In August 2001, the HKMA issued six credit modules of the Supervisory Policy Manual, consisting of "Large Exposures and Risk Concentrations", "Consolidated Supervision of Concentration Risks under Part XV: §79A", "Exemption of Financial Exposures: §81(6)(b)(i)", "Letters of Comfort: §81(6)(b)(ii)", "Underwriting of Securities: §§81 and 87" and "Major Acquisitions and Investments: §87A". These modules, which are all issued as statutory guidelines, set out the HKMA's supervisory approach towards the control of large exposures and risk concentrations as well as the manner in which its powers and discretion under Part XV of the Banking Ordinance will be exercised.

Every locally incorporated authorized institution (AI) is expected to review its current practices and make every effort to comply with the minimum standards as stipulated in the modules. In particular, AIs are expected to establish a policy on the control of large exposures and risk concentrations and to set an internal clustering limit to monitor the aggregate of their non-exempt large exposures. This memo provides further guidance in respect of some practical issues which AIs may encounter in complying with the new requirements.

Large Exposures and Risk Concentration Policy

Q. If an AI's existing credit policy already contained the details (e.g. definition of exposures, criteria for identifying a group of related persons and different types of exposure limits) that the HKMA expects AIs to include in their "Large Exposures and Risk Concentration" policy, is the AI still required separately to develop such a policy?

A. While the HKMA would like every AI to develop a separate policy regarding the control of large exposures and risk concentrations, it is acceptable for AIs to embed their policies on the relevant aspects within the existing credit policy, provided that the latter has been reviewed and approved by their Board of Directors. AIs are nonetheless still required to agree those relevant aspects contained in their credit policy with the HKMA.

Q. What factors should AIs consider when determining the definition of "exposures"?

A. AIs should not limit the definition of "exposures" to the §81 definition, though the latter should be complied with as a minimum. They should take into account the nature of their business and the complexity of their products. In any case, an AI's exposures to a counterparty should include its on- and off-balance sheet exposures and indirect exposures. Exposures arising from foreign exchange and gold contracts, interest rate contracts or other derivatives, whose credit conversion factors are not currently specified under §81(3), should also be captured where appropriate. For example, AIs should consider widening the definition of "exposures" to capture the outcome of their internal models which are used to measure exposures to individual counterparties arising from such instruments (e.g. positive replacement cost).

Q. What principles should AIs follow when determining the criteria for identifying "a group of related counterparties"?

A. AIs should not limit the definition of a "group of related counterparties" to that described in §81(1), though the latter should be complied with as a minimum. The definition should ideally capture all parties connected in such a way that the financial strength of any of them may affect that of the others, e.g., counterparties linked by cross-guarantees or whose liabilities are guaranteed by the same guarantor.

Q. Is it necessary for AIs to set various types of exposure limits (e.g. aggregate maximum exposure limits for an industry, an economic sector, a country or a region) in their "Large Exposures and Risk Concentration" policy?

A. AIs should take into account their business nature, scale of operation and risk appetite in determining their exposure limits. They need not set any exposure limit that is not applicable to their business operations, e.g., an aggregate maximum limit for exposures to a country or a region to which the AI does not have, and will not have, any cross-border exposures.

Q. When should AIs obtain the Board approval for their "Large Exposures and Risk Concentration" policy?

A. AIs should table their "Large Exposures and Risk Concentration" policy for Board approval as soon as practicable. The HKMA expects this to happen normally in the first or second Board meeting following the acceptance of the draft policy by the HKMA.

Clustering Limits

Q. What is a non-exempt large exposure?

A. Any exposure to a counterparty or a group of related counterparties which is equal to or more than 10% of an AI's capital base and not currently exempted from §81 of the Banking Ordinance is regarded as a non-exempt large exposure.

Q. What factors should AIs consider when determining their clustering limits?

A. In setting clustering limits, AIs should take into account the following factors:

- the level of the AI's capital adequacy ratio;
- consistency with the AI's "Large Exposures and Risk Concentration" policy;
- the number and size of existing non-exempt large exposures, including past trends;
- the business nature of the borrowers concerned and risk concentrations, if any; and
- the business nature of the AI and the experience of its management.

The broad principle is that the limit set by AIs should be realistic and should not be at a level so high that it will never be breached. Furthermore, AIs should ensure that they have sufficient grounds to justify a clustering limit that is higher than the industry benchmark (i.e. 200% of capital base).

Q. What is the interplay between the clustering limit and the aggregate lending limit applied to an AI for the purposes of managing risk concentration?

A. In the case of an exposure supported by a letter of comfort accepted by the HKMA under §81(6)(b)(ii), the entire amount of the exposure should be excluded for purposes of the clustering limit. The total of all exposures covered by a letter of comfort is, however, subject to an aggregate lending limit as specified by the HKMA. In other words, any large exposure which exceeds 25% of an AI's capital base due to the exemption under §81(6)(b)(ii) should be subject to the aggregate lending limit, while any non-exempt large exposure within 25% should be subject to the clustering limit. AIs should therefore have regard to both these limits when assessing their risk concentrations.

Q. Are there rules for calculating the total amount of exposures subject to the clustering limit?

A. There are a few rules that AIs are recommended to observe when calculating the total amount of exposures subject to the clustering limit:

1. An AI should identify all the non-exempt exposures that are equal to or more than 10% of its capital base;
2. An AI should exclude the whole amount of a large exposure which is more than 25% of its capital base due to an exemption under §81(6)(b)(ii);
3. To the extent that a non-exempt large exposure is guaranteed by a guarantor, an AI should include either its direct exposure to the borrower or its indirect exposure to the guarantor to avoid double-counting the same exposure; and
4. Where a non-exempt large exposure is less than 10% of an AI's capital base after excluding amounts guaranteed as described in item (3) above, the exposure should still be subject to the clustering limit.

- Prepared by the Banking Policy Department