporated AI is prohibited from acquiring or holding any part of the share capital of any other company or companies to an aggregate value in excess of 25% of the AI's capital base. While this has served as a useful and simple tool in limiting AIs' concentration risk arising from holding of shares, it raises certain operational issues. It imposes a limit on holdings of shares but does not cover, for example, other types of capital instruments or derivatives which essentially carry the same risk as holdings of shares. The treatment of shares held through CIUs is also unclear. Furthermore, it does not allow short positions, or hedging positions, to be set off against long positions.

125 To keep pace with market developments, we propose to enhance the relevant provisions to cover a wider range of equity exposures and recognise an appropriate extent of netting. Conceptually, all instruments conveying the economic substance of equity interests should be covered, instead of just holdings of shares. To this end, the HKMA proposes to adopt the definition of equity exposures under section 145 BCR (extracted in Annex 1 for ease of reference) for the purpose of defining equity exposures that are subject to the statutory limit set by the new rules.

126 As regards positions that can be set off, the HKMA proposes that reference be drawn from section 185 BCR, which provides for the netting of positions under the simple risk-weight method of the market-based approach for calculating risk weights of equity exposures under the IRB Approach. Accordingly:

(i) an AI may set off a short position in an equity exposure against a long position in the same equity exposure if that short position:
- has been explicitly designated by the institution as a hedge of the long position in that equity exposure (for instance, short cash positions and derivative instruments 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
- has a remaining maturity of not less than one year;

(ii) where the AI's short position in an equity exposure has a residual maturity which is shorter or longer than the residual maturity of the AI's long position in the same equity exposure, an AI should adjust, with all necessary modifications, the value of the AI's short position in the equity exposure in accordance with section 103 BCR;

(iii) where a net short position remains after the set-off of the AI's short position in an equity exposure against the AI's long position in the same equity exposure, an AI should treat the net short position as if it were a long position in that equity exposure; and

(iv) in relation to a short position in an equity exposure which is not permitted to set off a long position in the same equity exposure, an AI should treat the short position as if it were a long position in that equity exposure.

127 Subject to the quantitative impact study to be conducted, it is proposed that the resulting "equity exposures" should then not be more in aggregate than 25% of an AI's Tier 1 capital.

128 Furthermore, the HKMA also intends to incorporate flexibility in the proposed new Exposure Limits rules to allow an AI, on a case-by-case basis, to exclude certain exposures if specific conditions are satisfied. Conceptually, the AI should demonstrate to the satisfaction of the HKMA that the risks arising from the relevant exposures are fully mitigated. It is expected that this flexibility will only be exercised on an exceptional basis, given that the rules would have already catered for a reasonable range of set-offs.

17 Other Corresponding Revisions

129 For consistency and ease of operation, the limitations under the existing sections 87A, 88 and 90 of the BO, are proposed to be re-based as a ratio of the Tier 1 capital instead of the total capital base of an AI. Having considered the operation of such provisions in the past and the actual positions reported by AIs through periodic returns, we propose to provide in the proposed new Exposure Limits rules that:

(i) an AI shall not acquire share capital of a company to a value of 5% or more of the AI's Tier 1 capital unless the approval of the HKMA has been given;

(ii) an AI shall not purchase or hold any interest or interests in land of a value, or to an aggregate value, in excess of 25% of the AI's Tier 1 capital;

(iii) the aggregate of exposures to connected parties, equity exposures and interests in land shall not exceed 80% of an AI's Tier 1 capital.

130 For the provisions currently in sections 79, 79A, 82, 85, 86 and 91 BO, the HKMA considers that no changes are currently required, except for textual amendments and relocation from the BO to the proposed new Exposure Limits rules to be made as appropriate following the changes proposed above.

Annex 1: Section 145 Banking (Capital) Rules

(1) For the purposes of section 142(1) as read with Table 16—

(a) subject to paragraphs (b) and (c) and subsection (2), an authorized institution shall classify under the IRB class of equity exposures all of its direct and indirect equity interests (whether voting or non-voting) in a corporate where those interests are not consolidated or deducted for the purposes of determining the institution's capital base in accordance with Part 3;

(b) an authorized institution shall classify under the IRB class of equity exposures—

(i) holdings of any share issued by a corporate;

(ii) holdings of any equity contract;

(iii) holdings in any collective investment scheme which is engaged principally in the business of investing in equity interests;

(iv) holdings of any instrument which would satisfy the requirements set out in Division 2 of Part 3 for inclusion in the institution's CET1 capital or Additional Tier 1 capital if the instrument were issued by the institution; (L.N. 156 of 2012)

(v) holdings of any instrument—

(A) which is irredeemable;

(B) which does not embody an obligation on the part of the issuer except an obligation which falls within subparagraph (vi); and

(C) which conveys a residual claim on the assets or income of the issuer;

(vi) holdings of any instrument which embodies an obligation on the part of the issuer and in respect of which—

(A) the issuer may indefinitely defer the settlement of the obligation;

(B) the obligation requires (or permits at the issuer's discretion) settlement by the issuance of a fixed number of the issuer's equity shares;

(C) the obligation requires (or permits at the issuer's discretion) settlement by the issuance of a variable number of the issuer's equity shares and, other things being equal, any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in the value of a fixed number of the issuer's equity shares; or

(D) the institution has the option to require that the obligation be settled in equity shares unless the institution demonstrates to the satisfaction of the Monetary Authority that—

(I) in the case of a traded instrument, the instrument trades more like debt of the issuer than equity; or

(II) in the case of a non-traded instrument, the instrument should be treated as a debt holding;

(vii) holdings of any debt obligation, share, derivative contract, investment scheme or instrument, which is structured with the intent of conveying the economic substance of equity interests; and

(viii) any of the institution's liabilities on which the return is linked to that of equity interests; and

(c) an authorized institution shall not classify under the IRB class of equity exposures any equity holding which is structured with the intent of conveying the economic substance of debt holdings or securitization exposures.

(2) The Monetary Authority may, by notice in writing given to an authorized institution, require the institution to treat a debt holding of the institution as an equity exposure for the purposes of calculating the institution's credit risk if the Monetary Authority is satisfied that the nature and economic substance of the debt holding are such that the debt holding should more realistically be characterized as an equity exposure than as a debt holding.

(3) An authorized institution shall comply with the requirements of a notice given to it under subsection (2).

(4) In this section—

corporate (法團) means—

(a) a company; or

(b) a partnership or any other unincorporated body,

that is not a public sector entity. (L.N. 128 of 2014)