

Banking (Exposure Limits) (Amendment) Rules
Part B Detailed Proposals

Item	Heading	Matters to be Provided for	Remarks and Explanation of Policy Intent
1	Commencement	1.1 The amendments will come into operation on 1 January 2019.	
2	Amendment of Rule 6 “Notifiable event - prescribed notification requirement under section 81C of the Ordinance”	2.1 Amend Rule 6(2)(a) to the meaning along the following lines: “a failure to comply with a limit prescribed in a rule under Part 2, 4, 5, 6, 7, 8 or 9 applicable to an AI, or that limit as varied by the MA under a rule within the same part of that limit.”.	<p>In relation to prescribed notification requirements under BO section 81C (as inserted by section 9 of the BAO), to incorporate additional notifiable events relating to failure to observe the exposure limits to be included into the Rules by the BELAR.</p> <p>For Rule 6(2)(a), additional limits to be included are those referred to in paragraphs 4.1 (Part 4), 6.1, 6.2 (Part 5),</p>

			<p>8.1, 8.2 (Part 6), 23.1 (Part 7), 31.1 (Part 8) and 35.1 and 35.2 (Part 9) below (on top of Rule 10 under Part 2).</p> <p>Additional power to vary a limit is referred in paragraphs 9.1 (Part 6), 24.1 (Part 7), 32.1(Part 8) and 36.1 (Part 9) below (on top of Rule 11(1) under Part 2).</p>
		2.2 Amend Rule 6(2)(b) to the meaning along the following lines: “a failure to comply with any conditions imposed by the MA in giving a consent, approval or specification under the circumstances referred to in paragraph 4.2, 16.1(u) and 25.1(b) below”.	To add new notifiable events in relation to “conditions” on top of those under current rule 13(3)(b).
	Inclusion of new Parts 4,5,6,7,8,9 and 10 into the Rules	2.3 To insert the parts below after Part 3 of the Rules.	To replace sections 87A, 80, 81, 83, 85 and 88 of the BO.
<u>PART 4</u> – Acquisition of share capital in companies [Current BO s87A]			

Division 1 General			
3	Application of Part 4	<p>3.1 This Part will be expressed to apply to AIs <u>incorporated in Hong Kong</u></p> <p>3.2 The Rules will express that in this part, “value” in the case of shares in a company, means the total of</p> <p>(a) the current book value of the shares and</p> <p>(b) the amount for the time being remaining unpaid on the shares which is not counted under paragraph (a).</p> <p>3.3 If an AI must value the share capital of a company in accordance with this Division at fair value, rule 4 applies in determining the fair value.</p>	<p>By and large, this Part is a direct replication of s87A of the BO except: (i) reference base for the limit has been changed from capital base to Tier 1 capital and (ii) s87A(3) is to be replaced by other transitional provisions to be set out in Part 10. We will consult the industry on proposals for the transitional provisions soon.</p> <p>3.3: Cf rule14(3).</p>
Division 2: Limit on acquisition of share capital in companies			
4	Limit on acquisition of share capital in companies	<p>4.1 The Rules will provide that an AI shall not: –</p> <p>(a) acquire (whether by one acquisition or a series of acquisitions, and by whatever means) all or part of the share capital of a company (and whether or not the company was established by the institution) to a value of 5% or more of the Tier 1 capital of the institution at the time of the acquisition unless the approval of the MA has been granted to the</p>	<p>BO section 81A (as inserted by section 9 of the BAO) provides for the MA to make Rules prescribing limits, inter alia, on AIs’ exposures to the equity of any other company</p>

		<p>proposed acquisition of such share capital;</p> <p>(b) if any such approval referred to in (a) is revoked, hold share capital in the company to a value of 5% or more of the Tier 1 capital of the institution on or after the time such revocation comes into effect.</p> <p>4.2 The Rules will provide that the MA may at any time, by notice in writing served upon an AI, attach condition to an approval granted as referred to in paragraph 4.1(a) and may amend or cancel such conditions, in each case, with effect from the time specified in the notice (being a time reasonable in all the circumstances of the case).</p>	<p>(s81A(1)(b)). Cf BO s87A(2)(a).</p> <p>BO section 81A(3)(i) (as inserted by the BAO) empowers the MA to consent, subject to any conditions the MA thinks fit, to the incurring of specified exposures or the acquisition of specified interests generally, or in a particular case or class of cases such that the exposures or interests need not be taken into account in calculating whether an AI has reached a limit. Cf BO s87A(2)(b).</p> <p>Cf BO s87A(4).</p>
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		<p>4.3 The MA may revoke an approval as referred to in paragraph 4.1(a)- (a) in such case as he thinks fit; and (b) with effect from such time as he may specify being a time reasonable in all the circumstances of the case.</p> <p>4.4 Where the MA refuses to grant approval as referred to in paragraph 4.1(a) or revokes an approval, he should notify the AI concerned in writing of the refusal or revocation.</p>	<p>Cf BO s87A(5).</p> <p>Cf BO s87A(6).</p>
<u>PART 5 – Advance against security of own shares, etc [Current BO s80]</u>			
Division 1 General			
5	<p>Application of Part 5</p> <p>Interpretation</p>	<p>5.1 This Part will be expressed to apply to all AIs.</p> <p>5.2 In relation to any AI incorporated outside Hong Kong, this Part will be expressed to apply only to its principal place of business in Hong Kong and its local branches, and should so apply as if that principal place of business and those branches were collectively a separate AI.</p> <p>5.3 The Rules will provide for the following definition used in this Part:</p>	<p>Cf BO s79(4).</p> <p>BO section 81A(3)(e) (as inserted by the BAO) provides that Rules made by the MA may specify in respect of an AI incorporated outside Hong Kong that any provision of the</p>

		<p><i>“Basel Committee’s capital standards”</i> mean the capital standards first published by the Basel Committee in <i>International Convergence of Capital Measurement and Capital Standards</i> in April 1988, including any subsequent amendments and supplements.</p> <p>5.4 The Rules will provide for the following terms used in this Part should have the meaning given by section 2(1) of the Capital Rules:</p> <ul style="list-style-type: none"> • Additional Tier 1 capital instrument; • CET1 capital instrument; • Tier 2 capital instrument. <p>5.5 The Rules will provide that a capital-in-nature instrument means an instrument other than shares that is--</p> <p>(i) issued by an AI incorporated in Hong Kong and that qualifies as a CET1 capital instrument, additional Tier 1 capital instrument or Tier 2 capital instrument pursuant to the Capital Rules;</p> <p>(ii) issued by an institution incorporated outside Hong Kong that is eligible for inclusion in its capital base under any regulatory regime in the jurisdiction of its incorporation which is applicable to the institution and which prescribes requirements relating to the capital resources of financial institutions for the purpose of implementing locally in that jurisdiction the Basel Committee’s Capital Standards</p>	<p>Rules is to apply only to the business of the AI in Hong Kong.</p> <p>BO Section 81A(1)(a)(iv) (as inserted by the BAO) provides for Rules made by the MA to prescribe limits on exposures incurred by an AI against the security of its own shares or other instruments that are capital in nature. Section 81A(1)(a)(v) extends this to security over shares and capital instruments issued by group companies of the AI.</p> <p>The policy intent is to extend the type of restricted security from shares (as presently in BO s80) to cover all capital-in-nature instruments</p>
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		<p>with or without modification;</p> <p>(iii) issued by a holding company incorporated in Hong Kong of an AI incorporated in Hong Kong that would qualify as a CET1 capital instrument, additional Tier 1 capital instrument or Tier 2 capital instrument pursuant to the Capital Rules if the instrument were issued by the AI.</p>	<p>which are subordinated and designed to absorb loss outside of liquidation.</p> <p>Capital-in-nature instruments are most likely issued by regulated banking institutions. Paragraph 5.5(i) and (ii) captures such institutions incorporated in HK (i.e. AIs) and outside HK respectively. In addition, paragraph (iii) seeks to capture the capital-in-nature instrument issued by a local holding company (which may not be an AI) of a local AI. This is considered necessary for regulatory purposes as a local holding company may be required by the MA to issue capital-in-nature instruments pursuant to provisions in the BO (e.g. a condition under s70)</p>
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			and we wish to ensure such capital to be genuine and not falling under the mischief that s80 is intended to guard against.
Division 2 Limit on advances against security of own shares etc.			
6	Limit on advances against security of own shares, etc.	6.1 The Rules will provide that an AI shall not grant any advances, loans or credit facilities (including letters of credit), or give any financial guarantee or incur any liability, against the security of its own shares or capital-in-nature instruments.	Replication of BO section 80(1) with the restricted security extended from shares to capital-in-nature instruments to reflect latest policy intent.
	Limit on advances against security of shares, etc of holding companies, subsidiaries or fellow subsidiaries	6.2 The Rules will provide that an AI shall not, except with the approval in writing of the MA, which approval shall be subject to such conditions as the MA may think fit, grant any advances, loans or credit facilities (including letters of credit), or give any financial guarantee or incur any liability, against the security of the shares or capital-in-nature instruments issued by (a) any holding company of the institution; (b) any subsidiary of the institution; or (c) any other subsidiary of any holding company of the institution.	Replication of BO section 80(2) with the restricted security extended from shares to capital-in-nature instruments to reflect latest policy intent. BO section 81A(3)(i) (as inserted by the BAO) empowers the MA to consent, subject to any conditions the

			MA thinks fit, to the incurring of specified exposures or the acquisition of specific interests generally or in a particular case or class of cases.
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<u>PART 6 - Limit on exposures to single counterparty or group of linked counterparties [Current BO s81]</u>			
<u>Division 1 General</u>			
	Application of Part 6	7.1 This Part will be expressed to apply to AIs <u>incorporated in Hong Kong.</u>	BO section 81A(1)(a)(i) (as inserted by the BAO) provides that the MA may make Rules prescribing limits on AIs' exposures to a counterparty or a group of counterparties. Cf BO s81.
	Interpretation of Part 6	7.2 The Rules will provide that for the purposes of this Part— (a) the expression of “person” includes any partnership, any public body and any body of persons, corporate or unincorporated;	7.2(a) replicates BO s81(8)(a). We have determined not to adopt in the BELAR an equivalent provision to that

		<p>(b) any reference to a provision taking effect as if a particular method, approach, section(s) or division(s) of the Capital Rules were applicable to an institution should include the case where that method, approach, section(s) or division(s) is actually applicable to the institution;</p> <p>(c) For avoidance of doubt, derivative contract includes credit derivative contract.</p>	<p>currently in BO s81(8)(b) (i.e. “the expression debt securities shall mean any securities other than shares, stocks or import and export trade bills”) and to let the term “debt securities” take its ordinary meaning. We now consider that the original definition in s81(8)(b) is too wide and may capture unintended instruments.</p> <p>7.2(b) – examples of such references can be found in paragraphs 19.3, 19.4 and 19.5 etc.</p>
		<p>7.3 The Rules will provide that for the purposes of this Part, the following terms have the meaning given to them in section 2(1) of the Capital Rules:</p>	

		<ul style="list-style-type: none"> • <i>affiliate</i> • <i>asset sale with recourse</i> • <i>bank</i> • <i>basic approach</i> • <i>bond</i> • <i>CCF</i> • <i>CCP</i> • <i>central counterparty</i> • <i>client</i> • <i>comprehensive approach</i> • <i>counterparty credit risk</i> • <i>country</i> • <i>credit conversion factor</i> • <i>credit default swap</i> • <i>credit derivative contract</i> • <i>credit event</i> • <i>credit linked note</i> • <i>credit protection</i> • <i>credit protection provider</i> • <i>credit risk</i> • <i>currency mismatch</i> • <i>default fund contribution</i> • <i>default risk exposure</i> 	
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		<ul style="list-style-type: none"> • <i>derivative contract</i> • <i>direct credit substitute</i> • <i>financial sector entity</i> • <i>foreign public sector entity</i> • <i>forward forward deposits placed</i> • <i>group of companies</i> • <i>guarantee</i> • <i>haircut</i> • <i>incorporated</i> • <i>IRB approach</i> • <i>mark-to-market</i> • <i>note issuance and revolving underwriting facilities</i> • <i>notional amount</i> • <i>obligor</i> • <i>partly paid-up shares and securities</i> • <i>public sector entity</i> • <i>qualifying CCP</i> • <i>recognized netting</i> • <i>reference entity</i> • <i>reference obligation</i> • <i>risk-weighted amount</i> • <i>securities financing transaction</i> • <i>securitization issues</i> 	
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		<ul style="list-style-type: none"> • <i>securitization transaction</i> • <i>sovereign foreign public sector entity</i> • <i>specific provisions</i> • <i>standard supervisory haircut</i> • <i>standardized (credit risk) approach</i> • <i>trade-related contingency</i> • <i>transaction-related contingency</i> • <i>underlying exposures</i> <p>7.4 The following definitions will also be included for terms used in Part 6:</p> <ul style="list-style-type: none"> • <i>A group of linked counterparties</i> has the meaning given in paragraph 10; • <i>Asset-backed commercial paper programme</i> has the meaning given by section 227(1) of the Capital Rules; • <i>Call option</i> means an option contract which gives the holder of the contract the option or right to purchase; • <i>Category 1 AI</i> means an AI designated by the MA as a Category 1 AI as described in paragraph 13.2; • <i>Category 2 AI</i> means an AI which is not a Category 1 AI; • <i>Covered bond</i> has the meaning given by rule 17 of the Banking (Liquidity) Rules (Cap. 155 sub. Leg. Q); • <i>Counterparty credit risk exposure</i> means an exposure to counterparty credit risk; 	<p>Covered bond: see BCBS LE standards paragraph 68.</p>
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		<ul style="list-style-type: none"> • <i>Exposure</i> means any counterparty credit risk exposure as referred to under paragraph 13 and any non-counterparty credit risk exposures as referred to under paragraph 17; • <i>Exempted sovereign entity</i> means an entity falling within the categories identified in paragraph 16.1(d), (e), (f) or (g); • <i>Forward asset purchase</i>, in relation to an AI, means an off-balance sheet exposure to the credit risk of a loan, security or other asset (other than currency) that the institution has a contractually binding commitment to purchase from another party under a contract (excluding a put option contract written by the institution) on a specified future date; • <i>FSB</i> means the Financial Stability Board as defined in section 2(1) of the Financial Institutions (Resolution) Ordinance (Cap 628); 	<p>The definition of forward asset purchase is based on the same definition in Capital Rules section 2(1) with modification to exclude written put. The policy intent is that under the LE framework, treatment of options in the banking book should follow the same treatment in the trading book. See paragraph 17.6 below for the details. The calculation method follows the principle adopted in the BCBS LE standards that an exposure is measured assuming “jump-to-default” of the counterparty.</p>
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		<ul style="list-style-type: none"> • <i>Internationally designated global systemically important bank (international G-SIB)</i> – means, the holding company of a group of companies represented by a name that is included in the current list of global systemically important banks published by the FSB; • <i>G-SIB-linked group</i> means a group of linked counterparties pursuant to paragraph 10.1 where any of the persons specified under paragraph 10.1(a)-(g) is an international G-SIB or local G-SIB; • <i>Initial margin</i> has the meaning given by section 226V of the Capital Rules; • <i>Investment structure</i> means a structure which gives the investor an exposure to the assets underlying the structure, including without limitation, collective investment schemes and securitization transactions, etc; • <i>Liquidity support provider</i> means a party which provides liquidity facilities within the meaning of section 227(1) of the Capital Rules with modification that the meaning is applicable to any entity instead of only in relation to an AI; • <i>Loan-to-value ratio</i> has the meaning given to it by section 65(10) of the Capital Rules; • <i>Locally designated global systemically important bank (local G-SIB)</i> – means an AI designated by the MA under section 3S of the Capital Rules; • <i>Non-counterparty credit risk exposure means</i> an exposure which is not 	<p>Current list of G-SIB published by the FSB: http://www.fsb.org/wp-content/uploads/P211117-1.pdf</p>
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		<p>an exposure to counterparty credit risk, as referred to under paragraph 17;</p> <ul style="list-style-type: none"> • <i>Non-segregated initial margin</i> means initial margin which is not segregated initial margin; • <i>Original maturity</i>, in relation to an off-balance sheet exposure of an AI set out in Table A, means the period between the date on which the exposure is entered into by the institution and the earliest date on which the institution can, at its option, unconditionally cancel the exposure [cf the provision under item 9 of Table 10 under the Capital Rules section 71] • <i>Put option</i> means an option contract which gives the holder of the contract the option or right to sell; • <i>Recognized collateral</i> has the meaning given by section 51(1) of the Capital Rules; • <i>Recognized credit derivative contract</i> has the meaning given by section 51(1) of the Capital Rules; • <i>Recognized credit risk mitigation</i> means on-balance sheet netting referred to in paragraph 19.3, recognized collateral referred to in paragraph 19.4, recognized guarantee referred to in paragraph 19.5(a), recognized credit derivative contract referred to in paragraph 19.5(b) and a credit linked note referred to in paragraph 19.5(c); • <i>Recognized guarantee</i> has the meaning given by section 51(1) of the Capital Rules; 	
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		<ul style="list-style-type: none"> • <i>Segregated initial margin</i> means initial margin which is segregated from the collecting party’s proprietary assets by either placing the collateral constituting the margin with a third party custodian or through other legally effective arrangements to protect the collateral from the default or insolvency of the collecting party; • <i>Tranche</i> means a contractually established segment (“relevant segment”) of the credit risk associated with a pool of underlying exposures in a securitization transaction or in a transaction of similar structure where— <ul style="list-style-type: none"> (a) a position in the relevant segment entails a risk of credit loss greater than, or less than, that of a position of the same amount in each other contractually established segment; and (b) no account is taken of credit protection provided by third parties directly to the holders of positions in the relevant segment or in 	<p>The meaning of segregated initial margin is based on paragraph 3.4.4 of the HKMA’s Supervisory Policy Manual module CR-G-14 on non-centrally cleared OTC derivatives transactions – margin and other risk mitigation standards. http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf</p> <p>The definition of “tranche” is taken from section 227 of the Capital Rules with modification to accommodate transactions of a similar structure to securitization transactions. Different tranches represent different credit risk to the holder, which increases from</p>
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		other contractually established segments.	the senior tranche, mezzanine tranche to equity tranche.
Division 2 Limit on exposures			
8	Limit on AIs' exposures to single and linked counterparties	<p>General</p> <p>8.1 The Rules will provide that, subject as set out in paragraph 8.2 and 8.5, an AI must not incur aggregate exposures calculated as set out in paragraphs 13 and 14, to</p> <p>(a) a single counterparty or</p> <p>(b) a group of linked counterparties</p> <p>which exceed an amount equivalent to 25% of the Tier 1 capital of the institution.</p> <p>Additional limitation for local G-SIB</p> <p>8.2 The Rules will provide that, subject as set out in paragraph 8.3 and 8.4, an AI which is a local G-SIB must not incur aggregate exposures calculated as set out in paragraphs 13 and 14 to</p> <p>(a) a single counterparty within a G-SIB-linked group, or</p>	<p>8.1: CP paragraph 17, CP paragraph 18.</p> <p>In relation to paragraphs 8.1 and 8.2, the policy intent is that a local G-SIB has to comply with both 8.1 (for exposures other than to a G-SIB-linked group) and 8.2 (for exposures to an entity within a G-SIB-linked group and to such a group as a whole). Defer to the law draftsman on the appropriate drafting.</p> <p>8.2 to 8.4: CP paragraphs 19-21.</p> <p>For a clarifying example about</p>

		<p>(b) a G-SIB-linked group which exceed an amount equivalent to 15% of the Tier 1 capital of the institution.</p> <p>8.3 For an AI which has recently been designated as a local G-SIB, the Rules will provide that the exposure limit under paragraph 8.2 will start to apply on the first anniversary of the designation unless the MA notifies the AI of an earlier effective date which shall be not less than 6 months after designation.</p> <p>8.4 In relation to a local G-SIB (A), if a group of linked counterparties has recently become a G-SIB-linked group because an entity in that group has recently become an international G-SIB as a result of the name representing that entity and its group of companies has recently been included in the current list of global systemically important banks published by the FSB, the Rules will provide that the exposure limits under paragraph 8.2 will start to apply to A's exposure with respect to that group of linked counterparties on the first anniversary of the designation unless the MA notifies the AI in writing of an earlier effective date which shall be not less than 6 months after designation.</p> <p>8.5 The Rules will provide that in relation to the limit referred to in paragraph 8.1(b) and 8.2(b), if a group of linked counterparties includes a CCP, an AI</p>	<p>exposures between a local G-SIB and a G-SIB-linked group see Annex 3.</p> <p>For 8.2(a) and (b), the policy intent is that the 15% limit should apply to A's exposure to the entities in the G-SIB-linked group individually (per 8.2(a)) and collectively (per 8.2(b)).</p> <p>8.5: CP paragraph 106, BCB LE standards paragraph 86; LE</p>
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		<p>may exclude clearing related exposures (as referred to under paragraph 17.8(d)(a)) to the CCP from its aggregate exposures to that group of linked counterparties. To avoid doubt, such clearing related exposures to the CCP are still subject to the single counterparty limit under paragraph 8.1(a) or 8.2(a) (with the CCP being the single counterparty) if applicable.</p>	FAQ Q3.
9	MA's power to vary single and linked counterparty limit	<p>9.1 The Rules will provide that subject to the procedure set out in paragraphs 9.2, 9.3, 9.4 and 9.5, the MA may, by notice in writing served on an AI vary the limit referred to in paragraphs 8.1 and 8.2 above applicable to the institution if the MA is satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account (a) the risks associated with the level or concentration of the AI's single counterparty and linked counterparty exposures; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the risks associated with any such risk mitigation measures and (d) any other factors as the MA may consider relevant.</p> <p>9.2 If the MA proposes to serve such a notice on an AI, the Rules will require the MA to serve a draft of the notice on the institution.</p> <p>9.3 A draft notice will –</p> <ul style="list-style-type: none"> (a) specify – (i) the proposed variation of the limit; and 	BO section 81A(3)(j) (as inserted by the BAO) provides that the Rules may empower the MA to vary, in accordance with any procedure set out in Rules and in circumstances set out in the Rules, a limit applicable to an AI.

		<p>(ii) the circumstances pertaining to, and the grounds for, the proposed variation; and</p> <p>(b) include a statement that the institution may, within 14 days (or a longer period as the MA allows in any particular case) from the date of service of the draft notice, make written representations to the MA on any or all of the matters specified in the draft notice.</p> <p>9.4 If the AI makes representations on the draft notice served on the AI, the Rules will provide that the MA may, after considering the representations–</p> <p>(a) serve a notice on the institution in substantially the same terms as the draft notice;</p> <p>(b) serve a notice on the institution in terms modified to take account of any one or more of those representations that satisfies the MA that the modification concerned ought to be made; or</p> <p>(c) elect not to serve a notice on the institution if satisfied by the representations that a notice should not be served.</p> <p>9.5 If no representations are made by the AI, the Rules will provide that the MA may serve a notice on the institution in substantially the same terms as the draft notice.</p> <p>9.6 The Rules will provide that a decision of the MA to vary any single</p>	
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		<p>counterparty or linked counterparty limit imposed under these Rules is a decision to which section 101B(1) of the BO applies.</p> <p>9.7 To avoid doubt –</p> <p>(a) the MA will be allowed to serve a draft notice on an AI in substitution for an earlier draft notice served on the institution; and</p> <p>(b) the reference to “substantially the same terms as the draft notice” used in sub-paragraphs 9.4(a) or 9.5 above should not be construed to include the statement mentioned in sub-paragraph 9.3(b) above.</p>	<p>BO section 81A(4) (as inserted by the BAO) provides that the Rules may provide that a decision made by the MA under the Rules is a decision to which BO s101(B)(1) applies.</p>
Division 3 Grouping linked counterparties			
10	Determination of a group of linked counterparties	<p>10.1 The Rules will provide that subject as set out in paragraphs 11 and 12, in relation to a given counterparty, the persons below, being counterparties of the AI, will be regarded as a group of linked counterparties:</p> <p>(a) that counterparty;</p> <p>(b) any person which controls the given counterparty;</p> <p>(c) any other person which is also controlled by the person in (b);</p> <p>(d) any person which is controlled by the given counterparty;</p> <p>(e) any person (Person A), which is not related to the given counterparty by the control relationship in (b) to (d) above, but is so</p>	<p>10.1: CP paragraph 22 See Annex 1 for further elaboration and examples of grouping of linked counterparties (CP paragraph 24; BCBS LE standards paragraphs 19-28). (b) intends to capture</p>

		<p>interconnected with any person mentioned in (a) to (d) (Person B) that if Person B was to experience financial problems, in particular funding or repayment difficulties, Person A would also be likely to encounter funding or repayment difficulties;</p> <p>(f) any other person which is controlled by Person A in (e);</p> <p>(g) any other person which controls Person A in (e) and is so interconnected with Person A that if the Person A was to experience financial problems, in particular funding or repayment difficulties, that person would also be likely to encounter funding or repayment difficulties.</p> <p>10.2 For the purpose of paragraph 10.1, one counterparty is regarded as having control over another counterparty if it—</p> <p>(a) owns more than 50% of the voting rights in the other counterparty;</p> <p>(b) has control of a majority of the voting rights in the other counterparty pursuant to an agreement with other shareholders;</p> <p>(c) has the right to appoint or remove a majority of the members of the</p>	<p>“controllers” (see 10.2 below).</p> <p>(c) intends to capture “fellow subsidiaries”.</p> <p>(d) intends to capture “subsidiaries”.</p> <p>(e) intends to capture persons related by economic interdependence.</p> <p>(f) intends to capture subsidiaries of the persons in (e).</p> <p>(g) intends to capture a controller of the person (Person A) in (e) that is economically dependent on Person A.</p> <p>Consistent with the practice in the EU (and with our previous approach in relation to the Liquidity Rules), we intend to set out technical details for the operation of 10.1(e) in a Code of Practice issued under section</p>
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		<p>other counterparty’s board of directors (or a similar structure), or a majority of the members in the other counterparty’s board of directors (or a similar structure) have been appointed solely as a result of the first counterparty exercising its voting rights; or</p> <p>(d) 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).</p>	<p>97M of the BO (following amendment of section 97L(1) of the BO by section 18 BAO) [or in guidance to be issued pursuant to s7(3) of the BO]. Outline of contents for proposed guidance is set out in <u>Annex 1</u> for information.</p> <p>10.2: CP paragraph 23; BCBS LE standards paragraph 23.</p>
11	Determination of a group of linked counterparties - sovereigns	11.1 The Rules will provide that when determining a group of linked counterparties, if two or more counterparties that are not themselves exempted sovereign entities are controlled by or are economically dependent on a counterparty that is an exempted sovereign entity, and are otherwise not linked, those counterparties are deemed not to be a group of linked counterparties.	<p>11.1:CP paragraph 86; BCBS LE standards paragraph 61.</p> <p>See <u>Annex 1</u> for further elaboration.</p>
12	Determination of a group of linked counterparties - The	12.1 The rules will provide that when determining a group of linked counterparties, if two or more counterparties are either controlled by or economically dependent on The Financial Secretary Incorporated	12.1: Replication of contents of BO s81(4A) as regards FSI.

	Financial Secretary Incorporated	established under the Financial Secretary Incorporation Ordinance (Cap 1015) and are otherwise not linked, those counterparties are deemed not to be a group of linked counterparties.	
Division 4 Calculation of aggregate exposures			
13	Calculation of aggregate exposures	<p>13.1 The Rules will provide that an AI should follow the steps below to calculate its aggregate exposures to a given counterparty:</p> <p><u>(A) Non-counterparty credit risk exposures</u></p> <p>(i) Measure all non-counterparty credit risk exposures in the manner specified in paragraph 17 to the given counterparty;</p> <p>(ii) Offset long and short positions to the same counterparty in the trading book as set out in paragraph 18. A net short position after offsetting, should be deemed to be zero. To avoid doubt, offsetting short positions in the trading book against long positions in the banking book is not allowed;</p> <p>(iii) Offset an exposure to a counterparty (“A”) in the banking book by a short position arising from an option contract in relation to A also in the banking book;</p> <p>(iv) (a) If the institution is a category 1 AI, in relation to an exposure in the banking book (other than an exposure specified under paragraph 16.1) covered by recognized credit risk mitigation, adjust the exposure to the amount of the exposure not covered by</p>	<p>13.1(ii):CP paragraph 70, CP paragraph 79, CP paragraph 80.</p> <p>13.1(iv): CP paragraphs 44 and 45.</p> <p>13.1(iv) is part of the provisions seeking to compel</p>

		<p>recognized credit risk mitigation (the CRM uncovered portion) as calculated in the manner set out in paragraph 19.1, save for such exposure as the MA may specify;</p> <p>(b) If the institution is a Category 2 AI, in relation to an exposure in the banking book (other than an exposure specified under paragraph 16.1) covered by recognized credit risk mitigation referred to in paragraph 19.2, adjust the exposure to the CRM uncovered portion as calculated in the manner set out in paragraph 19.2, save for such exposure as the MA may specify;</p>	<p>the shifting of an exposure protected by credit risk mitigation to become an exposure to the credit protection provider. Paragraph 13.1(iv) provides for the reduction of the original exposure to the CRM <u>uncovered</u> portion. This is supplemented by paragraph 15.4 which requires a new exposure to be recognised against the credit protection provider in respect of the portion of the exposure covered by the recognized credit risk mitigation.</p> <p>To illustrate the effect of the “save for” provisions under 13.1(iv), assuming that the exposure specified by the MA is exposure arising from share margin financing (i.e. a loan</p>
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		<p>(v) Except for the off-balance sheet exposures covered under paragraph 17.2(c), deduct any specific provision made in respect of an exposure from the exposure;</p> <p><u>(B) Counterparty credit risk exposures</u></p>	<p>secured by shares), then an AI should value its exposure to the borrower without taking into account the share collateral. Accordingly it is not required to recognise an exposure to the issuer of the shares. (i.e. see paragraph 15.4, it is only required to recognise an exposure to the credit protection provider if the value of the original exposure is reduced.)</p> <p>13.1(v): CP paragraph 34. The calculation method of off-balance sheet exposures under paragraph 17.2(c) already incorporates deduction of specific provision. The exception in 13.1(v) seeks to avoid double-counting.</p>
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		<p>(vi) Subject to the exemptions set out under paragraph 16, calculate the counterparty credit risk exposure of all the derivative contracts which the institution has entered into with the given counterparty. The counterparty credit risk exposure is to be calculated as the “default risk exposure” determined by the same method as the AI currently adopts under the Capital Rules for the purposes of calculating its capital adequacy, provided that the method is not an internal modelling approach. (N.B. There is, however, no need under the Rules to convert the exposure into a risk-weighted amount as occurs under the Capital Rules for the purposes of determining regulatory capital). If the AI adopts an internal modelling approach to calculate the default risk exposure of derivative contracts under the Capital Rules, the AI should use another approach available under the Capital Rules, as notified by the MA in writing after consultation with the AI, to calculate counterparty credit risk exposure of derivative contracts for the purposes of this Part;</p> <p>(vii) Calculate the counterparty credit risk exposure of all the securities financing transactions which the institution has entered into with the given counterparty as the “default risk exposure” calculated by the same method it currently adopts under the Capital Rules for the purposes of calculating its capital adequacy (without conversion</p>	<p>13.1(vi)-(vii):CP paragraphs 38 and 41.</p> <p>Capital Rules section 10A(1)(a) and (2) provides for the methods available to calculate counterparty default risk (as defined in section 2(1) of the Capital Rules) of derivative contracts (i.e. the current exposure method CEM, which is outlined in section 2(1) of the Capital Rules, as well as the IMM(CCR)). Both methods estimate the future replacement cost (i.e. exposure at default) of a derivative contract or a group of derivative contracts at a future date when a default occurs. In brief, the exposure at default is estimated as the sum of (i) the current market value of the contract(s) and (ii)</p>
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		<p>into the risk-weighted amount), provided that the method is not an internal modelling approach. If the AI adopts an internal modelling approach to calculate the default risk exposure of securities financing transactions under the Capital Rules, the AI should use another approach available under the Capital Rules, as notified by the MA in writing after consultation with the AI, to calculate counterparty credit risk exposure of derivative contracts for the purposes of this Part;</p>	<p>a potential future exposure component which reflects the potential changes in the market value of the contract(s) between the computation date (or, if applicable, the date of the last remargining before default) and the date the contract(s) can be terminated and replaced. CEM is a simple method under which the potential future exposure component is calculated by using credit conversion factors specified by the Basel Committee, while the internal model method (IMM(CCR)) is a more risk sensitive approach under which banks can use internal models (if already approved by relevant competent supervisory authorities) to calculate the potential future exposure</p>
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			<p>component.</p> <p>Capital Rules section 10A(1)(b) and (2) provides for the methods available to calculate counterparty default risk of SFTs (i.e. a method that does not involve the use of internal models by an AI and IMM(CCR)). Both methods estimate the default risk exposure of SFTs by regarding the money or securities delivered by a bank under the SFTs to the counterparty concerned as an exposure to the counterparty secured by the money or securities received by the bank from the counterparty. Under the "non-modelling" method, potential changes in the market value of the securities delivered under the SFTs between the date of</p>
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		<p>(viii) (a) if the institution is a category 1 AI, in relation to a counterparty credit risk exposure in (vi) and (vii) above that is covered by recognized credit risk mitigation not yet considered in the calculation in (vi) and (vii) above, adjust the exposure to the CRM uncovered portion as calculated in the manner set out in paragraph 19.1, save for such exposure as the MA may specify;</p> <p>(b) if the institution is a Category 2 AI, in relation to a counterparty credit risk exposure in (vi) and (vii) above that is covered by recognized credit risk mitigation referred to in paragraph 19.2 not yet considered in the calculation in (vi) and (vii) above, adjust the exposure to the CRM uncovered portion as calculated in the manner set out in paragraph 19.2, save for such exposure as the MA may specify;</p>	<p>default and the date the securities can be liquidated are estimated by haircuts specified by the Basel Committee, while under the internal model method (IMM(CCR)) the bank can use internal models to estimate the changes.</p> <p>13.1(viii):CP paragraphs 44-45.</p>
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		<p>(ix) Deduct any specific provision made in respect of the derivative contracts or securities financing transactions covered by the calculation from the counterparty credit risk exposure calculated under (vi), (vii) and (viii) above.</p> <p><u>(C) Calculation of aggregate exposures against a given counterparty</u></p> <p>(x) Sum all the non-counterparty credit risk exposures and counterparty credit risk exposures against the given counterparty.</p> <p>13.2 The Rules will provide that for the purpose of the calculation described in paragraph 13.1, the MA may by notice in writing to an AI, designate an institution as a Category 1 AI if any of the following is satisfied:</p> <p>(a) the AI is internationally active;</p> <p>(b) the AI is significant to the general stability and effective working of the banking system in Hong Kong;</p> <p>(c) the AI has applied to become a Category 1 AI, and the MA has accepted to designate the AI as a Category 1 AI, subject to any conditions as the MA may think fit.</p>	<p>13.1(ix):CP paragraph 34.</p> <p>13.1(x):CP paragraphs 28 and 59.</p> <p>For 13.2(c), an example of a condition is adequate internal control systems to report “credit risk transfer” required on a Category 1 AI.</p>
14	Calculation of aggregate exposures to a group of linked	14.1 The Rules will provide that an AI should calculate its aggregate exposures to a group of linked counterparties by summing the aggregate exposure to each counterparty within the group of linked counterparties calculated	

	counterparties	according to the process set out in paragraph 13.	
Division 5 Calculation of exposures under certain circumstances			
15	General	15.1 The Rules will provide for the following specific circumstances in connection with the calculation of exposure to a given counterparty or a group of linked counterparties under Part 6.	
	Investments linked by a common risk factor	<p>15.2 The Rules will provide that if a person is</p> <ul style="list-style-type: none"> • the fund manager of more than one collective investment scheme to which the AI has an exposure arising from the holding of units or shares of the scheme (except where the custodian of the assets in the scheme or basket is a separate legal entity), • the liquidity support provider to more than one asset-backed commercial paper programme, to which the AI has an exposure arising from its holding of commercial papers issued under such programme, • the sponsor of more than one asset-backed commercial paper programme to which the AI has an exposure arising from its holding of commercial papers issued under such programme, • the credit protection provider (through credit default swaps or 	15.2: CP paragraphs 18, 25 26, 27 and 43 and BCBS LE standards paragraphs 80 and 81.

		<p>guarantee) of more than one synthetic securitization transaction in which the AI has invested,</p> <ul style="list-style-type: none"> • a person playing any other role which represents a common risk factor for more than one collective investment scheme, securitization issue or similar structure in which the AI has invested, <p>the AI is deemed to have an exposure to this person equivalent to the aggregate current book value of its holdings in the collective investment schemes, securitization transactions and similar structures linked by the person as stated above. This exposure should be included in the AI's non-counterparty credit risk exposures to the person in the calculation of aggregate exposures as set out in paragraph 13.1.</p>	
	Protection seller of credit derivative contract	<p>15.3 The Rules will provide that if an AI has entered into a credit derivative contract as a protection seller, where the fair value of the contract is positive from the perspective of the institution (i.e. the present value of contracted but not yet paid periodical payment from the protection buyer exceeds the present value of the expected obligation of the protection seller under the contract), this positive value should be included in the AI's counterparty credit risk exposures to the protection buyer in the calculation of aggregate exposures as set out in paragraph 13.1</p>	<p>15.3: BCBS LE standards footnote 19 to paragraph 48.</p>

<p>Exposure to credit protection providers</p>	<p>15.4 The rules will provide that if an AI has reduced the value of an exposure to the CRM uncovered portion of the exposure as set out in paragraph 19 or has offset an exposure in the trading book hedged by a credit derivative contract as set out in paragraph 18.4, the institution should include a new exposure to the credit protection provider as follows:</p> <ul style="list-style-type: none"> (a) where the credit protection is a recognized guarantee referred to in paragraph 19.5, the amount of reduction in the exposure covered by the guarantee should be included in the calculation of the AI’s aggregate exposure to the guarantor. (b) where the credit protection is a recognized collateral referred to in paragraph 19.4, the amount of reduction in the exposure covered by the collateral should be included in the calculation of the AI’s aggregate exposure to the issuer of the collateral. (c) Where the credit protection is a recognized credit derivative contract referred to in paragraph 19.5 or a credit derivative contract referred to under paragraph 18.4— <ul style="list-style-type: none"> (i) other than a credit default swaps (which is covered in (ii) below), the amount of reduction in the exposure covered by the credit derivative contract should be included in the calculation of the AI’s aggregate exposure to the counterparty of the credit derivative contract; 	<p>BCBS LE standards paragraph 43.</p> <p>15.4(b): Recognised collateral can only be financial collateral. For example a bond issued by a bank.</p>
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		<p>(ii) which is a credit default swap and (1) both the protected exposure and the credit default swap are in the trading book and (2) either the counterparty or the reference entity of the credit default swap is not a financial sector entity, an amount equivalent to the default risk exposure to the counterparty calculated as set out in paragraph 13.1(vi) should be included in the calculation of the AI's aggregate exposure to the counterparty of the credit default swap.</p>	<p>15.4(c)(ii): CP paragraph 78; BCBS LE standards paragraphs . 56 and 57.</p>
Division 6 Exempted exposures			
16		<p>16.1 The Rules will provide that for the purposes of this Part, exposures do not include:</p> <p>(a) exposure amount to a counterparty that is deducted in determining the capital base of the AI in accordance with the Capital Rules;</p> <p>(b) exposure to an affiliate of the AI if the conditions below are satisfied: the AI and the affiliate are accounted for on a full basis in the consolidated financial statements of the holding company of the group of companies to which they belong, for the purposes of and in compliance with the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants,</p>	<p>16.1(a):CP paragraph 33, BCBS LE standards paragraph 31, LE FAQ Q5.</p> <p>16.1(b): CP paragraph 110, BCBS LE standards paragraph 9 with local adaptation.</p>

		<p>the International Financial Reporting Standards issued by the International Accounting Standards Board or the standards of accounting practices applicable to the holding company in the place in which it is incorporated;</p> <p>(c) exposure in the trading book which is not associated with the default risk of a counterparty, for example, exposure to commodities and currencies;</p> <p>(d) exposure to the Government, including for the account of the Exchange Fund, through the holding of the Exchange Fund Notes and Bills;</p> <p>(e) exposure to the central government of a country;</p> <p>(f) exposure to the central bank of a country;</p> <p>(g) exposure to a sovereign foreign public sector entity;</p>	<p>16.1(c): CP paragraph 60.</p> <p>16.1(d): cf BO s81(6)(e). Exchange Fund is defined in BO s2(1).</p> <p>For 16.1(e) and (f) – BCBS LE standards paragraph 61. It should be noted that the Capital Rules will be revised so that an AI’s concentration risk of exposures to a group of connected sovereign entities will be subject to a risk-weighted amount.</p> <p>For 16.1(g), BCBS 61. The BCBS LE standards exempt a PSE that is treated like the</p>
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		<p>(h) exposure amount covered by recognized collateral or recognized guarantee issued by an entity listed under paragraph 16.1(d), (e), (f) or (g) above;</p> <p>(i) exposure amount covered by a letter of comfort with the consent of the MA, and subject to such conditions as the MA may impose, either generally or in any particular case or class of cases;</p>	<p>sovereign of its place of incorporation under the capital framework, from the LE limit. Currently no HK PSEs are treated like the Government under the Capital Rules. Therefore (g) only covers sovereign <u>foreign</u> PSEs.</p> <p>For 16.1(h), BCBS LE standards para. 61, also cf BO s81(6)(b)(i)(D). Under the BCBS LE standards, the exemption no longer refers to Tier 1 country.</p> <p>For 16.1(i), cf BO s81(6)(b)(ii) Section 81A(3)(i) of the BO (as inserted by the BAO) provides for the Rules to empower the MA to consent, subject to any conditions the MA thinks fit to impose, to the</p>
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		<p>(j) any share capital or debt securities held as security for facilities granted by the institution, except for the collateral referred to under paragraph 15.4(b);</p> <p>(k) any share capital or debt securities acquired by the institution in the course of the satisfaction of debts due to it, provided that all share capital and debt securities so acquired shall be disposed of at the earliest suitable opportunity, and in any event not later than 18 months after acquisition, or within such further period as the MA may consent to and subject to such conditions the MA may think proper to attach to such consent, in any particular case;</p>	<p>incurring of specified exposures in a particular case or class of cases such that the exposures need not be taken into account in calculating whether an AI has reached an applicable limit under the Rules.</p> <p>For 16.1(j), cf BO s81(6)(h) with necessary modification.</p> <p>For 16.1(k), cf BO s81(6)(h) and BO s81(7). “Consent” better aligned with the enabling power in BO s81A(3)(i) but may need to revert to “approve” if “consent” cause issue in the transitional provisions under Part 10.</p>
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		<p>(l) any share capital or debt securities acquired under an underwriting or subunderwriting contract provided that such share capital or debt securities are not held for a period exceeding 7 working days, or such further period as the MA may consent to and subject to such conditions as he may think proper to attach to such consent, in any particular case.</p> <p>(m) Any indemnity given by the institution to a person to protect that person against any damages which may be incurred by the person as a result of the person registering a transfer of shares where –</p> <p>(i) the instrument by means of which the transfer has been effected, or purports to have been effected, has been provided, or purports to have been provided , by a subsidiary of the institution;</p> <p>(ii) the authenticating signature on the instrument has been</p>	<p>For 16.1(l), cf BO s81(6)(i)(ii). The policy intent is not to include an equivalent provision to BO s81(6)(j) in the Rules. Under the new framework commitments are subject to a credit conversion factor (see Table A in paragraph 17.1 below) which should make exemption of underwriting commitment unnecessary.</p> <p>For 16.1(m), cf BO s81(6)(k).</p>
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		<p>imprinted on it by a machine used by the subsidiary to imprint that signature on such instruments; and</p> <p>(iii) that signature was unlawfully so imprinted on that instrument, or any financial guarantee given by the institution to that person in respect of any like indemnity given by that subsidiary to that person;</p> <p>(n) exposures to the Housing Authority, within the meaning of the Housing Ordinance (Cap 283), arising from guarantees the Housing Authority gives for the purposes of the Home Ownership Scheme or Private Sector Participation Scheme;</p> <p>(o) exposures to any of the following companies arising from the obligations placed upon the company for the purposes of the Mortgage Insurance Programme set up by The Hong Kong Mortgage Corporation Limited –</p> <p>(i) The Hong Kong Mortgage Corporation Limited, or</p> <p>(ii) any subsidiary of The Hong Kong Mortgage Corporation Limited;</p> <p>(p) exposures to any of the following companies arising from the obligations placed upon the company for the purposes of the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme set up by The Hong Kong Mortgage Corporation Limited –</p> <p>(i) The Hong Kong Mortgage Corporation Limited, or</p>	<p>For 16.1(n), cf BO s81(6)(kb).</p> <p>For 16.1(o), cf BO s81(6)(kc). Subparagraph (ii) is added in response to the recent restructuring of HKMC to transfer its Mortgage Insurance Programme to a subsidiary subject to the guarantee of HKMC.</p> <p>For 16.1(p), cf BO s81(6)(m).</p> <p>For 16.1(q), cf BO s81(6)(l). Specific provisions made in</p>
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		<p>(ii) any company that issues mortgage-backed securities in connection with the Programme;</p> <p>(q) exposure amount which it has been written off in the books of the institution;</p> <p>(r) exposure to an AI or a bank if it is settled within the same calendar day of the location where it has been incurred;</p> <p>(s) exposure of an AI, where the AI acts as a receiving bank in the context of an initial public offer, and the exposure is incurred to another AI for the purposes of placing the subscription monies received by the receiving bank to the interbank market; [If a definition of initial public offering (IPO) is required, it is an act of offering the stock of a company on a public stock exchange for the first time. If a definition of receiving bank is required—in relation to an IPO, it is a bank appointed by the issuer to receive subscription monies and provide services such as returning monies to unsuccessful subscribers.]</p>	<p>respect of exposures are now taken care of by paragraph 13.1(v) (exposure calculation).</p> <p>16.1(r): CP89-90, BCBS LE standards paragraphs 65-67; LE FAQ Q1.</p> <p>16.1(s) is a local specific exemption. The local IPO process involves the transfer of subscription monies to receiving banks. The exemption seeks to avoid the large exposure limit restricting the normal process for a receiving bank to recycle the subscription monies back to the interbank market and in light of the removal of the general interbank exemption under the current BO section 81(6)(a)</p>
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		<p>(t) exposure to qualifying CCPs related to clearing activities as referred to under paragraph 17.8 Error! Reference source not found.;</p> <p>(u) any exposure: (i) specified in a consent given by the MA (which consent may be given to the AI, or a class of AIs, or generally to all AIs) where the MA considers that it is reasonable to allow such exposure not to be taken into account in calculating whether the AI has reached the limit referred to in paragraph 8.1 and 8.2, having regard to (a) the nature and risks associated with the exposure; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the risks associated with any such risk mitigation measures; and (d) any other factors as the MA may consider relevant; and (ii) subject to such conditions as the MA thinks fit to impose on any such consent.</p>	<p>and (g).</p> <p>16.1(t): LE FAQ Q2.</p> <p>16.1(u) is similar to rule 13(2) and (3) under Part 3 of the rules.</p> <p>Section 81A(3)(j) of the BO (as inserted by the BAO) empowers the MA to consent to the incurring of specified exposures, generally or in a particular case or class of cases, such that such exposures need not be taken into account in calculating if limits under the Rules exceeded.</p>
Division 7 Scope and valuation of exposures			
17	General	17.1 The rules will provide that if an AI's exposure must be valued in	Cf rule 14(3).

		accordance with this Division at fair value, rule 4 applies in determining the fair value.	
	Non-counterparty credit risk exposures in the banking book	<p>17.2 The Rules will provide that an AI's non-counterparty credit risk exposures in the banking book include the following:</p> <p>(a) any exposure arising from on-balance sheet items which are neither derivative contracts (except for credit-linked notes) nor specified in other parts of this paragraph 17, measured at the current book value;</p> <p>(b) holdings of shares in a company, measured at the current book value and the amount for the time being remaining unpaid on the shares which is not counted under the current book value of the shares;</p> <p>(c) off-balance sheet exposures measured at the principal amount [defined in paragraph 17.3 below] of the exposures, net of specific provisions, multiplied by the credit conversion factors specified in the table below:</p>	<p>17.2(a): CP35.</p> <p>17.2(a): Credit linked note is a credit derivative contract by definition. However, the policy intent is that an AI holding a credit linked note (an on-balance sheet item) should recognise an exposure to the issuer of the credit linked note like holding any bond.</p> <p>17.2(c): CP paragraph 36. CCFs are designed to convert an off-balance sheet "contingency" into a credit equivalent amount by applying a factor representing an</p>

		<p>Table A</p> <table border="1"> <thead> <tr> <th data-bbox="629 435 752 531"></th> <th data-bbox="752 435 1301 531">Off-balance sheet exposures</th> <th data-bbox="1301 435 1565 531">Credit Conversion Factor</th> </tr> </thead> <tbody> <tr> <td data-bbox="629 531 752 584">(i)</td> <td data-bbox="752 531 1301 584">Direct credit substitutes</td> <td data-bbox="1301 531 1565 584">100%</td> </tr> <tr> <td data-bbox="629 584 752 636">(ii)</td> <td data-bbox="752 584 1301 636">Transaction-related contingencies</td> <td data-bbox="1301 584 1565 636">50%</td> </tr> <tr> <td data-bbox="629 636 752 689">(iii)</td> <td data-bbox="752 636 1301 689">Trade-related contingencies</td> <td data-bbox="1301 636 1565 689">20%</td> </tr> <tr> <td data-bbox="629 689 752 742">(iv)</td> <td data-bbox="752 689 1301 742">Asset sales with recourse</td> <td data-bbox="1301 689 1565 742">100%</td> </tr> <tr> <td data-bbox="629 742 752 794">(v)</td> <td data-bbox="752 742 1301 794">Forward asset purchases</td> <td data-bbox="1301 742 1565 794">100%</td> </tr> <tr> <td data-bbox="629 794 752 847">(vi)</td> <td data-bbox="752 794 1301 847">Partly paid-up shares and securities</td> <td data-bbox="1301 794 1565 847">100%</td> </tr> <tr> <td data-bbox="629 847 752 900">(vii)</td> <td data-bbox="752 847 1301 900">Forward forward deposits placed</td> <td data-bbox="1301 847 1565 900">100%</td> </tr> <tr> <td data-bbox="629 900 752 979">(viii)</td> <td data-bbox="752 900 1301 979">Note issuance and revolving underwriting facilities</td> <td data-bbox="1301 900 1565 979">50%</td> </tr> <tr> <td data-bbox="629 979 752 1315">(ix)</td> <td data-bbox="752 979 1301 1315"> <p>Off-balance sheet exposures that do not fall within any of items (i) to (viii) above and arise from commitments-</p> <p>(a) Subject to paragraph (d), which have an original maturity of not more than one year;</p> </td> <td data-bbox="1301 979 1565 1315"> <p>100% or the factors below</p> <p>(a) 20%</p> </td> </tr> </tbody> </table>		Off-balance sheet exposures	Credit Conversion Factor	(i)	Direct credit substitutes	100%	(ii)	Transaction-related contingencies	50%	(iii)	Trade-related contingencies	20%	(iv)	Asset sales with recourse	100%	(v)	Forward asset purchases	100%	(vi)	Partly paid-up shares and securities	100%	(vii)	Forward forward deposits placed	100%	(viii)	Note issuance and revolving underwriting facilities	50%	(ix)	<p>Off-balance sheet exposures that do not fall within any of items (i) to (viii) above and arise from commitments-</p> <p>(a) Subject to paragraph (d), which have an original maturity of not more than one year;</p>	<p>100% or the factors below</p> <p>(a) 20%</p>	<p>assessment of the likelihood of the off-balance sheet item coming onto the balance sheet.</p> <p>Table A is generally copied from Table 10 under the Capital Rules section 71(1), but made subject to a floor CCF of 10% as required under the LE framework (BCBS LE standards paragraph 35).</p> <p>(ix) The formulation “100% or the factors below” seeks to accommodate preference of some banks to measure undrawn credit facility at the nominal value (even though this may be “less favourable” to the banks as it results in a</p>
	Off-balance sheet exposures	Credit Conversion Factor																															
(i)	Direct credit substitutes	100%																															
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			<p>(b) Subject to paragraph (d), which have an original maturity of more than one year;</p> <p>(c) Which may be cancelled at any time unconditionally by the AI or which provide for automatic cancellation due to a deterioration in the credit worthiness of the person to whom the institution has made the commitments;</p> <p>(d) The drawdown of which will give rise to an off-balance sheet exposure falling within any of item (i) to (viii); or</p>	<p>(b) 50%</p> <p>(c) 10%</p> <p>(d) The lower of the CCF applicable to the exposure based on the original maturity of the commitment or the CCF applicable to the off-balance sheet exposure arising from the</p>	<p>higher credit equivalent amount and hence higher exposure value than if a lower percentage is used).</p>
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				drawdown of the commitment concerned	
		(x)	Any off-balance sheet exposure other than default risk exposures in respect of derivative contracts or securities financing transactions that do not fall within any of items (i) to (ix).	100%	Paragraph 17.2(x) is meant to be a catch-all provision. Capital Rules s73(a) provides that items not specified in Table 10 (of the Capital Rules) are subject to a 100% CCF.
		17.3	For the purposes of paragraph 17.2(c), principal amount, in relation to an exposure listed in Table A, means – (i) in the case of an exposure which is an undrawn facility or the undrawn portion of a partially drawn facility, the amount of the undrawn commitment; (ii) in other cases, the contracted amount of the exposure.		Cf: reference to meaning of principal amount under Capital Rules section 51(1).
	Certain non-counterparty credit risk exposures in either the banking book	17.4	The Rules will provide that an AI's non-counterparty credit risk exposures set out in sub-paragraph 17.5, 17.6, 17.7, 17.10 and 17.11 are to be measured by the methods as set out under those paragraphs, irrespective of whether the exposures are in the banking book or trading book.		

	<p>or trading Book</p>	<p><u>Securities financing transactions – exposure to underlying assets</u></p> <p>17.5 The Rules will provide that an exposure in respect of the securities underlying a securities financing transaction will be valued in accordance with the following provisions.</p> <p>(a) If the securities financing transaction is a repo-style transaction that falls within paragraph (a) or (b) of the definition of repo-style transaction in section 2(1) of the Capital Rules, an AI shall treat the securities sold or lent under the transaction remaining as its holding and value the exposure pursuant to paragraph 17.2(a) and (b) if the securities are held in the banking book; or paragraph 17.15 if the securities are held in the trading book.</p> <p>(b) If the securities financing transaction is a repo-style transaction that falls within paragraph (d) of the definition of repo-style transaction in section 2(1) of the Capital Rules the institution shall treat any securities which it provides as collateral under the transaction as remaining as its holding and value the exposure pursuant to paragraph 17.2(a) and (b) if the securities are held in the banking book; or paragraph 17.15 if the securities are held in the trading book.</p> <p><u>Option contract – exposure to underlying assets</u></p> <p>17.6 For derivative contracts in the form of option contracts, the Rules will provide that exposure to the underlying assets should be valued as the</p>	<p>17.5:CP paragraph 38.</p> <p>Cf Capital Rules section 75(2).</p> <p>Cf Capital Rules section 75(4).</p> <p>17.6:CP paragraphs 39-40, 67-69. The BCBS LE standards</p>
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		<p>change in option price that would result from a default in respect of the assets underlying the option. The respective exposures arising from simple call options and put options should be valued at:</p> <ul style="list-style-type: none"> - Long call: V - Long put: -S+V - Short call: -V - Short put: S-V <p>where S = strike price and V = fair value of the option contract.</p> <p><u>Central counterparty</u></p> <p>17.7 The Rules will provide that an AI must measure its exposure to a central counterparty as a sum of both clearing related exposure and exposure not related to clearing.</p> <p>17.8 The Rules will provide that unless exempted in the circumstances set out under paragraph 16, non-counterparty credit risk exposures to a central counterparty should be valued according to the provisions in Table B below:</p> <p>Table B</p> <table border="1" data-bbox="577 1161 1610 1305"> <thead> <tr> <th data-bbox="577 1161 1093 1209"></th> <th data-bbox="1093 1161 1610 1209">Measurement method</th> </tr> </thead> <tbody> <tr> <td data-bbox="577 1209 1093 1257">(a) <u>Clearing related exposure</u></td> <td data-bbox="1093 1209 1610 1257"></td> </tr> <tr> <td data-bbox="577 1257 1093 1305">(i) Non-counterparty credit risk</td> <td data-bbox="1093 1257 1610 1305">These exposures should be calculated</td> </tr> </tbody> </table>		Measurement method	(a) <u>Clearing related exposure</u>		(i) Non-counterparty credit risk	These exposures should be calculated	<p>are not clear about the treatment of options in the banking book. The policy intent is to apply the same treatment as that applied to options in the trading book.</p> <p>17.7: CP paragraphs 107-109.</p> <p>Clearing exposures and non-clearing exposures are subject to different treatments.</p> <p>It should be noted that an AI's clearing related exposure to a qualifying CCP is exempted under paragraph 16.1(t).</p>
	Measurement method								
(a) <u>Clearing related exposure</u>									
(i) Non-counterparty credit risk	These exposures should be calculated								

		<p>exposures arising from derivative contracts and securities financing transactions entered into with a CCP in relation to the clearing services provided by the CCP</p>	<p>using the measures prescribed in other parts of paragraph 17 for the respective type of exposures. For example, exposures to the underlying assets of derivative contracts should be measured as set out in paragraphs 17.6 and 17.16 to 17.19.</p>	<p>In relation to (vi), generally shares are at current book value plus unpaid amount (paragraph 17.2(b)) – for CCP shareholdings the intention is to value differently.</p>
(ii) Segregated initial margin	The exposure value is 0.			
(iii) Non-segregated initial margin	The exposure value is the nominal amount of initial margin posted.			
(iv) Funded default fund contribution	Nominal amount of the funded contribution.			
(v) Unfunded default fund contribution	The exposure value is 0.			
(vi) Holding of shares in the CCP	The exposure value is the nominal amount of shares held			
		<p>17.9 For avoidance of doubt, an AI should also include counterparty credit risk exposures arising from derivative contracts and securities financing transactions entered into with a CCP, unless exempted as set out in paragraph 16, in calculating its aggregate exposures to the CCP under</p>		

		<p>paragraph 13.1.</p> <p><u>Covered bonds</u></p> <p>17.10 The Rules will provide that a covered bond should be valued:</p> <ul style="list-style-type: none"> (a) at its nominal value; or (b) if the conditions (i) to (iii) below are satisfied at the inception of the covered bond and throughout its remaining maturity, at 30% of its nominal value. <p><u>Conditions:</u></p> <ul style="list-style-type: none"> (i) The pool of underlying assets must exclusively consist of: <ul style="list-style-type: none"> – 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% risk weight under section 65(1) of the Capital Rules if the mortgages had been extended by the AI holding the covered bonds and in aggregate have a loan-to-value ratio of 80% or lower. To avoid doubt, this 80% or lower loan-to-value ratio requirement is in addition to similar requirements set out in section 65(1) of the Capital Rules. (ii) The nominal value assigned by the issuer to cover the issuer’s obligations under the covered bonds should exceed the outstanding 	<p>17.10:CP paragraphs 92-95</p> <p>“covered bonds” are distinguishable from other securitizations because they are subject to specific legislative/regulatory frameworks which provide for bondholders to have recourse to a pool of cover assets assigned for the purpose and also to the issuer generally, (i.e. the recourse under the bonds is not limited to the cover pool).</p>
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		<p>(nominal value) of the covered bonds by at least 10%. The value of the pool of assets for this purpose does not need to be that required by the legislative framework. However, if the legislative framework does not stipulate a requirement of at least 10% “over-collateralization”, the issuer of the covered bond needs to publicly disclose on a regular basis that its cover pool meets the 10% requirement in practice. In addition to the primary assets listed under condition (i) above, the additional collateral may include substitution assets (cash or short term-liquid and high-quality assets held in substitution of the primary assets to top up the cover pool for the purposes of managing the pool) and derivative contracts entered into for the purposes of hedging the risks arising in the covered bond programme.</p> <p>(iii) in order to calculate the loan-to-value ratio for mortgages secured on residential real estate referred to in (i) above, the operational requirements included in section 206(i) and (j) of the Capital Rules, as if that section was applicable to the covered bond issuing institution, regarding the objective value of collateral and the frequency of revaluation must be used.</p> <p><i>Investment structures</i></p> <p>17.11 The Rules will provide that investment structures should be valued according to the provisions below:</p>	<p>17.10(iii): BCBS LE standards paragraph 71 with necessary modification.</p> <p>17.11:CP paragraphs 97-99, 101; BCBS LE standards</p>
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		<p>(a) subject to subparagraphs (b), (c) and (d) below, an AI must apply a look-through approach to any investment structure by assigning an exposure to each asset underlying the investment structure. The exposure value to an underlying asset should be measured according to paragraph 17.13;</p> <p>(b) if the amount of exposure to each asset underlying the investment structure, measured by the method in paragraph 17.13 below, is smaller than 0.25% of its own Tier 1 capital, the AI may assign the exposure to the investment structure itself as a distinct counterparty. The exposure should be the current book value of the institution's investment in the investment structure. In this case, the AI would not be required to look through the structure to assign an exposure to each underlying asset;</p> <p>(c) if the amount of exposure to any asset underlying the investment structure, measured by the method in paragraph 17.13 below, is equal to or above 0.25% of the AI's Tier 1 capital, the AI must assign an exposure to each of these assets at the respective measured value. An AI may choose to look through to each asset in the rest of the portfolio underlying the investment structure (i.e.</p>	<p>paragraphs 73-75.</p> <p>When checking whether the exposure to each underlying asset may exceed 0.25% of the Tier 1 capital, the AI needs to consider only the exposure to the underlying asset that results from the investment in the structure.</p>
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		<p>full look-through as in (a)) or assign an exposure to the investment structure itself equivalent to the sum of the value of the remainder of the portfolio's underlying assets, obtained by the method in paragraph 17.13 below, each of which individually is less than 0.25% of the AI's Tier 1 capital (i.e. partial look-through);</p> <p>(d) if an AI is unable to identify the underlying assets of a structure:</p> <ul style="list-style-type: none"> • where the total exposure amount of its investment in the investment structure does not exceed 0.25% of its Tier 1 capital, the AI must assign the total exposure amount of its investment (at the current book value) to the investment structure itself as a distinct counterparty; • otherwise, it is required to assign the total exposure amount of its investment in the investment structure to a hypothetical counterparty called the "unknown client". The AI should aggregate all exposures to the unknown client as if they were related to a single counterparty to which the large exposure limit in paragraph 8.1 would apply. 	<p>An AI may hold more than one investment structure each satisfying the condition that the underlying assets cannot be identified and the investment amount exceeds 0.25% of its Tier1 capital. These holdings in the investment structures are to be summed together as an exposure to the "unknown client".</p>
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		<p>17.12 In relation to paragraph 17.11(b), an AI must not enter into schemes to avoid the application of a look-through approach with a view to circumventing the exposure limits in this Part, for example, by investing in several individually immaterial investment structures with identical underlying assets.</p> <p>17.13 The calculation method to ascertain the exposure value to be assigned to an underlying asset referred to in paragraph 17.11(a), (b), and (c) above is as follows:</p> <p>(a) If the rights of all the investors in the investment structure are the same (i.e. as a class all investors have the same rights to share the profit and loss and asset of the structure, e.g. investment funds), the exposure to an asset underlying the structure is measured by the formula below:</p> $E(A) = \text{Min} (S_A \times \text{NAV}_{AI} / \text{NAV}_S), \text{BV}$ <p>Where</p> <p>E(A) = AI's exposure to asset A underlying an investment structure;</p> <p>S_A = The investment structure's exposure to asset A as disclosed in the latest financial report of the investment structure;</p>	<p>17.12: CP paragraph 100, BCBS LE standards paragraph 76.</p> <p>17.13(a):CP paragraph 102.</p> <p>17.13(a) The formula is not explicit from the BCBS LE standards. It has been developed locally to cater for the fact that, in relation to holdings in an investment structure that carries leverage, the exposure to an underlying asset should take into account the leverage but in any case be capped at the value of investment in the investment structure.</p>
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		<p>NAV_{AI} = Net asset value of the share of the AI's holding of the shares or units of the investment structure;</p> <p>NAV_S = Net asset value of the investment structure;</p> <p>BV = Current book value of the shares or units of the investment structure</p>	<p>Illustrative example – An investment fund is financed by \$250 equity shares and \$100 debts. Its investments (current book value) include \$120 bonds, \$80 stock A, \$90 stock B and \$60 stock C. NAV of the fund is \$250. Assuming that an AI holds 50% of the equity shares in this fund, the NAV of the AI's share of the fund is \$125. Further assume this is the current book value of the AI's holding of the shares of this fund. The fund's exposure to stock A is \$80 (i.e. leveraged exposure compared with the case the CIS if purely financed by equity). The AI's share of exposure to stock A is \$40 ($80 \times 125/250$). This exposure is compared with the BV of the AI's investment in</p>
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		<p>(b) If there are differences in seniority levels among the investors in an investment structure (e.g. securitisation transaction), exposure to the underlying assets should be measured as follows:</p> <ul style="list-style-type: none"> (i) first, ascertain the lower of (I) the value of the tranche in the investment structure in which the AI invests and (II) the nominal value of each underlying asset included in the portfolio of assets underlying the investment structure; and (ii) second, apply the pro rata share of the AI's investment in the tranche to the value determined in (i). 	<p>the fund because in any case its exposure to an underlying asset of the fund must not exceed the value of its investment in the fund. Taking this into account, its exposure to stock A is \$40 (the lower of \$40 and \$125).</p> <p>17.13(b): CP paragraph 103.</p> <p>An illustrative example is provided in <u>Annex 2</u>.</p>
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		For avoidance of doubt, an exposure to a counterparty that is the issuer of a relevant asset underlying an investment structure must be added to the AI's non-counterparty credit risk exposures to that counterparty in the calculation of aggregate exposures under paragraph 13.1.	
	Non-counterparty credit risk exposures in the trading Book	<p>17.14 The Rules will provide that an AI's non-counterparty credit risk exposures in the trading book include those set out in subparagraphs 17.15, 17.16, 17.17, 17.18 and 17.19.</p> <p><i>Shares and debt securities</i></p> <p>17.15 Exposure in respect of holdings of shares and debt securities should be measured at current market value.</p> <p><i>Derivative transactions and contracts – exposure to underlying assets</i></p> <p>17.16 Derivative contracts (except for (i) options contracts and (ii) credit derivative contracts) such as swap contracts, futures contracts and forward contracts must be decomposed into individual legs following section 289(2)(c)(i), (ii) and (iii) and section 292(1)(c), (d) and (e) of the Capital Rules as if those rules were applicable to the AI. Only legs representing non-counterparty credit risk exposure and counterparty credit risk exposure are required to be included as an exposure for the purposes of this Part. To avoid doubt, if the decomposed exposure is to a hypothetical government bond or interest rate instrument as set out under</p>	<p>17.15:CP paragraph 62.</p> <p>17.16:CP paragraphs 63 and 85.</p>

		<p>the Capital Rules above, that exposure can be ignored.</p> <p>17.17 For a credit derivative contract other than nth-to-default swaps, where the AI is the protection seller, the AI should recognize an exposure to the reference entity measured as the amount due in the case a credit event specified in the contract occurs minus the absolute mark-to-market value of the credit derivative contract.</p> <p>17.18 For nth-to-default swaps, where the AI is the protection seller, the AI should either</p> <p>(a) recognize an exposure to each basket position calculated as the notional amount of the instrument multiplied by m: $m = \max(1/n, \min(1, 1.6-0.2n))$</p> <p>Where n stands for the number of positions in the basket that need to default to trigger the payment by the protection seller. Long positions in an nth-to-default swap should not be recognized as a credit risk mitigant and should be excluded from the exposure calculation; or</p> <p>(b) recognize a risk exposure in the full nominal amount of the instrument to each basket position (or group of linked basket positions).</p> <p><i>Other derivative transactions and contracts in the trading book</i></p>	<p>17.17:CP paragraph 64.</p> <p>17.18:CP paragraphs 65-66.</p> <p>The method to deal with nth-to-default swaps is local specific. This is developed to answer requests for guidance on this front.</p> <p>Nth-to-default credit default swaps are a form of basket credit default swap. The “nth” in “nth-to-default” refers to the number of reference entities in the basket that must default before the conditions to</p>
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		<p>17.19 For other derivative transactions and contracts in the trading book not specified in sub-paragraphs 17.6 and 17.16 to 17.18 above, a long position in the underlying obligor should be measured as the amount of loss that would be sustained by the AI if the underlying obligor was to immediately default and a short position in the underlying obligor should be measured as the amount of gains to the AI if the underlying obligor was to immediately default.</p>	<p>settlement under the swap contract are met. For example, a second to default product would mean that if any two of the (say) five to ten specified reference entities suffered a credit event and the other conditions to settlement were met, the transaction would settle (i.e. the protection buyer stops paying the premium and receives the difference of the principal amount of the nth defaulted entity and the recovered value). The settlement would however only relate to the “nth” reference entity to default.</p> <p>See also para. 15.3.</p>
<p>Division 8 Offsetting and risk mitigation</p>			

18	Offsetting long and short positions in the trading book	<p>18.1 The Rules will provide that an AI may offset a long position and short position in the same issue of securities in the trading book.</p> <p>18.2 Two issues are defined as the same if the issuer, coupon, currency and maturity, priority to claim on the issuer’s income or assets, as applicable, are identical.</p> <p>18.3 An AI may offset a long position and short position in different issues of securities issued by the same counterparty in the trading book if the short position is junior, or of equivalent seniority, to the long position.</p> <p>18.4 An AI may also offset its exposure to a counterparty arising from its holdings of the securities issued by that counterparty in the AI’s trading book against a credit derivative contract entered into to hedge the exposure if the reference obligation of the credit derivative contract is junior or of equivalent seniority to the position being hedged.</p> <p>18.5 For the purposes of subparagraphs 18.3 and 18.4— (a) in order to determine the relative seniority of long and short positions in different issues of securities, securities may be allocated into broad buckets of degrees of seniority (for example, “equity”, “subordinated debt” and “senior debt”). If applicable, this categorization should be applied consistently across an AI’s entire portfolio of positions in its</p>	<p>18.1 and 18.2: CP paragraph 72.</p> <p>Securities are intended to cover both shares of a company and bonds.</p> <p>18.3: CP paragraphs 73 and 76.</p> <p>18.4: CP paragraph 74.</p> <p>18.5: CP paragraphs 75-76.</p>
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		<p>trading book;</p> <p>(b) an AI may choose not to allocate securities to different seniority buckets (in which case, no offsetting of long and short positions in different issues relating to the same counterparty could be recognised) or not to apply the offsetting under these subparagraphs in calculating the exposure to the counterparty.</p>	
19	Credit Mitigation	<p>Risk</p> <p>19.1 Subject to paragraph 19.3, the Rules will provide that for the purpose of paragraph 13.1(iv)(a), a category 1 AI must calculate the CRM uncovered portion of an exposure, according to paragraph 19.3, 19.4 and 19.5.</p> <p>19.2 The Rules will provide that for the purpose of paragraph 13.1(iv)(b), a category 2 AI must calculate the CRM uncovered portion of—</p> <p>(a) an exposure subject to on-balance sheet netting according to paragraph 19.3; and</p> <p>(b) an exposure covered by recognized collateral according to paragraph 19.4 if the recognized collateral is cash.</p> <p>On-balance sheet netting</p> <p>19.3 The Rules will provide that if an AI’s exposure to a counterparty arising</p>	<p>19 and subparagraphs: CP paragraph 44 which requires CRM techniques to follow the STC approach.</p> <p>19.1:CP paragraphs 53-57, 77.</p> <p>19.2:CP paragraph 57.</p> <p>19.3:CP paragraphs 49-50.</p>

		<p>from an on-balance sheet item is subject to recognized netting under a valid bilateral netting agreement, the AI may calculate the CRM uncovered portion of the exposure as the net credit exposure calculated by Formula 7 of the Capital Rules, subject to the maturity mismatch adjustments and requirements under section 103(1) and (3) of the Capital Rules, as if (i) Formula 7 and section 103(1) and (3) of the Capital Rules were applicable to the institution and (ii) any deposit involved in recognized netting was an acceptable credit protection under Formula 7.</p> <p>Exposure covered by recognized collateral</p> <p>19.4 The Rules will provide that if an exposure of an AI is covered by recognized collateral pursuant to sections 77, 79 and 80 of the Capital Rules other than collateral within the meaning of section 79(1)(p) as if these sections of the Capital Rules were applicable to the AI,</p> <p>(a) where the AI adopts the basic approach to calculate the credit risk of the exposure under the Capital Rules, it must calculate the CRM uncovered portion of the exposure by:</p> <p>(i) for an exposure other than specified in Table A under paragraph 17.2, using Formula A below; and</p> <p>(ii) for an exposure specified in Table A under paragraph 17.2, firstly using Formula A, then multiplying the result by the CCF in Table A applicable to the exposure.</p>	<p>19.4:CP paragraph 51(b). BCBS LE standards paragraphs 36-38 and 42.</p> <p>Under the Capital Rules, an AI is required to use the STC approach to calculate credit risk capital charge (i.e. a default option) unless it applies and is approved to use another approach. The other approaches available are the BSC approach, which is simpler and the IRB approach,</p>
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		<p>Formula A: CRM uncovered portion = max [0, (original exposure – current market value of recognized collateral)]</p> <p>Where original exposure means the value of the exposure as calculated according to these Rules.</p> <p>(b) where the AI adopts the standardized (credit risk) approach to calculate the credit risk of the exposure under the Capital Rules —</p> <p>(i) for an exposure with respect to which the simple approach is used to account for the credit risk mitigation effect of recognized collateral under Division 6 Part 4 of the Capital Rules, calculate the CRM uncovered portion of the exposure by the same method as under 19.4(a);</p> <p>(ii) for an exposure with respect to which the comprehensive approach is used to account for the credit risk mitigation effect of recognized collateral under Division 7 Part 4 of the Capital Rules, calculate the CRM uncovered portion of the exposure</p> <p>(I) for an exposure other than that specified in Table A under paragraph 17.2, as the net credit exposure in Formula 2 under section 87 or Formula 4 under section 89 of the Capital Rules, as the case requires depending upon the nature of the exposure, subject to the haircuts provisions applicable where the recognized collateral consists of a</p>	<p>which is complicated but may result in a lower amount of capital charge. The BSC approach referred to in paragraph 19.4(a) is a “home grown” Hong Kong alternative to the STC approach and IRB approach made available under the Capital Rules locally to cater for the less sophisticated AIs. In other words, it is not an approach recognized in the Basel capital framework.</p> <p>Each of the BSC approach, STC approach and IRB approach carries its own methods to recognize collateral for credit risk mitigation method. However, for the purposes of these rules, only the methods under the STC approach are acceptable for</p>
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		<p>basket of securities under section 90 of the Capital Rules and the maturity mismatches provisions under section 103, of the Capital Rules as if those sections and formula were applicable to the institution, and</p> <p>(II) for an exposure specified in Table A under paragraph 17.2, as the net credit exposure in Formula 3 under section 88 of the Capital Rules, subject to the haircuts provisions applicable to a basket of securities under section 90 of the Capital Rules and the maturity mismatches provisions under section 103 of the Capital Rules, as if those section and formula were applicable to the institution.</p> <p>(c) where the AI adopts the IRB approach to calculate the credit risk of the exposure under the Capital Rules, the AI should determine the treatment of recognized collateral pursuant to section 78 of the Capital Rules (i.e. simple approach or comprehensive approach) as if that section was applicable to the AI—</p> <p>(i) in the case where the AI determines that the simple approach should apply (after applying the provision of section 78 of the Capital Rules), calculate the CRM uncovered portion of the exposure by the same method as under paragraph 19.4(a);</p> <p>(ii) in the case that where the AI determines that the comprehensive approach should apply (after applying the provisions of section</p>	<p>recognizing a credit risk mitigation technique.</p> <p>Given the foregoing, an “as if” formulation is used in this paragraph, which serves to clarify that the BSC and IRB AIs under the Capital Rules should use the STC methods for the purposes of these rules as if those methods were applicable to them. In addition, reading together with paragraph 7.2(b), the “as if” formulation does not preclude a STC AI under the Capital Rules to use the STC methods for the purposes of these Rules.</p> <p>Under the STC approach of the Capital Rules, two methods are acceptable to the treatment of</p>
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		<p>78 Capital Rules), calculate the CRM uncovered portion of the exposure by the same method as under paragraph 19.4(b)(ii).</p>	<p>exposures covered by recognized collateral. They are the simple approach and the comprehensive approach. The STC approach already has provisions specifying when to use which approach. The STC and IRB AIs are required to follow the same specification to determine which approach to use under these Rules. However, as BSC AIs are only required to use the simple approach under the Capital Rules, they should also use the same approach under these Rules (see 19.4(b)(i)).</p> <p>The simple approach involves substituting the risk-weight of protected exposure by that of the issuer of the collateral under the Capital Rules.</p>
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			<p>However, since the concept of risk-weight substitution does not apply to the LE framework, these rules “borrow” the collateral recognition criteria under the simple approach but apply “exposure deduction” to take into account recognized collateral. The method is adapted in these Rules as set out in Formula A.</p> <p>The comprehensive approach applies “exposure deduction” to take into account recognized collateral, subject to prescribed haircut to the value of collateral. This approach is by and large fully imported into these Rules.</p> <p>Similar to recognized collateral, the BCBS LE framework only accepts</p>
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		<p>Exposure covered by recognized guarantee or recognized credit derivative contract</p> <p>19.5 The Rules will provide that if an exposure of an AI is covered by</p> <ul style="list-style-type: none"> (a) a recognized guarantee pursuant to section 98 of the Capital Rules as if that section was applicable to the institution or (b) a recognized credit derivative contract pursuant to section 99 of the Capital Rules, other than a credit linked note, as if that section was applicable to the institution, <p>the AI should calculate the CRM uncovered portion of the exposure by Formula B below:</p> <p>Formula B:</p> <p>CRM uncovered portion = max {0, (original exposure – G * (1-H_{fx}))}</p> <p>where –</p> <p>original exposure means the value of the exposure as calculated according</p>	<p>recognized guarantee and recognized credit derivative contract under the STC approach, even if an AI uses a different approach for capital calculation purposes. Therefore the “as if” formulation is also applied here.</p> <p>19.5: CP paragraphs 51(a) and 52; BCBS LE standards paragraphs 36, 37, 38 and 42.</p> <p>19.5(b):CP paragraphs 46, 52 and 74-76; BCBS LE standards paragraph 53.</p>
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		<p>to these Rules.</p> <p>G = maximum liability of the credit protection provider to the AI under the credit protection; and</p> <p>H_{fx} = haircut applicable in consequence of a currency mismatch, if any, pursuant to the standard supervisory haircuts specified in Schedule 7 of the Capital Rules, subject to adjustment as set out in section 92 of the Capital Rules</p> <p>The credit protection of recognized guarantee and recognized credit derivative contract represented by “G” under Formula B is subject to the maturity mismatch adjustments and requirements under section 103 of the Capital Rules.</p> <p>(c) a credit linked note (i.e. the AI seeking credit protection is the protection buyer and the issuer of the note), the CRM uncovered portion of the exposure is calculated pursuant to the methodology set out in paragraph 11.5 as if the exposure was secured by the amount of sales proceeds of the note as cash deposits.</p>	
20	Overlap of coverage of credit risk	20.1 The Rules will provide that if a portion of an exposure is covered by more than one form of recognised credit risk mitigation as set out in paragraph	BCBS LE standards paragraph 42 provides that a bank must

	mitigation	<p>1920, an AI should use the form of credit risk mitigation specified in paragraph 20.2 to calculate the CRM uncovered portion of the exposure.</p> <p>20.2 The form of credit risk mitigation referred to in paragraph 20.1 is the one which would result in the lowest risk-weighted amount of the exposure covered by the overlapping credit risk mitigation if Division 5 to Division 9, Part 4 of the Capital Rules are applied to calculate the risk-weighted amount of the exposure, as if these Divisions were applicable to the institution. If the risk-weighted amount is the same for two or more forms of credit risk mitigation, an AI may choose any one of the forms of credit risk mitigation at its discretion.</p>	<p>reduce the value of the exposure to the original counterparty by the amount of eligible CRM technique recognised for risk-based capital requirement purposes. Accordingly the proposal in paragraph 20 follows the treatment for multiple recognized credit risk mitigation under Capital Rules section 102(2).</p>
<u>PART 7 – Limit on exposures to connected parties [Current BO s83]</u>			
Division 1 General			
21	Application of Part 7	21.1 This Part will be expressed to apply to AIs <u>incorporated in Hong Kong</u> .	
22	Interpretation of Part 7	<p>22.1 The following definitions should be included for terms used in Part 7:</p> <ul style="list-style-type: none"> • “<i>Exposure</i>” has the same meaning given in paragraph 7.4 above. • “<i>Relative</i>”, in relation to a person, means the person’s:- <ul style="list-style-type: none"> (a) lineal ancestor; (b) step-parent and adaptive parent; 	<p>In response to industry comments, we have determined to streamline the definition of relative taking into account international practices and local circumstances.</p>

		<p>(c) brother and sister;</p> <p>(d) spouse (include anyone living as such);</p> <p>(e) spouse’s parent, step-parent and adaptive parent;</p> <p>(f) spouse’s brother and sister;</p> <p>(g) son and daughter; and</p> <p>(h) specified descendent;</p> <p>and for the purposes of this definition, son includes step-son and adopted son and daughter includes step-daughter and adopted daughter;</p> <ul style="list-style-type: none"> • “<i>Lineal ancestor</i>”, in relation to a person, means the person’s parent, grandparent, great grandparent and so on; • “<i>Non-listed company</i>” means a company not listed on a recognized stock market but shall not include any public statutory corporation designated for the purposes of this definition by the Financial Secretary by notice in the Gazette. • “<i>Specified descendent</i>”, in relation to a person, means the person’s grandson and granddaughter, great-grandson and great granddaughter and so on. 	<p>Cf BO s79(1). “recognized stock market” is defined in s2(1) of the BO.</p>
Division 2 Limit on exposures to connected parties			
23	Limitation on	23.1 The Rules will provide that subject to the exemptions referred to in	This seeks to replicate the

	exposures to connected parties	<p>paragraph 25.1, an AI must not incur exposures, calculated as set out in paragraph 27.1, to, or on behalf of</p> <ul style="list-style-type: none"> (a) any person or body specified in paragraph 26.1 if the aggregate exposures to those persons and bodies would exceed 15% of its Tier 1 capital; (b) any one or more persons who are individuals specified in paragraph 26.1 if the aggregate exposures to those individuals would exceed 5% of its Tier 1 capital; (c) any person who is an individual specified in paragraph 26.1 if the total exposures to that single individual would exceed \$10,000,000. 	<p>substance of the 3 limits under BO s83(1) and (2).</p> <p>BO Section 81A(1)(a)(ii) (as inserted by the BAO) provides that the MA may make Rules prescribing limits on exposures to a party connected to the AI.</p>
24	MA may vary the limit on connected parties exposures	<p>24.1 The Rules will provide that subject to a procedure similar to that set out in Rule 11 of the first batch of Rules (and also in paragraph 9 above) the MA may, by notice in writing served on an AI vary the limit referred to in paragraph 23.1 above applicable to the institution if the MA is satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account (a) the risks associated with the level or concentration of the AI's connected counterparty exposures; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the risks associated with any such risk mitigation measures and (d) any other factors as the MA may consider relevant.</p>	<p>BO Section 81A(3)(j) (as inserted by s9 of the BAO) empowers the MA to vary, in accordance with a procedure set out in the Rules and in circumstances set out in the Rules, a limit applicable to an AI.</p>
Division 3 Exempted exposures			

25	Exemptions of exposures to connected parties from paragraph 23	<p>25.1 Exemption of exposures as mentioned in paragraph 23.1 should include:</p> <p>(a) exposure to the extent which it has been written off in the books of the institution;</p> <p>(b) any exposure in circumstances where the MA has consented to such exposures not being taken into account in calculating whether the AI has reached the limit referred to in paragraph 23.1(a), (b) and (c), subject to any conditions that the MA may think proper to attach to the consent.</p>	<p>Cf BO s83(3A). Not necessary to exempt exposures covered by specific provision because calculation of exposure under the Rules will be net of specific provision.</p> <p>Cf BO s83(4A). BO section 81A(3)(i) (as inserted by s9 of the BAO) empowers the MA, to consent, subject to any conditions the MA thinks fit, to the incurring of specified exposures generally or in a particular case or class of cases such that the exposures need not be taken into account in calculating whether an AI has reached a limit under the Rules.</p>
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Division 3 Calculation of aggregate exposures to all connected parties			
26	Scope of connected parties	<p>26.1 For the purposes of the limits referred to in paragraph 23.1(a), (b) and (c), the following persons and bodies should be specified:</p> <ul style="list-style-type: none"> (a) any director of the institution (b) any relative of any such director; (c) any employee of the institution who is responsible (either individually or as a member of a committee) for approving loan applications; (d) any relative of any such employee; (e) any controller or minority shareholder controller of the institution (other than an AI, or a bank incorporated outside Hong Kong which is not an AI but is approved by the MA for these purposes of this paragraph); (f) any relative of an individual who is a controller or minority shareholder controller of the institution; (g) any firm, partnership or non-listed company other than an AI, or a bank incorporated outside Hong Kong which is not an AI but is approved by the MA for these purposes) in which the AI or any of its controllers, minority shareholder controllers or directors (including their relatives in the case of individuals) is interested as director, partner, manager or agent; and (h) any individual, firm, partnership or non-listed company of which any 	<p>Cf s83(4)BO.</p> <p>“Controller”, “minority shareholder controller” used in paragraph 26 which are already defined in BO s2(1). We intend to apply the same meaning to these terms in this Part. We understand a separate definition is not required.</p>

		controller, minority shareholder controller or director of the AI (including their relatives in the case of individuals) is a guarantor.	
27	Calculation of exposures	<p>27.1 For the purposes of this Part, an AI should calculate an exposure to a connected party by the same method as specified in paragraph 13 above, subject to the following exceptions:</p> <ul style="list-style-type: none"> (a) in relation to subparagraph 13.1(iv), an AI must apply subparagraph 13.1(iv)(a), i.e. by the method applicable to a Category 1 under paragraph 19.1, to calculate the CRM uncovered portion of an exposure, even if the AI is a Category 2 AI; and (b) in relation to an exposures covered by recognized collateral under paragraph 19.4, real property is deemed to be a recognized collateral for the purpose of calculating an exposure to a connected party, provided that the requirements specified in section 77(a), (b), (c), (d), (e), (ea), (f) and (g) of the Capital Rules are satisfied. If section 77 does not apply to the institution under the Capital Rules, the institution should make the calculation as if the section did apply. <p>27.2 The Rules will provide that if an AI's exposure to a connected party must be valued in accordance with this Division at fair value, rule 4 applies in determining the fair value.</p>	<p>The policy intent is that only the portion of connected counterparty exposures that is not covered by recognized collateral, a recognized guarantee or a recognized credit derivative contract will be subject to the exposure limits. For this purpose, recognized collateral includes real property (which is not to be recognized or accepted under Part 6).</p> <p>27.2: Cf rule 14(3).</p>

28	Supplementary provisions	<p>28.1 The provisions of this Part shall apply to an exposure arising from a facility granted to or on behalf of a person or body jointly with another person or body as they apply to a facility granted to or on behalf of a person or body severally.</p> <p>28.2 For the purposes of paragraphs 23.1(b), 23.1(c) and 26, an exposure incurred to any firm, partnership or non-listed company which a person specified in subparagraph 26.1(a), (b), (c), (d), (e) or (f) is able to control, shall be deemed to be incurred to that person.</p>	<p>Cf BO s83(5).</p> <p>Cf BO s83(6).</p>
<u>PART 8 – Limitation on advances to employees [Current BO s85]</u>			
Division 1 General			
29	Application of Part 8	<p>29.1 The Rules will provide for this Part to apply to all AIs.</p> <p>29.2 The Rules will provide that, in relation to any AI incorporated outside Hong Kong, this Part should apply only to its principal place of business in Hong Kong and its local branches, and should do so as if that principal place of business and those branches were collectively a separate AI.</p>	<p>Cf BO s85(1).</p> <p>Cf BO s79(4). BO Section 81A(3)(e) (as inserted by s9 of the BAO) provides that Rules made by the MA may specify in respect of an AI incorporated outside Hong Kong that any provision of the Rules is to apply only to</p>

			the business of the AI in Hong Kong.
30	Interpretation	<p>30.1 The following definitions will be included for use in Part 8 :</p> <ul style="list-style-type: none"> • Value means current book value; • Unsecured means granted without security, or in respect of any advance, loan or credit facility granted or financial guarantee or other liability incurred with security, any part thereof which at any time exceeds the current market value of assets constituting that security. • Security means such security as would, in the opinion of the MA, be acceptable to a prudent banker. 	<p>Cf BO s79(1) the definition of value.</p> <p>Cf BO s79(3) the definition of “unsecured” and “security”.</p>
Division 2 The limitation			
31	Limitation on advances to employees	<p>31.1 The Rules will provide that an AI shall not, without the written consent of the MA given generally or in any particular case or class of case, provide to any one of its employees any facility as specified in paragraph 31.2 to an aggregate amount of such facilities in excess of one year’s salary for the employee.</p> <p>31.2 For the purposes of paragraph 31.1 the following facilities are specified –</p> <ul style="list-style-type: none"> (a) the granting, or permitting to be outstanding, of unsecured advances, unsecured loans or unsecured credit facilities including unsecured letters of credit; (b) the giving of unsecured financial guarantees; and (c) the incurring of any other unsecured liability. 	<p>Replication of BO s85(1) and (2).</p> <p>BO section 81A(1)(a)(iii) (as inserted by the BAO) provides that the MA may make Rules prescribing limits on exposures to employees of the AI.</p> <p>BO section 81A(3)(i) empowers the MA to consent, subject to any conditions the</p>

			MA thinks fit, to the incurring of specified exposures generally or in a particular case or class of cases such that the exposure need not be taken into account in calculating whether an AI has reached a limit under the Rules.
32	MA may vary the limit on advances to employee	32.1 The Rules will provide that subject to a procedure similar to that set out in Rule 11 (and also in paragraph 9 above) the MA may, by notice in writing served on an AI vary the limit referred to in paragraph 31.1 above applicable to the institution if the MA is satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account (a) the risks associated with the level or concentration of the AI's exposure to an employee of the AI; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the risks associated with any such risk mitigation measures and (d) any other factors as the MA may consider relevant.	Section 81A(3)(j) of the BO (as inserted by s9 of the BAO) empowers the MA to vary, in accordance with a procedure set out in the Rules and in circumstances set out in the Rules, a limit applicable to an AI.
Part 9: Limit on holding of interest in land [Current BO s88]			
Division 1 General			
33	Application of Part 9	33.1 The Rules will provide for this Part to apply to AIs <u>incorporated in Hong Kong</u> .	Cf BO s88(1).

34	Interpretation of Part 9	34.1 The Rules will provide for the definition of “ <i>value</i> ” (referred to in paragraph 35) as representing the current book value.	
Division 2 Limit on the holding of interest(s) in land			
35	Limitation on the holding of interest(s) in land by AI	35.1 The Rules will provide that an AI shall not purchase or hold any interest or interests in land situated in or outside Hong Kong of a value or to an aggregate value, as the case may be, in excess of 50 per cent of the Tier 1 capital of the institution.	<p>BO section 81A(1)(b)(ii) (as inserted by the BAO) provides that the MA may make Rules prescribing limits on the holdings of interests in land by an AI.</p> <p>To support the repeal of BO section 90, a new limit (in the form of an aggregate limit on all interests in land) is introduced under paragraph 35.1 with a view to regulating an AI’s interest in bank premises. For background, section 90 prescribes an aggregate limit on the exposures under section 83(1)</p>

		<p>35.2 The Rules will provide that an AI shall not purchase or hold any interest or interests in land situated in or outside Hong Kong, except the interest or interests in land are excluded in paragraph 35.3, of a value or to an</p>	<p>(connected party exposure), section 87(1) (equity exposure), section 88(1) (exposure in interests in land excluding bank premises) and section 88(2) (bank premises). There are separate exposure limit for each of the first three types of exposure but not the exposure in bank premises under section 88(2). Therefore the new limit under paragraph 35.1 is proposed so that, after the repeal of section 90, all types of exposures covered under the aggregate limit of section 90 will eventually be regulated by individual limits separately.</p> <p>The current limit set out in BO s88(1) is replicated under paragraph 35.2, but the limit is</p>
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		<p>aggregate value, as the case may be, in excess of 25 per cent of the Tier 1 capital of the institution.</p> <p>35.3 For the limit set out under paragraph 35.2, interest or interests in land does not include a land situated in or outside Hong Kong to any value, where the occupation of such land is, in the opinion of the MA, necessary for conducting the business of the institution or providing housing or amenities for staff of the institution.</p> <p>35.4 For the purposes of paragraph 35.3, but without limiting the generality thereof, the MA may in his discretion regard as necessary for conducting the business of an AI the whole of any premises in which an office of the institution is situated.</p>	<p>rebased to Tier 1 capital rather than total capital base.</p> <p>Replication of BO s88(3).</p>
36	MA may vary the limit on holding of interest(s) in land	<p>36.1 The Rules will provide that subject to a procedure similar to that set out in Rule 11, the MA may, by notice in writing served on an AI vary the limit referred to in paragraph 35.1 and 35.2 above applicable to the institution if the MA is satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account (a) the risks associated with the level or concentration of the AI's acquisition or holdings of interests in land; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the risks associated with any such risk mitigation measures and (d) any other</p>	<p>Section 81A(3)(j) of the BO (as inserted by s9 of the BAO) empowers the MA to vary, in accordance with a procedure set out in the Rules and in circumstances set out in the Rules, a limit applicable to an AI.</p>

		factors as the MA may consider relevant.	
Division 3 Exempted interests in land			
37	Exemption of interests in land	37.1 For the purposes of this Part, the assessment of the value of interests in land shall not take into account the value of any interest in land mortgaged (or otherwise provided as security) to the AI to secure a debt due to the AI nor the value of any interest in land acquired pursuant to entry into possession of land so mortgaged (or over which security is enforced), provided that the interest acquired is disposed of at the earliest suitable opportunity, and in any event not later than 18 months after its acquisition or within such further period as the MA may, in writing, allow in any particular case.	Replication of BO s88(5).
<p>Part 10: A transitional provision for Part 4 to Part 9 – This Part is designed to contain transitional provisions for Part 4 to Part 9. We will consult the industry of these transitional provisions soon. Consideration will also be given to whether the contents of Part 3 of the Rules (i.e. transitional arrangements for Part 2) could be moved to the Part 10 to make the Rules neater.</p>			

Guidance on grouping of related counterparties

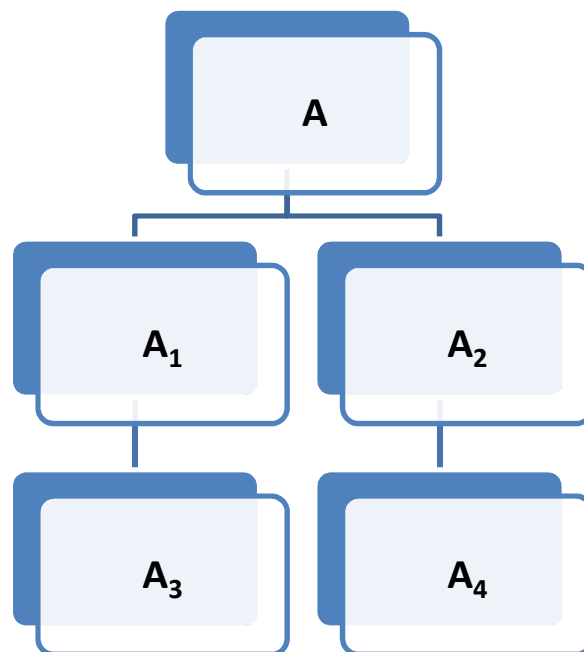
Introduction

1. An AI's exposures to a group of linked counterparties are subject to the "single counterparty" large exposures limit. The criteria on the grouping of counterparties that are regarded as "linked" for this purpose are set out in paragraph 10 of Part B of this set of proposals. The high level principles for including an entity into a group of linked counterparties are:
 - by controlling interest (paragraph 10.1(a), (b), (c) and (d) – the meaning of "control" is stated in paragraph 10.2);
 - by or in relation to economic interdependence (paragraph 10.1(e), (f) and (g)).

Linking by controlling interest

2. In simplified terms, linking by controlling interest is to combine a given counterparty, its controllers, its subsidiaries and its fellow subsidiaries that are also counterparties of the AI as a group of linked counterparties.
3. For example, in Diagram 1 below assuming that A is the holding company of A1, A2, A3 and A4: all the entities falling within this controlling structure that are counterparties of the AI should be regarded as a group of linked counterparties of the AI. To avoid doubt, a subsidiary should be included in the linked group of counterparties even if its holding company is not a counterparty of the AI. For example, in Diagram 1 if A is not a counterparty of the AI but A₁, A₂, A₃, A₄ are, A₁ to A₄ should still be treated as a group of linked counterparties of the AI. Similarly, if A₁ is not a counterparty of the AI but A₃ is, A₃ should still be included in this group of linked counterparties.

Diagram 1



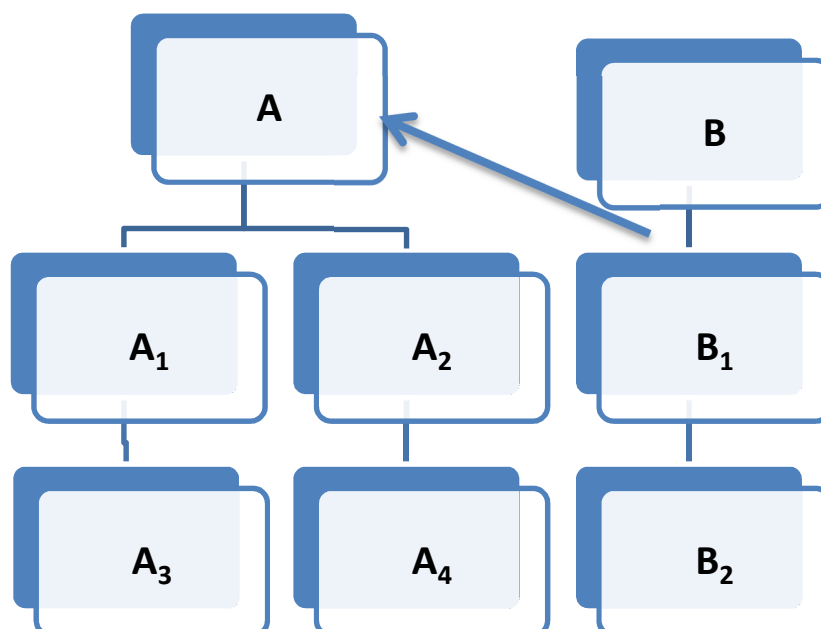
Linking by economic interdependence

4. According to paragraph 10.1(e) of Part B of this set of proposals, a counterparty (Z) should be included in a group of linked counterparties if:
 - the counterparty (Z), is not related to the given counterparty (X) by virtue of controlling interest, but is so interconnected with any person mentioned in paragraph 10 (a) to (d) (i.e. the given counterparty (X) and persons who are themselves counterparties and are linked to the given counterparty (X) by controlling interest) that if one of them was to experience financial problems, in particular funding or repayment difficulties, such a counterparty (Z) would also be likely encounter funding or repayment difficulties.
5. The interconnection concept leading to co-vulnerability described in 4 above is referred to below as the economic interdependence criteria.
6. As noted in relation to paragraph 10.1 of Part B of this set of proposals the MA may publish guidance on the requirements in paragraph 10.1(e). Set out below is an outline of the proposed operational guidance for the economic interdependence criteria.

7. Firstly, an AI is required to identify possible counterparties linked by the economic interdependence criteria to a counterparty only if its exposures to that individual counterparty exceed 5% of its Tier 1 capital. If this threshold is not exceeded, it is up to the AI to decide whether to apply the economic interdependence criteria to exposures below the limit for the purposes of enhanced risk management. AIs are encouraged to identify and group counterparties which constitute a single risk to the extent practicable for risk management purposes.
8. Secondly, an AI should assess whether the financial problems of a given counterparty (Y) (picking up the example in paragraph 4 above – Y could be the given counterparty X or any of the counterparties connected to X by controlling interest) would be expected to lead to difficulties in another counterparty (Z) taking into account the following considerations (BCBS LE standards paragraph 26):
 - (a) 50% or more of the gross receipts or gross expenditures (on an annual basis) of the other counterparty (Z) are derived from transactions with the given counterparty (Y);
 - (b) the other counterparty (Z) has fully or partly guaranteed the exposure of the given counterparty (Y), 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 counterparty (Z) is likely to default if a claim occurs;
 - (c) a significant part of the other counterparty's (Z) product/output is sold to the given counterparty (Y), and the given counterparty (Y) cannot easily be replaced by other customers;
 - (d) the expected source of funds to repay the loans of both counterparties (Y and Z) is the same and neither counterparty has another independent source of income from which the loans may be fully repaid; (LE FAQ Q4)
 - (e) it is likely that the financial problems of the given counterparty (Y) would cause difficulties for the other counterparty (Z) in terms of full and timely repayment of liabilities;
 - (f) the insolvency or default of the given counterparty (Y) is likely to be associated with the insolvency or default of the other counterparty (Z); or
 - (g) Both counterparties (Y and Z) rely on the same source for the majority of their funding and neither counterparty has another independent source of funding.
9. Thirdly, economic interdependence is directional. For example, in Diagram 2

below, A and B are holding companies of two separate groups. Assuming that the economic interdependence criteria apply and B₁ is economically dependent on A (i.e. a problem in A will lead to a problem in B), B₁ has to be included in the group to which A belongs. The next paragraph will further elaborate upon the extent to which the entities in “B” should be included in the “A” group. If the economic interdependence relationship does not hold in the reverse direction, i.e. a problem in B₁ will not lead to a problem in A, it is not necessary to include A in the “B” group.

Diagram 2

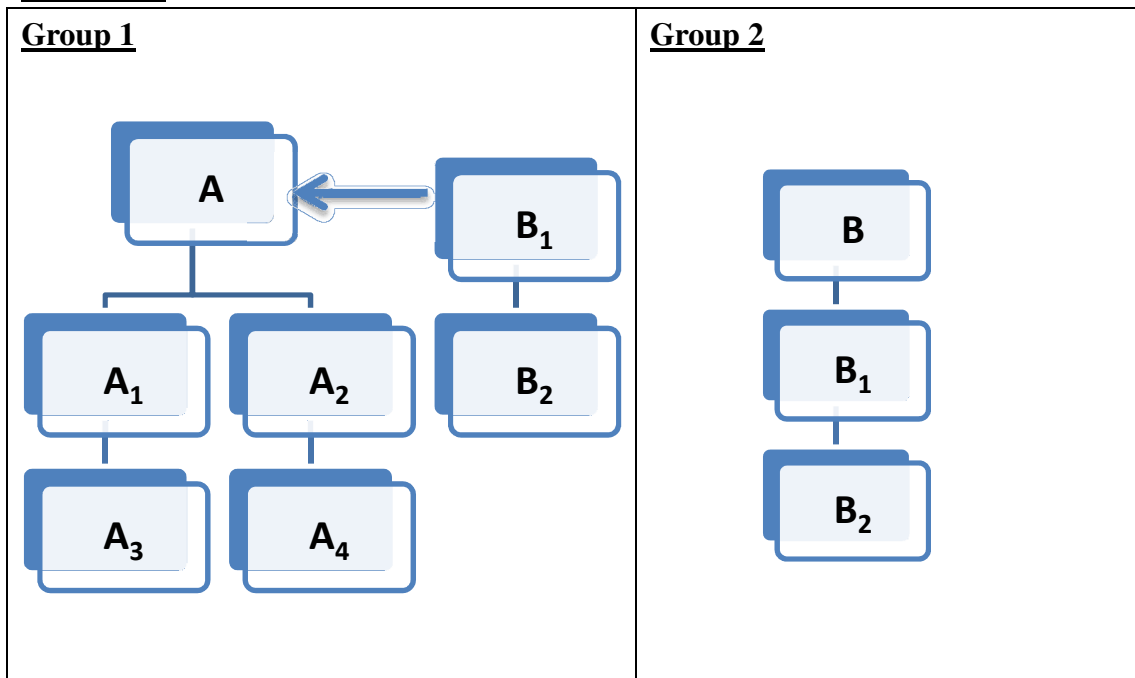


10. Fourthly, with reference to practices proposed by other major jurisdictions, when a counterparty (‘relevant counterparty’) is economically dependent on another counterparty and hence has to be included in the group to which the other counterparty belongs, all the entities “below” the relevant counterparty in the organisation structure should also be included in that group. Following the previous example (i.e. B₁ is linked to A by economic interdependence), B₂ should also be included in the “A” group. The policy thinking behind grouping the entities “below” is that if the problem in A affects B₁, it is highly likely that the entities under B₁’s control will also be affected. However, in practice it is more uncertain whether the problem will spread to the controllers of B₁. Therefore, grouping of the controllers (i.e. B in this example) of the entity linked by

economic interdependence is only required if B is also economically dependent on B₁.

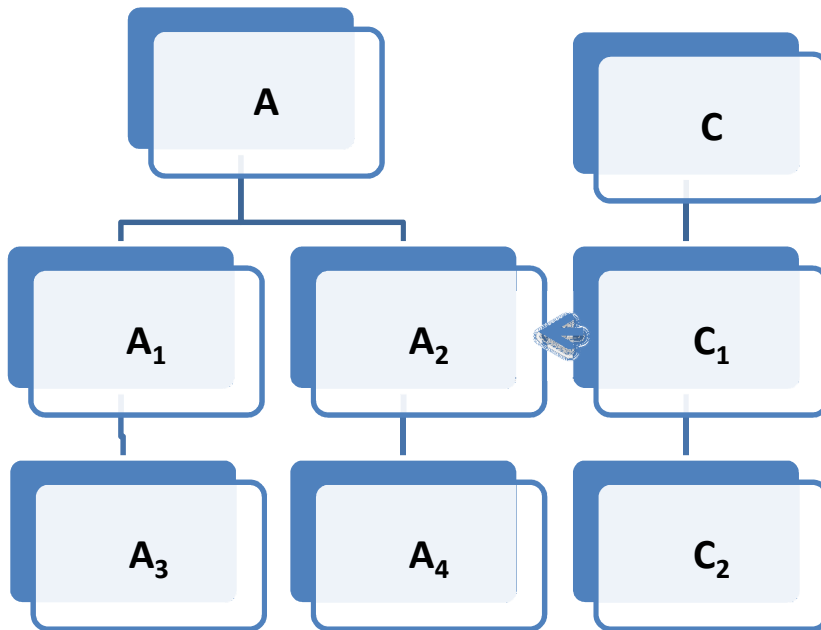
11. Based on the example in Diagram 2, assuming that all the entities stated are counterparties of the AI and B is not economically dependent on B₁, the following two groups of linked counterparties should be identified:

Diagram 3



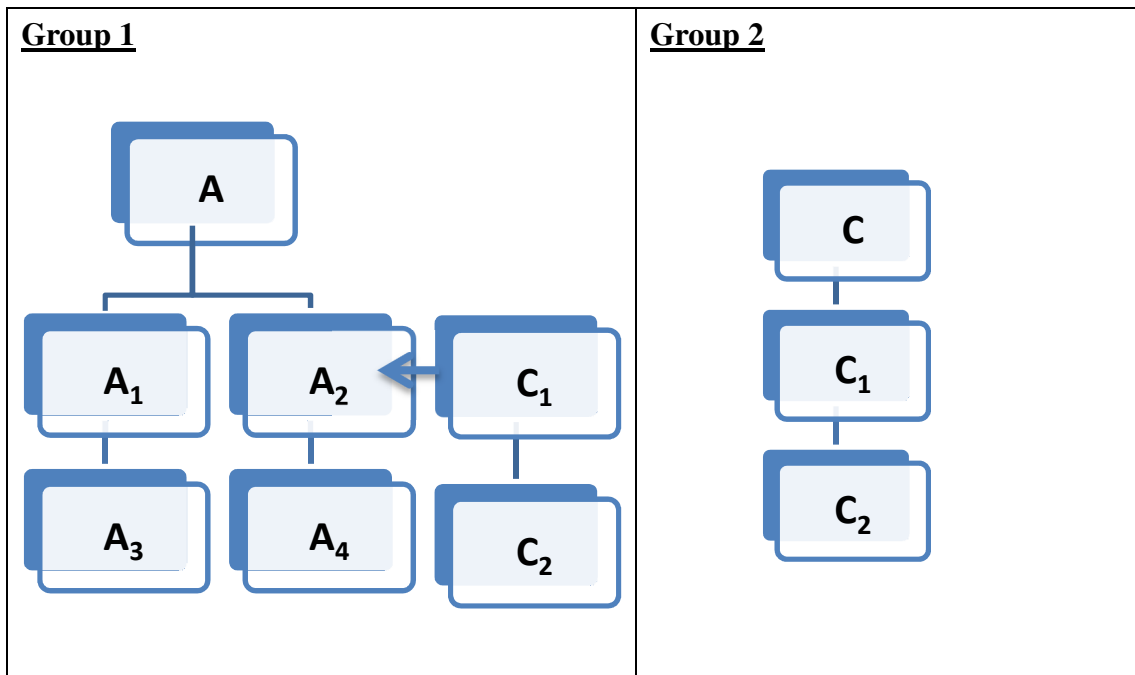
12. Lastly, notwithstanding the threshold referred to in paragraph 7 above, as noted in that paragraph AIs are encouraged for risk management purposes (over and above the requirements in the Rules) to identify and monitor counterparties which constitute a single risk to the extent practicable and possible. This concept is illustrated through the example in Diagram 4. In this case, C₁ is economically dependent on A₂. This is different from the example in Diagram 2 in that C₁ is economically dependent on a subsidiary rather than the holding company in the “A” group.

Diagram 4



13. Following the policy intent stated above, the following two groups of linked counterparties should be identified (assuming that C is not economically dependent on C₁):

Diagram 5



14. If A₂ is not a counterparty of the AI or the AI's exposure to A₂ is less than 5% of

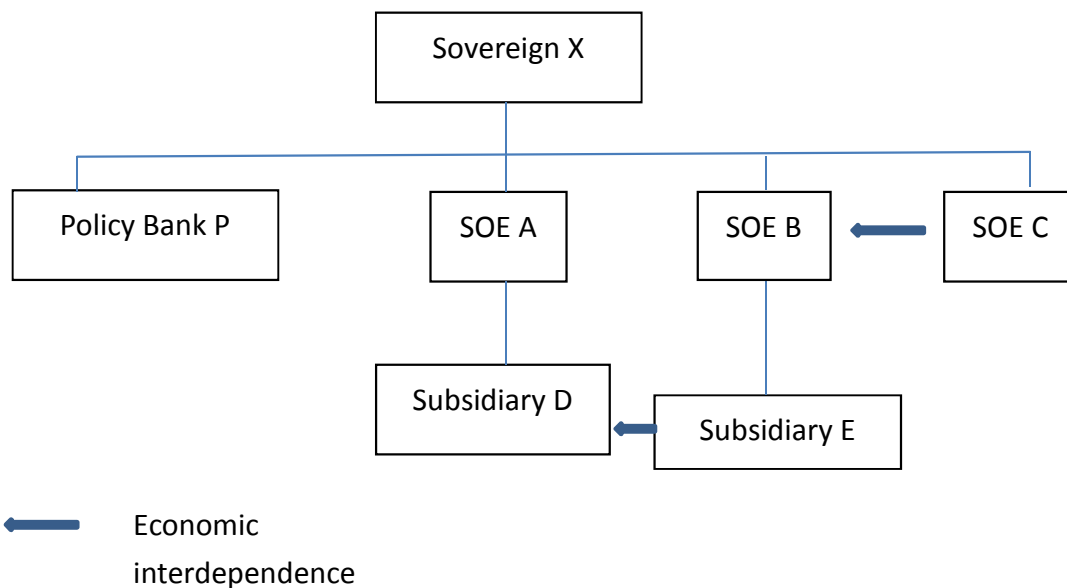
the AI's Tier 1 capital, the AI would not be required by the Rules to identify possible counterparties linked to A₂ by economic interdependence. Accordingly it is legitimate for the AI to omit C₁ and C₂ in the "A" group under the Rules. Notwithstanding this, if the AI is aware of the economic interdependence relation between A₂ and C₁, it is encouraged to include C₁ and C₂ in the "A" group as a single risk for risk management purposes.

Grouping of sovereign exposures

15. Paragraph 16 of Part B of this set of proposals provides that exposures to specified sovereign entities are exempted from the single counterparty large exposures limit. Exempted sovereign entities include the Government (including exposure for the account of the Exchange Fund, through the holding of Exchange Fund Notes and Bills), a central government, a central bank and a sovereign foreign public sector entity. While a hard limit does not apply to these exposures, exposure concentration to a sovereign group will in future be subject to an additional risk-weight add-on under the regulatory capital framework, the effect of which will be to require AIs to hold additional capital to reflect the additional risk. See Part C (separate drafting instructions for the sovereign treatment in the Banking Capital Rules) for further details.
16. Reflecting the above exemption, paragraph 11 of Part B of this set of proposals provides that when considering a group of linked counterparties, if two or more counterparties that are not themselves exempted sovereign entities are controlled by or are economically dependent on a counterparty that is an exempted sovereign entity, and are otherwise not connected, those counterparties are deemed not to be a group of linked counterparties. This is illustrated by the example below.

Example

Consider sovereign X and its connected entities:



where,

- E is economically dependent on D (i.e. a problem in D will cause difficulty in E; assuming that the 5% threshold condition as referred to under paragraph 7 to apply economic interdependence is satisfied)
- C is economically dependent on B (i.e. problem in B will cause difficulty in C; assuming that the 5% threshold condition as referred to under paragraph 7 to apply economic interdependence is satisfied)

Without the provision of paragraph 11 of Part B of this set of proposals, normally X, P, A, B, C, D and E should constitute a single group of linked counterparties.

In a nutshell, the provision of paragraph 11 allows P, A, B, C to be treated as separate groups, unless they themselves are connected (e.g. B and C).

It is necessary to find out whether an entity connected to X is a central bank or sovereign foreign public sector entity first. If yes, it is not necessary to group the entity with other entities connected to X. In this example, if P is a sovereign foreign public sector entity, it will not be necessary to group P with other entities connected to X such as A, B and C.

If however P is not a sovereign public sector entity, considering P and A:

- they are not exempted sovereign entities;
- they are controlled by X (an exempted sovereign entity) and otherwise not

connected.

According to paragraph 11 of Part B of this set of proposals, P and A are deemed not to be a group of linked counterparties. Accordingly, an AI should treat P and A as two separate groups and the single counterparty large exposure limit should apply to each of them separately:

- Sovereign X – P group (in this example, include X and P)
- Sovereign X – A group (in this example, include X, A, D and E)

It is worth mentioning that while X is included in each of the P and A group, the exposures to X are exempted because X is an exempted sovereign entity. In future when an AI reports large exposures to the HKMA, it will be expected to follow the above convention to label a sovereign group. (The reporting requirements will be imposed pursuant to a power already available under section 63(2) of the BO.)

Apart from the P group and A group, following the principles for grouping linked counterparties as clarified above, the following groups which are connected to sovereign X should also be identified:

- Sovereign X – B group (in this example, include X, B, E and C)
- Sovereign X – C group (in this example, include X and C)

Example of an investment structure with different seniority levels

Consider a securitisation structure consisting of mortgage loans as described below:

1. the asset pool includes 70 loans with a nominal value of HKD 1m each and one loan worth HKD 30m
2. the tranches are:
 - equity tranche: HKD 20m
 - mezzanine tranche: HKD 30m
 - senior tranche: HKD 50m

An AI holds HKD 20m (100%) of the equity tranche and HKD 3m (10%) of the mezzanine tranche

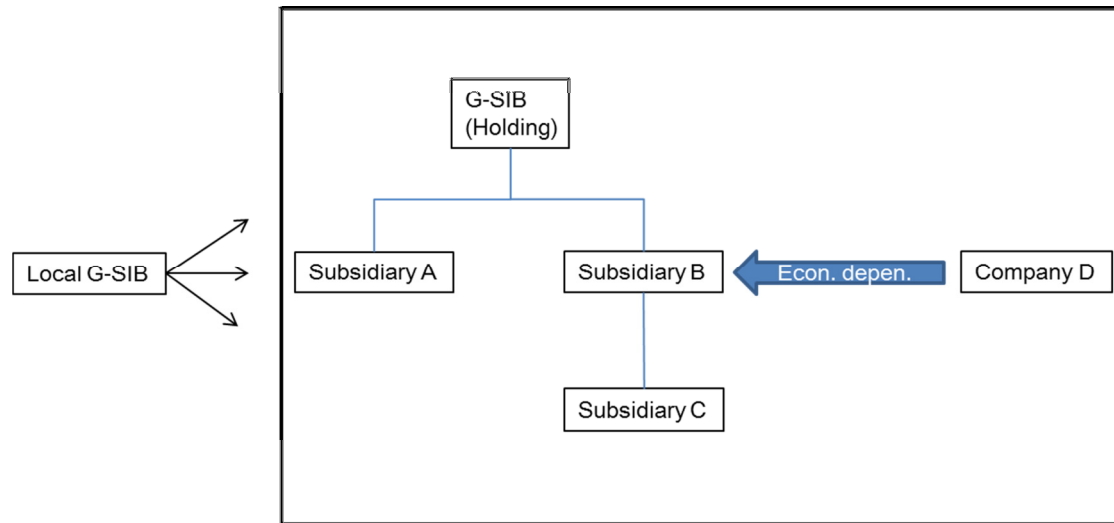
3. The AI's exposure to *each* of the 70 loans worth HKD 1m in the equity tranche is:
 $\min(\text{value}[\text{equity tranche}], \text{value}[\text{loan}] * (\text{percentage share of tranche held by the AI}))$
 $= \min(\text{HKD } 20\text{m}, \text{HKD } 1\text{m}) * 100\% = \text{HKD } 1\text{m}$
4. The AI's exposure to *each* of the 70 loans worth HKD 1m in the mezzanine tranche is:
 $\min(\text{HKD } 30\text{m}, \text{HKD } 1\text{m}) * 10\% = \text{HKD } 0.1\text{m}$
5. The AI's exposure to the loan worth HKD 30m in the equity tranche is:
 $\min(\text{HKD } 20\text{m}, \text{HKD } 30\text{m}) * 100\% = \text{HKD } 20\text{m}$
6. The AI's exposure to the loan worth HKD 30m in the mezzanine tranche is:
 $\min(\text{HKD } 30\text{m}, \text{HKD } 30\text{m}) * 10\% = \text{HKD } 3\text{m}$

Notes:

- Exposures from different tranches have to be summed up to obtain the AI's overall exposure to the underlying loan. For example, the exposure to *each* of the 70 HKD 1m loans is HKD 1.1m (HKD 1m + HKD 0.1m)
- The AI only needs to apply the look-through approach to exposures equal to or above 0.25% of its Tier 1 capital
- The AI 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 the investment structure itself rather than in the underlying assets (see paragraph 15.2 of Part B of this set of proposals).

Example for exposure of a local G-SIB to a G-SIB-linked Group

Consider the following example:



In the example, the companies in the box constitute a G-SIB-linked group.

The local G-SIB must not have exposures in excess of 15% of its tier 1 capital to (i) the G-SIB-linked group,¹ as well as, (ii) to any individual group member.

¹ Negative exposures to any G-SIB-linked group member are set to 0 when aggregating.