Supervisory Policy Manual		
CR-G-8	**Large Exposures and Risk Concentrations**	V.3 - Consultation

This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Interpretation

In this module,

- ***BCBS*** means Basel Committee on Banking Supervision;
- ***BELR*** means the Banking (Exposure Limits) Rules (Cap.155S);
- ***BO*** means the Banking Ordinance (Cap.155);
- ***SA-CCR approach*** means the standardized approach for measuring counterparty credit risk published by the BCBS on 31 March 2014 as updated by complementary FAQs, subject to any further publication by the BCBS to amend or consolidate the approach;

and unless otherwise specified,

- other abbreviations and terms in this module follow those used in the BELR;
- a reference to a Rule or a Part means a Rule or a Part respectively of the BELR

Purpose

To set out the minimum standards and requirements that AIs are expected to follow, and to describe how the HKMA proposes to exercise its supervisory powers, in relation to controls on large exposures and risk concentrations

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §16(10)

Previous guidelines superseded

Guideline 5.3 "Specification of Factors for Off-balance Sheet

Exposures under §81(3) of the Banking Ordinance" dated 04.10.91; CR-G-8 "Large Exposures and Risk Concentrations" (V.1) dated 31.08.01; CR-G-8 "Large Exposures and Risk Concentrations" (V.2) dated 01.04.04

Application

To all locally incorporated AIs

For AIs incorporated outside Hong Kong, the overall supervision of large exposures and risk concentrations is expected to be the responsibility of their home regulatory authorities. They are, however, required to report the large exposures of their Hong Kong operation to the HKMA in the "Return of Large Exposures - MA(BS)28" and certify compliance with certain provisions under the BELR applicable to them[1] as specified in the "Certificate of Compliance - MA(BS)1F(b)".

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[1] Parts 4 and 5 are applicable to the Hong Kong operation of AIs incorporated outside Hong Kong.

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1. Introduction

1.1 Background

1.1.1 The minimum authorization criterion under paragraph 8 of the Seventh Schedule to the BO provides that the MA should be satisfied that an AI complies with the provisions of Part XV of the BO and the provisions of the rules made under that part (i.e. the BELR), which set out the limitations on exposures and risk concentrations of AIs.

1.1.2 Moreover, under paragraph 12 of the Seventh Schedule, the MA should be satisfied that the business of an AI is carried out with integrity, prudence and the appropriate degree of professional competence and in a manner which is not detrimental to the interests of depositors or potential depositors. Whether an AI has the proper control systems to manage its large exposures and guard against concentration risks is one of the factors that the MA will take into account in assessing the compliance with this minimum authorization criterion.

1.1.3 Failure to adhere to the standards and requirements in this module may indicate that an AI does not have adequate systems to control its risk concentrations and carry out its business in a prudent manner. This may call into question whether the AI continues to satisfy the above-mentioned minimum authorization criteria under the Seventh Schedule to the BO.

1.1.4 Non-compliance with this module may also constitute a ground for the MA to impose a higher minimum capital adequacy ratio on the AI under §97F of the BO to lessen any additional risk from the concentration.

1.1.5 For the purpose of this module, any exposure to a counterparty or an LC group which is greater than or equal to 10% of an AI's Tier 1 capital is regarded as a large exposure.

1.2 Forms of risk concentration

1.2.1 Risk concentration can be viewed as any exposure with the potential to produce losses that are substantial enough to threaten an AI's capital strength or earnings or otherwise undermine public confidence in the AI. It can take many forms, including exposures to particular types of asset (e.g. interest in land or shares), individual counterparties, groups of linked counterparties and counterparties in specific geographical locations, economic or industry sectors.

1.2.2 Risk concentration may also arise from subtler or more situation-specific factors. For example, the financial problems in a particular industry or country may have a contagion effect on other industries or countries that have a close economic linkage with it.

1.3 Rationale for controlling risk concentrations

1.3.1 Diversification of risk is essential in banking. Many past bank failures have occurred due to risk concentrations of some kind. It is therefore essential for AIs to properly manage risk concentrations from exposures to particular counterparties, industries, economic sectors, countries or regions.

1.3.2 While some concentration risks are common to the local banking industry and cannot be totally avoided, they can be managed by adopting proper risk control and diversification strategies. Safeguarding against risk concentrations should form an important component of an AI's risk management systems.

2. Statutory limitations on exposures and risk concentrations

2.1 General

2.1.1 The statutory limitations on exposures and risk concentrations are set out in the BELR. This module covers mainly Parts 7, 2 and 6, which are relevant to locally incorporated AIs for the control of exposures and risk concentrations[2]. They relate to:

- limitation on exposures to a counterparty or a LC group (Part 7);
- limitation on equity exposure (Part 2); and
- limitation on holding of interest in land (Part 6).

2.1.2 Other relevant parts, which deal with limitations on exposures to connected parties (Part 8) and acquisition by AIs incorporated in Hong Kong of share capital in companies (Part 3), are covered under CR-G-9 “Exposures to Connected Parties” and CR-L-5 “Major Acquisitions and Investments: BELR Part 3”.

2.1.3 Subsections 2.2 to 2.13 below provide a summary of the key provisions contained in Parts 7, 2 and 6. They also endeavour to interpret these Parts in simplified language. In case of doubt, AIs should consult the HKMA or seek relevant legal advice.

2.2 Summary of relevant sections in the BELR

2.2.1 Under Rule 44(1), an AI is subject to a statutory limit of 25% of its Tier 1 capital on its exposure to any individual counterparty or LC group.

2.2.2 In addition, an AI designated by the MA as a local G-SIB is subject to another limit. Its exposures to a G-SIB-linked group or any counterparty in a G-SIB-linked group

[2] AIs should also refer to Part 5, which sets out the limitation on advances to employees.

must not exceed 15% of its Tier 1 capital. A G-SIB-linked group is an LC group in which an entity is an international G-SIB [3] or local G-SIB. A locally incorporated AI is not a local G-SIB just because it is a subsidiary of an international G-SIB. A local G-SIB is designated specifically by the MA under §3S of the Capital Rules.

2.2.3 Various exposures are not to be taken into account for determining the aggregate exposure to a single counterparty (ASC exposure) or aggregate exposure to a LC group (ALCG exposure) under Rule 48 (see subsections 2.11 below for details).

2.2.4 Apart from the Part 7 limitation on single counterparty / LC group exposure, an AI should not incur any equity exposure to an aggregate value in excess of 25% of its Tier 1 capital under Rule 11, Part 2.

2.2.5 Part 6 sets out limitation on holding of interest in land. Under Rule 35(b), an AI should not hold interest in land, excluding self-used land, exceeding 25% of its Tier 1 capital. Under Rule 35(a), an AI should not hold interest in land exceeding 50% of its adjusted Tier 1 capital amount. Adjusted Tier 1 capital amount is the amount of Tier 1 capital plus the amount of cumulative gain arising from the revaluation of the institution's self-use land in accordance with the applicable accounting standards (if any) which has been excluded from the calculation of the amount of its Tier 1 capital under the Capital Rules.

2.2.6 Exemptions from the limits in Part 2 and Part 6 are available under Rules 14 and 38 respectively (see subsection 2.13 for details).

2.2.7 The MA is empowered by Rule 12 to vary the equity exposure limit and Rule 45 to vary the large exposure limits applicable to an AI. It is expected that these powers will be exercised for tightening a limit if warranted on prudential grounds, e.g. if an AI has shown significant control weaknesses in the monitoring of credit concentration risk. Any proposal to exercise these limit variation powers will be subject to the consultation

[3] That means, the entity is in the FSB G-SIB list or it is a member of a group of companies that is in the FSB G-SIB list or any member of which is in the FSB G-SIB list.

processes prescribed in the BELR.

2.2.8 Rule 6 empowers the MA to require AIs that have any subsidiary to comply with the above statutory limits under the BELR on an unconsolidated basis, consolidated basis or on both an unconsolidated and consolidated basis (see Rule 6 and CR-L-1 "Consolidated Supervision of Concentration Risks: BELR Rule 6" for more guidance). The MA has the discretion to decide which subsidiaries of an AI are to be included in the consolidation. Generally, consolidation for the purposes of §79A of the BO and Rule 6 will include subsidiaries that undertake financial business and those which incur risks regulated by the BELR (e.g. insurance subsidiaries or property holding subsidiaries).

2.2.9 Under Rule 2(2), the term "Tier 1 capital" for the purposes of the BELR has the meaning given by §2(1) of the Capital Rules. However, the basis of consolidation should be as required under Rule 6. The subsidiaries consolidated for the BELR purposes may differ from those included for the purpose of calculation of the capital adequacy ratio on a consolidated basis in a notice given under §3C(1) of the Capital Rules.

2.2.10 The MA may require an AI to provide evidence or information to prove that it complies with the statutory limits under the BELR.

2.3 Definition of exposure under Part 7

2.3.1 For the purposes of Part 7, exposure includes any exposure pertinent to the risk of default of a counterparty. As a rule of thumb, an AI must consider all exposures that require capital under the Capital Rules except those which are not linked to the risk of default of a counterparty; for example, holdings of a commodity or a foreign currency. An exposure may be on- or off-balance sheet, booked in the trading book or banking book and include indirect exposure to a credit protection provider, as elaborated in the next subsection. An exposure has to be valued by the methods prescribed under Part 7, which may be different from that under the Capital Rules.

2.3.2 For the avoidance of doubt, an AI should recognise an exposure arising from the balance of its Nostro account maintained with another AI/bank only in respect of the amount of the balance that has completed the settlement process and become available to the AI (i.e. on the basis of available balance instead of ledger balance).

2.4 **Treatments of credit risk transfer**

2.4.1 A credit risk transfer mechanism is introduced generally for exposures in the banking book under the BELR. If an AI's exposure to an obligor is protected by a recognized credit risk mitigation, the AI should take into account the credit risk mitigation to reduce the amount of exposure to the obligor and at the same time recognize an exposure to the credit protection provider. AIs should refer to Subdivisions 2 and 3, Division 3 of Part 7 for details.

2.4.2 In relation to credit risk transfer, the HKMA will on its volition designate AIs which are internationally active or systemically important locally as a Category A institution. These institutions are subject to compulsory credit risk transfer. Other AIs will be Category B institutions, which should determine an exposure to a direct obligor without regard to any credit risk mitigation available to protect the exposure except for recognized credit risk mitigation, which is (i) recognized netting done under a valid bilateral netting agreement or (ii) recognized collateral that is a cash deposit.

2.4.3 Nonetheless, if the value of collateral is recognized in the calculation of the counterparty credit risk exposure value for any instrument with counterparty credit risk in accordance with Rules 59 and 60, the AI must also recognize an exposure to the collateral issuer. The amount assigned to the collateral issuer is the amount by which the exposure to counterparty is reduced. This applies independently of whether the AI is a Category A or Category B institution.

2.4.4 Apart from the exceptional situation stated in the preceding paragraph, a Category B institution may opt for implementing credit risk transfer in exposure calculation by applying for the designation of Category A institution. The HKMA will grant the designation if it is satisfied that the institution has the capacity (systems and resources) to determine an ASC exposure or an

ALCG exposure taking into account the effect of credit risk mitigation applicable to a Category A institution. In assessing an AI's application, the MA will consider the following factors:

- whether the AI has established systems and processes to support the accurate calculation of the ASC exposure and ALCG exposure by taking into account the effect of credit risk mitigation, including but not limited to the systems and processes for:
  - (i) maintenance of exposure records and corresponding credit risk mitigation records;
  - (ii) determining whether a credit risk mitigation is a recognized CRM under Part 7;
  - (iii) calculation of exposure after CRM and the corresponding recognition of exposure to the credit protection provider;
- whether the IT system for the purposes of sub-paragraph (iii) of the first bullet point has successfully completed user acceptance tests;
- whether the systems and processes in the first bullet point have been reviewed by a party or unit independent of the development team to ensure that it calculates ASC exposure or ALCG exposure accurately taking into account the effect of credit risk mitigation applicable to a Category A institution according to Part 7;
- whether there is a unit within the institution responsible for ensuring the effectiveness of the systems and keeping track of room for improvement of the systems.

2.4.5 The designation of AIs for the purposes of Part 7 is conducted independently from the designation of AIs under the Banking (Liquidity) Rules ("Liquidity Rules"). Notwithstanding that, in practice the HKMA will likely designate a category 1 institution under the Liquidity Rules as a Category A institution under Part 7 except for institutions of which the designation as a category 1 institution is purely for liquidity reasons. The HKMA will review the designation of Category A institutions annually and on a needed basis.

2.4.6 As an AI incorporated outside Hong Kong is not subject to Part 7, they will not receive designation as a Category A institution or Category B institution under that part. In the light that the credit risk transfer mechanism is an international standard, an AI incorporated outside Hong Kong may apply credit risk transfer as if it were a Category A institution for the purposes of reporting the return of large exposures. Alternatively, it may (i) either apply similar credit risk adjustment and risk transfer mechanism under the formal rules of its place of incorporation to implement the "Supervisory framework for measuring and controlling large exposures" issued by the BCBS in 2014 ("BCBS large exposure standard") or (ii) (if the regulator of its place of incorporation does not implement the BCBS large exposure standard) apply the credit risk adjustment and risk transfer mechanism as applicable to it under its home rules on large exposures (to avoid doubt, this accommodates no credit risk adjustment and no credit risk transfer). As applicable, the AI should inform its usual contact in the HKMA of its intention to report exposures without regard to credit risk transfer (like a Category B institution) and provide the details of the relevant regulations of its home jurisdiction to the HKMA. It should also inform the HKMA when it changes to report exposures taking into account credit risk transfer in the future.

2.4.7 Exposures booked in the trading book are subject to the trading book offsetting provisions under Subdivision 4, Division 3 of Part 7. Where the offsetting involves a credit derivative contract under Rule 56(2), an exposure to the credit protection provider has to be recognized pursuant to Rule 54, similar to credit risk transfer for the banking book. This "risk transfer" in the trading book applies to a Category A institution and a Category B institution alike.

2.4.8 An AI may incur an exposure to the issuer of a recognized collateral with respect to which the AI has no other banking relationship. The BELR does not intend to introduce new requirements on know-your-customer (KYC) in this respect. However, the HKMA expects an AI should have factored into its collateral acceptance policy the KYC principles. For example, a prudent banker should not accept collateral issued by an entity on an international sanction list in relation to money laundering.

2.5 **A group of linked counterparties ("LC group")**

2.5.1 Rule 41 provides two major factors for linking two or more counterparties to form an LC group – i.e. by control and by economic dependence.

2.5.2 Apart from subrule (7) of Rule 41, the control factor is relatively simple and straightforward. Subrule (7) provides that if a parent entity controls a subordinate entity only by virtue of its fiduciary capacity on behalf of a non-anonymous beneficiary, the subordinate entity is not to be treated as being controlled by the parent entity. To avoid doubt, the subordinate entity is treated as being controlled by the beneficiary if a normal criterion of control is met. For example, a trustee legally controls a trust but in a fiduciary capacity on behalf of beneficiaries known to the AI. The AI is not required to treat the trustee and the trust as an LC group. If one of the beneficiaries controls the trust by its beneficiary interests, the AI should treat the beneficiary and the trust as an LC group.

2.5.3 The economic dependence factor is more complicated and elaborated below.

2.5.4 First, an AI may not attempt to consider whether any counterparties are economically dependent on a counterparty of the AI ("reference counterparty") if (i) the exposure to the reference counterparty does not exceed 5% of the AI's Tier 1 capital or (ii) the reference counterparty is an exempted sovereign entity. This results from Rule 41(3), which allows an AI to exclude the following entities from the LC group of a reference counterparty to which the exposure does not exceed 5% of the AI's Tier 1 capital: an entity economically dependent on the reference counterparty (Rule 41(3)(a)) and entities that it controls (Rule 41(3)(b)) and entities that control it and are economically dependent on it (Rule 41(3)(c)).

2.5.5 The 5% threshold applies on a per entity (instead of per group) basis. When considering whether the exposures to an entity has exceeded this threshold, an AI should take into account all exposures after credit risk mitigation, offsetting and deduction to the entity, including, e.g. arising from credit risk transferred to the entity as a credit protection provider or look-through to the entity underlying an investment structure.

2.5.6 Rule 41(4) provides for the following:

"For subrule (1), if a counterparty of an authorized institution (counterparty A) is a linked counterparty of the reference counterparty by virtue of subrule (2)(a), (b) or (c) and the institution's ASCE ratio in relation to the counterparty A does not exceed 5%, the institution, in determining its ASC exposure to the LC group (by reference to the reference counterparty), may treat any of the following entities as not being in the LC group—

(a) an entity specified in subrule (2)(d) that is economically dependent on counterparty A;

(b) an entity specified in subrule (2)(e) that is controlled by an entity specified in paragraph (a);

(c) an entity specified in subrule (2)(f) that controls and is economically dependent on an entity specified in paragraph (a)."

2.5.7 In relation to a reference counterparty, any of its controller, fellow subsidiary and subsidiary (counterparty A) is to be included in the LC group of the reference counterparty (Rule 41(2)(a), (b) and (c)). Normally, any counterparty economically dependent on counterparty A is also included in the same LC group (Rule 41(2)(d), (e) or (f)). However, Rule 41(4) provides that if the AI's ASCE ratio to counterparty A does not exceed 5%, counterparties economically dependent on counterparty A may be excluded from the grouping. It follows that if the AI's ASCE ratio to counterparty A does not exceed 5%, the AI may not attempt to check for counterparties economically dependent on counterparty A. This is the key content of Rule 41(4). In fact subrule (4) is provided for avoidance of doubt. By looking at counterparty A from the perspective of "a reference counterparty", subrule (3) should already serve the same purpose.

2.5.8 For a counterparty of which the exposure is disregarded under Rule 48, as a matter of course, it is not necessary to check for counterparties economically dependent on it, for example, an exempted sovereign entity.

2.5.9 Under Rule 41(8), an entity (Entity A) is economically dependent on another entity (Entity B) if they are connected in a way that if Entity B were to encounter financial problems (in particular funding or repayment difficulties), Entity A would also be likely to encounter financial problems (in particular funding or repayment difficulties). The concept of economic dependence is further elaborated in the Banking (Exposure Limits) Code ("the Code"), which is the code of practice issued for clarifying the BELR.

2.5.10 The Code provides for the following:

"an AI should regard, for the purposes of Rule 41(8) of the BELR, that if Entity B were to encounter financial problems (in particular funding or repayment difficulties), Entity A would also be likely to encounter financial problems (in particular funding or repayment difficulties) and hence Entity A is economically dependent on Entity B when any of the following applies:

(i) 50% or more of the gross receipts (on an annual basis) of Entity A are derived from transactions with Entity B;

(ii) 50% or more of the gross expenditure (on an annual basis) of Entity A are derived from transactions with Entity B, and Entity B cannot easily be replaced by other suppliers;

(iii) Entity A has fully or partly guaranteed the exposure of Entity B, 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 Entity A is likely to default if a claim occurs;

(iv) 50% or more of Entity A's product/output or services is sold to Entity B, and Entity B cannot easily be replaced by other customers;

(v) the expected source of funds to repay the loans of both Entity A and Entity B is the same and neither Entity A nor Entity B has another independent source of income from which the loans may be fully repaid;

(vi) it is likely that the financial problems of Entity B would cause difficulties for Entity A in terms of full and timely repayment of liabilities;

(vii) the insolvency or default of Entity A is likely to be associated with the insolvency or default of Entity B;

(viii) both Entity A and Entity B rely on the same source for 50% or more of their funding and neither Entity A nor Entity B has another independent source of funding."

2.5.11 For criteria (i), (ii), (iii), (iv), (vi) and (vii) above, economic dependence is one-way, i.e. if Entity A depends on Entity B, Entity A has to be included in the LC group of Entity B (but not vice versa). The situation is different for criteria (v) and (viii) above where Entity A and Entity B depend on the same third party as the sole source of funding. In that case, Entity A and Entity B have to be included in the LC group of each other.

2.5.12 In general, except as specified in paragraphs 2.5.7 and 2.6.1, any counterparty ("Counterparties A"), that is economically dependent on (1) the reference counterparty, (2) an entity an entitythat controls the reference counterparty, or (3) an entity that is controlled by the reference counterparty or the entity that controls the reference counterparty, has to be taken into account in the formation of an LC group of the reference counterparty. The BELR, however, do not require institution to identify counterparties that are economically dependent on Counterparties A. The overarching principle underlying economic dependence is whether the financial problem of one entity will likely cause financial problem in another counterparty and in general, AIs are expected to be able to only identify direct economic dependent relationship. For example, counterparty A is economically dependent on the reference counterparty X and counterparty B in turn is economically dependent on counterparty A. If AI's ASCE ratio to reference counterparty X exceeds 5%, it should identify counterparty A in the formation of the LC group of reference counterparty X and may not attempt to further check whether any entity in turn is indirectly economically dependent on counterparty X via counterparty A. Nonetheless, if it comes to the AI's knowledge that counterparty B is indirectly economically dependent on X, as a good practice, the AI is encouraged to include counterparty B in the LC group of counterparty X for risk management. After all, it is our supervisory expectation that an AI should seek to include counterparties that constitute a single risk of the reference counterparty in the LC group of the reference counterparty.

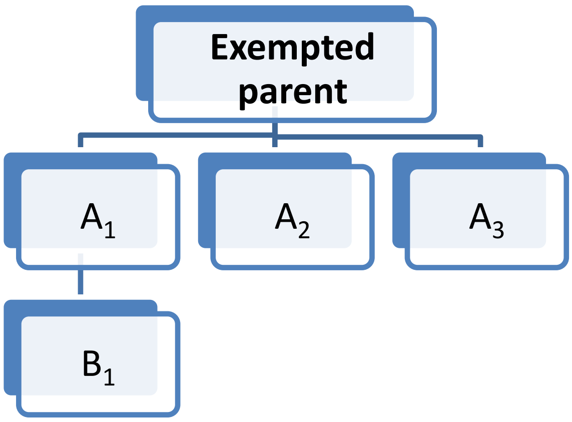
2.5.13 The Code provides further details for identifying entities which are economically dependent on another entity. Among others, paragraph 7(4)(v) and (viii) of the Code holds two entities as economically dependent on each other if they rely on the same source of funds and neither of them has another independent source of funds. To avoid doubt, an AI should not put two counterparties in an LC group merely because they rely on the same primary banker for funds, unless neither of them has another independent source of funding.

2.5.14 AIs are free to adopt an internal policy more stringent than the Code to identify counterparties linked by economic dependence. For example, by disapplying the 5% threshold under Rule 41(3) and (4).

2.6 Grouping special controllers

2.6.1 If entities are directly controlled by or economically dependent on an exempted sovereign entity, a specified sovereign-owned entity or The Financial Secretary Incorporated established under the Financial Secretary Incorporation Ordinance (Cap.1015), and are otherwise not in an LC group, regardless of whether the exempted sovereign entity, the specified sovereign-owned entity or the Financial Secretary Incorporated is a counterparty of the institution, these entities are treated as not being in an LC group of the institution.

2.6.2 In the diagram below, A_1, A_2 and A_3 are controlled by the same entity (parent entity). Normally all four of them and B_1 have to be put together as an LC group. However, if the parent entity is an exempted sovereign entity, specified sovereign-owned entity or The Financial Secretary Incorporated stated under Rule 41(5) (collectively exempted parent), and A_1, A_2 and A_3 are not otherwise linked, it is not necessary to group A_1, A_2 and A_3 together in an LC group. This de-grouping under Rule 41(5), however, only applies to entities controlled by an exempted parent but not to the exempted parent itself. Therefore, each of A_1, A_2 and A_3 should be grouped with its exempted parent as usual. In the case that the exempted parent is an exempted sovereign entity, the exposure to the exempted sovereign entity is exempted pursuant to Rule 48(1)(c). In addition, although both A_1 and B_1 are controlled by an exempted sovereign entity, A_1 controls B_1. In other words, the condition for degrouping under Rule 41(5) that the entities "are not otherwise linked" is violated. Accordingly B_1, A_1 and the exempted parent should form an LC group.



2.6.3 Currently the list of specified sovereign-owned entity includes only China Investment Corporation ("CIC") and Central Huijin Investment Ltd. ("Huijin"). These are special purpose vehicles of the Chinese Government through which the investment holdings of the large state-owned finance companies (including the big four banks, large insurance companies, etc) are held. The special treatment makes it unnecessary to include these finance companies in an LC group just because they are controlled by the two special purpose vehicles stated above. Again, an individual finance company controlled by CIC and Huijin should still be grouped with these two companies, and individual finance companies have to be grouped if they themselves are linked by other relevant criteria cited under Rule 41.

2.7 **Sovereign concentration risk**

2.7.1 While Part 7 strictly adheres to the BCBS large exposure standards by excluding exposures to an exempted sovereign entity from the statutory limits, by experience exposures to sovereigns may not be risk free. An AI is therefore required to provide additional capital under the Capital Rules if it has concentrated sovereign exposures. In brief, an AI may have exposures to the exempted sovereign entities of a jurisdiction up to 100% of its Tier 1 capital without the need for additional capital. Beyond that threshold, additional capital is required. The applicable risk weight to the amount of exposures in excess of the 100% Tier 1 capital threshold is increasing with the magnitude of the amount in excess. Details are set out in Part 10 of the Capital Rules as amended by the Banking (Capital)(Amendment) Rules 2018.

2.8 **Valuation of exposures**

2.8.1 AIs should refer to Divisions 4 and 5 of Part 7 for details of valuation of CCR and non-CCR exposure respectively. In particular, AIs should pay attention to the following when determining the value of an exposure under the BELR:

- The credit conversion factors for measuring the value of off-balance sheet items in the banking book set out in Schedule 1 to the Rules resemble those used under the Capital Rules but subject to a minimum of 10%.
- An AI should recognize two distinct exposures on a derivative contract – one to the underlying of the contract and another to the counterparty of the contract.
- For measuring exposures to the underlying of a futures, forward or swap contract, the contract must be decomposed into separate legs under §§289(2)(c)(i), (ii) and (iii) and 292(1)(c), (d) and (e) of the Capital Rules, as if those provisions were applicable to the institution. For example, an equity forward contract is decomposed into a leg

representing a position in the underlying equity (§292(1)(c)) and a leg representing an interest rate exposure (§292(1)(e)). The first leg represents a non-CCR exposure in the underlying equity, which should be included for valuation. The second leg is an interest rate exposure, which should be excluded (Rule 48(1)(b)). In relation to a bond futures contract, the contract may be decomposed into a leg of the underlying bond and a leg representing an exposure being treated as arising from a zero-coupon specific risk-free security. An exposure to the latter leg may also be excluded (Rule 75(5)).

- In relation to a securities, commodities and foreign exchange transaction,

  (a) if the transaction is processed on a DvP or PvP mechanism, recognition of an exposure to the counterparty arising in the ordinary course of settlement of the transaction is not required. For example, in a securities sales transaction processed by DvP, the seller does not need to recognize the account receivable from the buyer as an exposure unless the buyer does not pay within the ordinary settlement period. In this case the exposure value is the higher of zero and the replacement cost of the contract concerned. The ordinary settlement period in the context of this paragraph is capped at five business days;

  (b) if the transaction is not processed on a DvP or PvP mechanism, after the first contractual payment/delivery has occurred, an AI that has made the payment/delivery should recognize an exposure to the counterparty for the amount of payment/delivery in full if the counterparty has not paid/delivered the second leg on the same business day, according to the time zone where each payment is made.

- For the purposes of Part 7,

  (a) If the AI does not adopt an internal modelling approach to calculate the amount of the default risk exposure of its derivative contracts for calculating its capital adequacy ratio under the Capital Rules, it should use the method that it currently adopts for that calculation, but without converting the exposure into a risk-weighted amount as in the case of determining regulatory capital under the Capital Rules.

(b) If an AI adopts an internal modelling approach (i.e. IMM(CCR)) to calculate the amount of the default risk exposure of its derivative contracts for calculating its capital adequacy ratio under the Capital Rules, in relation to Rule 59 (b), the MA will propose the AI to adopt the following methods for calculating the amount of default risk exposure under Part 7:

- before the SA-CCR approach is implemented locally, the method set out under paragraph (a), (b) or (f) of the definition of default risk exposure under §2(1) of the Capital Rules relevant to the AI;
- after the SA-CCR approach is implemented locally, the SA-CCR approach.

(c) If the AI does not adopt an internal modelling approach (i.e. IMM(CCR)) to calculate the amount of the default risk exposure of its securities financing transactions for calculating its capital adequacy ratio under the Capital Rules, it should use the method that it currently adopts for that calculation, but without converting the exposure into a risk-weighted amount as in the case of determining regulatory capital under the Capital Rules.

(d) If an AI adopts an internal modelling approach to calculate the amount of the default risk exposure of its securities financing transactions for calculating its capital adequacy ratio under the Capital Rules, in relation to Rule 60 (b), the MA will propose the AI to use the method set out under paragraph (c) or (d) of the definition of default risk exposure under §2(1) of the Capital Rules (as the case requires) as if those paragraphs were applicable to the AI.

2.9 **Valuation of CRM uncovered portion of exposure protected by recognized collateral**

2.9.1 Irrespective of the method used under the Capital Rules, Part 7 only accepts the simple approach and comprehensive approach under the STC approach to the treatment of recognized collateral for valuation of the CRM uncovered portion of an exposure. In this connection, an AI should pay attention to the following:

- §78 of the Capital Rules contains the criteria of when to use the simple approach or comprehensive approach;
- When the simple approach is used, the protected exposure is reduced by the market value of the recognized collateral. This is different from the treatment under the Capital Rules, which takes the form of "risk-weight substitution". This modification corresponds to the overarching principle of the large exposure standards of capturing the risk of immediate default of a counterparty and therefore risk-weights which reflect probability of default are irrelevant;
- As reflected in §77(g)(i) of the Capital Rules, the simple approach does not allow the maturity of the collateral to be shorter than that of the protected exposure. Furthermore, the simple approach does not apply haircuts to the collateral value as it is applied under the comprehensive approach;
- The comprehensive approach is by and large the same as that under the Capital Rules without modification. Nonetheless, attention should be paid to any adjustments to the haircuts required under §§90, 91 and 92 of the Capital Rules.
- As reflected in §103 of the Capital Rules, credit risk mitigation with maturity shorter than that of the protected exposure is recognized only when the credit risk mitigation's original maturity is equal to or greater than one year and the residual maturity is not less than three months. If there is a maturity mismatch in respect of a credit risk mitigation, the adjustment under §103 of the Capital Rules applies.

2.10 **Overlapping credit risk mitigation**

2.10.1 Pursuant to Rule 83, if the same portion of an exposure of an authorized institution is covered by more than one recognized credit risk mitigation, whether of the same or different type, an AI should adopt the one that would result in the lowest risk-weighted amount of the portion of exposure covered by the overlapping recognized credit risk mitigation. If the risk-weighted amount for the CRM uncovered portion is the same for two or more of the overlapping recognized CRMs, an AI may take into account any one of those recognized CRMs.

Example A) An exposure of $100 is protected by (i) a cash deposit of $100, (ii) a recognized guarantee for $100 (assume the guarantor's risk weight is 20%) and (iii) a government bond of $100 with a risk weight of 20%. The risk-weighted amount of the exposure by the treatment of each of these credit risk mitigation is as follows:

(i) Cash deposit: $0 (risk weight of cash is zero);

(ii) Recognized guarantee: $20;

(iii) Recognized collateral: $20.

Since cash deposit results in the lowest risk weighted amount under the Capital Rules, this should be taken as the credit risk mitigation for large exposure purposes.

Example B) An Exposure of $100 is protected by (i) $100 stock X and (ii) $100 stock Y. Both stocks have the same risk weight. As a result, the risk-weighted amount of the exposure is the same whether stock X or stock Y is taken as the credit risk mitigation. In that case, an AI may choose either one as the credit risk mitigation. It is also acceptable to take into account both stocks (e.g. on a pro-rata basis or other reasonable basis) as credit risk mitigation.

2.11 **Exposure disregarded**

2.11.1 Rule 48(1) sets out a number of exposures to be disregarded for the purposes of Part 7. Particular attention is drawn to the following:

- Subrule (a) – exemption to an AI's exposure to its own affiliates which 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. To complement this exemption, an AI is required to set an internal limit on aggregate exposures to its own group of companies (including but not limited to the affiliates exempted under subrule (a), e.g. an AI may include other affiliates for internal risk management purposes). The limit should be expressed as a ratio of aggregate intragroup exposures to the amount of the AI's Tier 1 capital. Such limit should be in line with the AI's internal risk appetite and take into account the AI's operational need as well as the group policies and arrangements for liquidity/market risk management. Aggregate intragroup exposures should be determined according to Rule 46 as if the exemption to intragroup exposures under Rule 48(1)(a) did not apply.
- Subrule (c) – exemption to the Government. This exemption generally covers the HKMA. An AI's exposure to the HKMA is for the account of the Exchange Fund, which is part of the Government.
- Subrule (d) – this subrule exempts a security held by an institution for a financial facility provided by the institution other than a recognized collateral being taken into account to calculate the CRM uncovered portion of an exposure of the AI or a collateral mentioned in rule 54(2)(a)(ii).
- Subrule (k) – this subrule provides exemption to intraday exposure to a bank (including AI), i.e. an exposure to a bank that meets both of the following descriptions: (i) exposure was incurred at a location on a particular calendar day by reference to time zone of that location; (ii) that calendar date has not ended at that location. In this paragraph "a location" should mean a location of the counterparty. The operation of this subrule is illustrated by the following examples:

  - Example (1) An AI places money to a bank in

New York at 2230 Hong Kong time / 0930 New York time on Day 0. The exposure will be exempted until 0000 of Day 1 New York time or 1300 Hong Kong time of Day 1.

- Example (2) An AI places money to a bank in New York at 1030 Hong Kong time on Day 1 / 2130 New York time on Day 0. The exposure will be exempted until 0000 of Day 1 New York time or 1300 Hong Kong time of Day 1.
- Example (3) An AI's London branch places money to a bank in New York at 1500 London time on Day 0 / 1000 NY time on Day 0 / 2300 Hong Kong time on Day 0. The exposure will be exempted until 0000 of Day 1 New York time or 0500 London time of Day 1 or 1300 New York time of Day 1.

• It should be noted that exposure to a multilateral development bank is not exempted under the current BELR. This exemption is considered not necessary locally as an AI seldom has substantial exposure to a multilateral development bank.

2.11.2 Rule 48(1)(n) provides a general exemption power to the MA. The HKMA expects that it will rarely exercise the general exemption power unless under exceptional situations (e.g. under a crisis exempting certain exposures to banks is essential to maintain the financial stability.). The HKMA will consider other cases only if the cases are prudentially justified. For example, due to the unique circumstances of a case, certain exposures of an AI should more appropriately be exempted from the exposure limit but subject to other regulatory measures.

2.12 Deduction

2.12.1 Rule 57 provides for certain deduction from the amount of an exposure. Under Rule 57(1)(d), in valuing an exposure of an AI, the amount of exposure covered by a letter of comfort approved by the MA should be deducted provided that the condition (if any) attached to the approval, whether generally or in any particular case or class of cases, are complied with. Typically the MA's approval of a letter of comfort is attached with a condition that the AI's exposure must not exceed a maximum lending limit. Exceeding the maximum lending limit constitutes a breach of the condition under Rule 57(1)(d)(ii). This results in the exposure no longer eligible for deduction and is also a notifiable event under Rule 7(2)(k)(iii).

2.12.2 Based on the letter of comfort issued by the Government to the HKMA, exposure arising from the 80% Loan Guarantee Product under the SME Financing Guarantee Scheme set up by The Hong Kong Mortgage Corporation Limited to (a) The Hong Kong Mortgage Corporation Limited or (b) a subsidiary of The Hong Kong Mortgage Corporation Limited is deductible under Rule 57(1)(d) by virtue of the transitional provisions of Rule 116.

2.12.3 It should be noted that it is the MA's policy to cease the acceptance of the existing letters of comfort securing the exposures of foreign bank subsidiary AIs from 1 July 2020. In future letters of comfort will only be accepted in exceptional cases. For details please refer to CR-L-3 "Letter of Comfort: BELR Rule 57(1)(d)".

2.13 Exempt exposures under Parts 2 and 6

2.13.1 Rule 14(1) provides exemptions to certain equity exposures from the exposure limit in Rule 11. However, some of these exemptions require the MA's written approval, including exemptions to:

- An equity exposure arising from the holding of capital interest acquired under an underwriting or sub-underwriting contract for a period not exceeding seven working days (or such further period as may be approved by the MA[4]);
- An equity exposure arising from the holding of capital interest in another AI or a company carrying out nominee, executor or trustee functions, or other functions related to banking, deposit-

[4]MA's approval is not required for the exemption on holding of capital interest acquired under an underwriting or sub-underwriting contract for a period not exceeding seven working days. See CR-L-4 "Underwriting of Securities" for the MA's policy on extending the exemption period for the underwriting or sub-underwriting of securities.

taking or insurance business, investments or other financial services;

- An equity exposure arising from the holding of capital interest which is deducted from the AI's capital base under Part 3 of the Capital Rules;
- An equity exposure specified in a consent under Rule 14(2). In this connection, the MA intends to give consent to equity exposure arising from stabilizing action undertaken by a stabilizing manager in relation to an IPO, subject to the following conditions:

(i) the stabilizing action must include all of the following - over-allocation of the shares offered before listing, selling relevant shares creating a short position before listing and acquisition of relevant shares to close out short position within the stabilizing period specified in a relevant agreement.

(ii) the stabilizing manager has been granted an option from the issuer company at offer price to subscribe new shares to cover over-allocation (Green Shoe option);

(iii) the purchase of relevant shares (either from a market purchase or through exercising the Green Shoe option) must be for the sole purpose of preventing or minimizing any reduction in the market price of the relevant securities;

(iv) the stabilization activities are conducted in accordance with the Securities and Futures (Price Stabilizing) Rules (Cap. 571W);

(v) the exemption is valid until the end of the stabilizing period set out in a relevant agreement.

2.13.2 An AI should apply to the HKMA in writing if it intends to obtain the exemption under paragraph 2.13.1.

2.13.3 Except a general policy has been established in this module, the HKMA expects it will rarely exercise the general consent power under Rule 14(2). An AI should only propose a case for the HKMA's consideration if it is prudentially justified. For example, due to the unique circumstances of a case, it is convincing for certain equity exposures of an AI to be exempted from the equity exposure limit but subject to other regulatory measures.

2.13.4 Also excluded from the equity/land exposure limit are equity interests/ interests in land (i) mortgaged to an AI or held as security for facilities granted by an AI under Rule 14(1)(a)/Rule 38(a); or (ii) acquired by an AI during debt recovery under Rule 14(1)(b)/Rule38(b). In the case (ii), however, such equity interests/interests in land acquired should be disposed of within 18 months after its acquisition or within such further period as may be approved by the MA.

3. Prudent principles for controlling risk concentrations

3.1 AIs should carefully manage and avoid excessive risk concentrations of various kinds, including exposures to individual counterparties (see paragraph 3.3 below), groups of counterparties with similar characteristics, economic and geographical sectors, types of lending with similar characteristics (e.g. property lending, share margin financing, taxi loans) and holdings of securities or investments.

3.2 Statutory limits are not necessarily indicative of the level of risks an AI should take. For example, a statutory limit of 25% under Rule 44(1) does not mean that as high a level of exposure as this is appropriate for a particular counterparty or a particular AI. AIs should establish internal exposure limits that are reasonable in relation to their Tier 1 capital and balance sheet size. They should require exceptional justifications before allowing such limits to be exceeded.

3.3 When considering the extension of large credit facilities (in particular those exceeding 10% of an AI's Tier 1 capital), AIs should exercise extra care in ensuring that prudent credit granting criteria are met. They should have a thorough understanding of the borrower's background, financial strength and repayment sources, nature of business and funding needs, as well as management capabilities. The credit decision should be supported by an in-depth credit assessment of the borrower's debt-servicing capacity based on sufficient and reliable information (see CR-G-2 "Credit Approval, Review and Records" for further guidance).

3.4 Although certain types of exposure or exposures to certain counterparties are not subject to the statutory limit under Rule 44 (see subsections 2.11 and 2.12 above for the nature of such exemptions or deductions), this does not mean that they are totally free of credit risk. AIs should still exercise particular care to avoid undue concentration of risk in respect of any such exposure. Preferably, the exempted exposures or the exposure to exempt counterparties should each be contained within 25% of an AI's Tier 1 capital.

3.5 AIs should avoid undue reliance on collateral, guarantees, or credit derivative contracts. Where collateral (or a guarantee) is taken to support a large exposure, AIs should make sure that the primary consideration is the borrower's debt-servicing capacity. Part 7 allows for the reduction of exposure to the extent that the exposure is secured by an eligible credit risk mitigation. AIs should however note that the reduction of exposure does not imply that the excess risk on the CRM covered exposure is totally eliminated.

3.6 As a general rule, AIs should ensure that the level of exposure to any counterparty, whether the exposure is exempt or covered by CRM, is commensurate with that counterparty's financial strength and creditworthiness.

3.7 AIs that have developed an internal risk rating system for credit risk management may have regard to the internal ratings assigned to individual counterparties as a basis for setting the internal exposure limits for these counterparties. The internal risk rating system in use should be commensurate with the nature, size and complexity of an AI's activities.

3.8 AIs should not necessarily limit the definition of a "group of linked counterparties" by the criteria for linking in subsection 2.5 above. The definition should ideally capture all parties linked in such a way that the financial strength of any of them may affect that of the others, i.e. counterparties that constitute a single risk, e.g. an AI may choose to apply linking by economic dependence without regard whether the reference counterparties to which the AI's ASCE ratio exceeds 5%.

3.9 Apart from credit risk, it is important for AIs to ensure that other risks associated with large exposures (e.g. legal, operational and market risk) are adequately monitored and controlled. For example, there should be adequate control procedures to ensure that the AI's legal rights are properly protected and that the chance of operational fraud or errors is minimized. Exposures subject to market risk should be periodically revalued.

3.10 Where appropriate, AIs should conduct stress-testing and scenario analysis of large exposures to assess the impact of different scenarios and of the potential losses that may arise from changes in key risk factors such as economic cycles, interest rate and other market movements and liquidity conditions.

4. Prudential limits

4.1 Authority

4.1.1 Consistent with paragraph 12 of the Seventh Schedule to the BO, the HKMA may set prudential limits to prevent AIs from taking excessive concentration risks that may be detrimental to the interests of depositors or potential depositors.

4.1.2 If an AI is, in the opinion of the HKMA, exposed to a significant level of risk concentration that may affect its financial stability, the HKMA may set prudential limits on the AI's exposures to particular counterparties, groups of counterparties, economic or geographical sectors. These limits will be determined on a case-by-case basis, having regard to the AI's individual circumstances.

4.1.3 The HKMA may also direct an AI to take such other measures as it deems necessary to reduce its level of risk concentration.

4.2 Clustering limit

4.2.1 Normally, an AI which has a "clustered" loan portfolio (i.e. a large number of sizeable single exposures) will be subject to a higher level of concentration risk than an AI with a widely diversified loan portfolio.

4.2.2 In this regard, every locally incorporated AI is expected to set an internal limit in its large exposures and risk concentrations policy (see subsection 5.2 below) to control the aggregate of its non- exempt large exposures, other than exposures to AIs and banks[5], on both an unconsolidated and consolidated basis[6] (referred to as the clustering limit hereafter). This limit, expressed in terms of amount or percentage of an AI's Tier 1 capital, should be approved by its Board of Directors and agreed with the HKMA.

4.2.3 As a reference, most AIs in Hong Kong have an aggregate amount of non-exempt large exposures which is within 200% of their Tier 1 capital. This appears to provide a reasonable benchmark for AIs to set their clustering limit. The HKMA will have regard to this level in monitoring an AI's large exposures. It is important that the limit set by AIs should be realistic and should not be set at a level so high that it could never be breached.

4.2.4 In considering whether the clustering limit set by an AI is acceptable, the HKMA will take into account the following factors:

- the level of the AI's capital adequacy ratio;
- consistency with the AI's large exposures and risk concentrations policy (see subsection 5.2 below);
- the number of exposures, their individual size and the nature of business of the borrowers concerned; and
- the characteristics of the AI, including the nature of its business and the experience of its management.

4.2.5 In determining the amount of exposures subject to the clustering limit, an AI should aggregate those exposures that are equal to or more than 10% of its Tier 1 capital, which are currently not disregarded under Rule 48[7] and not to AIs or banks.

[5] In other words, the clustering limit does not apply to exposures to AIs and banks.
[6] The subsidiaries for consolidation for the purposes of the clustering limit are the same as that for compliance with Part 7 as the AI has been notified of under Rule 6.
[7] See Rule 48 for the exemptions available.

4.2.6 In the case of an exposure supported by a letter of comfort approved by the MA under Rule 57(1)(d)(i), the amount of the exposure so covered by the letter of comfort is excluded for the purposes of the clustering limit. The total of all exposures covered by a letter of comfort is, however, subject to aggregate lending limit as specified by the MA. See paras. 2.4.3 and 2.5.1 of CR-L-3 "Letters of Comfort: BELR Rule 57(1)(d)" for more details.

4.2.7 AIs should establish adequate systems to monitor compliance with the clustering limit agreed with the HKMA.

5. Controls over large exposures and risk concentrations

5.1 Oversight by Board of Directors

5.1.1 The Board of Directors should ensure that the AI fully understands its legal obligations in relation to the limitations on exposures and risk concentrations under the BELR.

5.1.2 The Board should ensure that the AI establishes a policy on the control of large exposures and risk concentrations. The policy, and any changes thereto, should be reviewed and approved by the Board.

5.1.3 The Board should be responsible for ensuring that the AI establishes appropriate procedures and systems to identify, measure and control large exposures and risk concentrations and to monitor compliance with the approved policy.

5.1.4 The Board should ensure that large exposures are approved by the appropriate level of management in the AI. Normally, the Credit Committee approves large credits to customers, e.g. those with total facilities in excess of 5% of the AI's capital base[8] (see subsection 2.1 of CR-G-2 "Credit Approval, Review and Records").

5.1.5 The Board should receive regular reports to facilitate its review of the AI's large exposures and risk concentrations.

[8] An AI may also define large credits requiring special approval with reference to its Tier 1 capital following the implementation of BELR.

5.2 **Policy**

5.2.1 The details that should be included in the large exposures and risk concentration policy depend on the nature of an AI's business and its scale of operation.

5.2.2 Nevertheless, the policy should cover as a minimum the following:

- the definition of exposure. While the definition under Part 7 is already very comprehensive, an AI is free to extend the definition as appropriate;
- the criteria to be used for identifying a group of linked counterparties;
- the individual and aggregate exposure limits for various types of counterparty (e.g. governments, banks, corporate and individual borrowers). The 25% statutory limit under Rule 44(1) should not necessarily be seen as the maximum limit for counterparty exposures;
- the aggregate maximum exposure limits for an industry, an economic sector, a country, a region or a group of borrowers which have a similar or homogeneous risk;
- the delegation of credit authority within the AI for approving large exposures;
- the circumstances in which the above limits can be exceeded and the party authorized to approve such excesses, e.g. the AI's Board of Directors or Credit Committee with delegated authority from the Board;
- any differentiation between the limits for secured and unsecured exposures. AIs should note however that secured exposures are not risk free;
- the clustering limit (see subsection 4.2 above), i.e. the maximum amount of aggregate non-exempt, non-bank large exposures, in terms of amount or percentage of the AI's Tier 1 capital, which may exist at any one time;
- the procedures for identifying, reviewing,

monitoring and controlling large exposures; and

- the allocation of responsibility for reporting large exposures to the HKMA and for ensuring compliance with the BELR, Part XV of the BO (e.g. §81B) and other prudential obligations in relation to concentration risk.

5.2.3 Where applicable, the above internal limits should be set on both a solo and a consolidated basis.

5.2.4 Every AI is required to agree its policy on large exposures and risk concentrations with the HKMA. The HKMA should be consulted prior to any changes to the policy.

5.3 Regular monitoring

5.3.1 AIs should have a central liability record (preferably based on an automated system) for each large exposure. AIs should be able to monitor such exposures against statutory and prescribed internal limits on a daily basis. See CR-G-2 "Credit Approval, Review & Records" and CR-G-3 "Credit Administration, Measurement and Monitoring" for further guidance.

5.3.2 Every AI should have adequate management information and reporting systems that enable management to identify risk concentrations within the asset portfolio of the AI or of the group (including subsidiaries and overseas branches) on a timely basis. If a concentration does exist, AIs should reduce it in accordance with their prescribed policies.

5.4 Independent audits and compliance

5.4.1 AIs should maintain regular and independent checks on the adequacy of controls over large exposures and on compliance with relevant internal policies and applicable laws and regulatory requirements.

5.4.2 AIs should ensure that their internal or external auditors conduct a regular review of the quality of large exposures and controls to safeguard against risk concentrations. Their review should ascertain whether:

- the AI's relevant policies, limits and procedures are complied with; and

- the existing policies and controls remain adequate and appropriate for the AI's business.

5.4.3 Management should take prompt corrective action to address concerns and exceptions raised.

5.4.4 There should also be an independent compliance function[9] to ensure that all relevant internal and statutory requirements and limits (including the BELR and Part XV provisions of the BO) are complied with. Any breaches of statutory requirements and deviations from established policies and limits should be reported to senior management, and the HKMA where appropriate, in a timely manner.

6. Consequences of breaches

6.1 Notification in general

6.1.1 An AI should notify the HKMA immediately of any breach of the statutory limits under the BELR, the clustering limit or other prudential limits agreed with the HKMA.

6.2 Statutory Notification

6.2.1 If an AI fails to comply with an exposure limit or a condition attached to the MA’s approval that falls under notifiable event under Rule 7(2), the AI must, pursuant to Rule 7(1), (i) immediately notify the MA of the event; and (ii) provide the MA with any particulars of the event that the MA requests. This notification requirement is referred to as the prescribed notification requirement under §81C of the BO.

6.2.2 An AI should notify the MA of a notifiable event in writing, to be supported by the following information to the extent available and practical:

- which exposure limit or condition under the BELR has been breached;
- when the breach started;
- how the breach was identified;
- what causes the breach;

[9] For AIs whose scale of business is small, the HKMA may determine on a case-by-case basis whether it is acceptable to allow their external or internal auditors or in-house lawyers to undertake the compliance function.

- whether the breach has been rectified, if so when and how;
- what remedial action has been taken by the AI.

6.2.3 If the information above is not available all at once, it can be provided by batches based on availability.

6.2.4 In terms of timing, once a breach is confirmed, the AI should notify the HKMA immediately. If the AI becomes aware that a breach has likely occurred but it takes time to investigate, it is expected to report the case to the HKMA first and complete its investigation as soon as possible. If a breach is eventually confirmed, it should notify the HKMA formally without delay.

6.3 Remedial Action

6.3.1 Pursuant to §81A(5) of the BO, an AI must comply with any provision of the BELR applicable to it. This does not confine to the provisions on exposure limits or conditions that constitute notifiable events. If an AI contravenes §81A(5), pursuant to section 81B, the MA must enter into discussions for the purposes of determining what remedial action should be taken by the institution to comply with the section, but the MA is not bound by the discussions. The MA may, after holding such discussions, by notice in writing served on the AI to require it to take the remedial action specified in the notice. This is referred to under §81C of the BO as the remedial action requirement.

6.4 Offence

6.4.1 Pursuant to §81C(2) of the BO, failure to comply with a prescribed notification requirement or remedial action requirement is an offence. The AI itself and every director, every chief executive and every manager[10] of the AI are liable to penalties (e.g. fine and imprisonment). The HKMA will consider whether the offence should be recommended for prosecution based on the circumstances of each case.

6.4.2 On the one hand, the breach of statutory limits under the BELR may indicate that the AI does not have adequate

[10] The meaning of "manager" is as defined under §2(1) of the BO.

systems of control to ensure that the limits specified in the BELR will not be exceeded. On the other hand, the breach of prudential limits agreed with the HKMA may indicate that the AI does not carry out its business in a prudent manner. This may call into question whether the AI continues to satisfy the relevant authorization criteria under the Seventh Schedule to the BO (i.e. paras. 8 and 12). The HKMA will consider whether the MA's power to revoke the authorization of the AI is exercisable[11] and if so, whether it should be exercised.

6.4.3 If a breach occurs, the HKMA may consider taking other appropriate actions, e.g. increasing the AI's minimum capital adequacy ratio or limiting its business expansion. It may also require the AI to agree a timetable to bring the exposure quickly below the statutory limit or any agreed limit and to report progress on a regular basis.

6.5 Regulatory reporting

6.5.1 AIs are required to report to the HKMA their large exposures in the "Return of Large Exposures - MA(BS)28" and to certify compliance with the BELR in the "Certificate of Compliance - MA(BS)1F(a)".

6.5.2 Where necessary, the HKMA may require particular AIs to adhere to different reporting requirements in relation to large exposures.

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[11] The MA's power to revoke the authorization of an AI is exercisable when the AI fails to meet any minimum authorization criterion stipulated in the Seventh Schedule to the BO.