

**PROPOSALS FOR
BANKING (EXPOSURE LIMITS) (AMENDMENT) RULES 2018**

BANKING (EXPOSURE LIMITS) (AMENDMENT) RULES 2018

Introduction

1. A set of proposals for the Banking (Exposure Limits) (Amendment) Rules 2018 is set out below comprising:
 - Part A Overview;
 - Part B Detailed proposals.

2. The following abbreviations are used in this set of proposals:
 - “AI” means authorized institution as defined under the BO;
 - “BAO” means the Banking (Amendment) Ordinance 2018;
 - “BCBS” means the Basel Committee as defined under the BO;
 - “BCBS LE standards” means the standards set out in the *Supervisory framework for measuring and controlling large exposures* issued by BCBS in April 2014¹;
 - “BELAR” means the Banking (Exposure Limits) (Amendment) Rules 2018 which are the subject of these drafting instructions;
 - “BELR” means the Banking (Exposure Limits) Rules which are currently under negative vetting by the Legislative Council;
 - “BO” means the Banking Ordinance (Cap. 155);
 - “Capital Rules” means the Banking (Capital) Rules (Cap. 155L);
 - “CCF” means “Credit conversion factor” and has the meaning given by section 2(1) of the Capital Rules;
 - “CCP” means central counterparty;
 - “CP” means the consultation paper (CP 16.01) on *Exposure Limits*

¹<https://www.bis.org/publ/bcbs283.htm>

issued by the HKMA in March 2016²;

- “Comprehensive approach” means the comprehensive approach referred to in Divisions 5 and 7, Part 4 of the Capital Rules;
- “EI” means economic interdependence;
- “FSB” means the Financial Stability Board as defined in section 2(1) of the Financial Institutions (Resolution) Ordinance (Cap 628);
- “G-SIB” means global systemically important bank;
- “HKMA” means the office of the MA;
- “LE” means large exposure;
- “LE FAQ” means the *Frequently asked questions on the supervisory framework for measuring and controlling large exposures* issued by BCBS in September 2016³;
- “Liquidity Rules” means the Banking (Liquidity) Rules (Cap 155Q);
- “MA” means the Monetary Authority appointed under section 5A(1) of the Exchange Fund Ordinance (Cap. 66);
- “QIS” means quantitative impact studies;
- “Repo transaction” means a transaction specified in paragraph (a) under the definition of repo-style transaction in section 2(1) of the Capital Rules;
- “Rules” means the Banking (Exposure Limits) Rules;
- “Simple approach” means the simple approach referred to under Divisions 5 and 6, Part 4 of the Capital Rules.

3. The following terms have the meaning assigned to them under section 2(1) of

²http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/other-basel-committee-standards/CP16.01_Exposure_Limits_22March2016.pdf

³<https://www.bis.org/bcbs/publ/d384.htm>

the Capital Rules:

- BSC approach;
- Collective investment scheme;
- Counterparty credit risk;
- Derivative contract;
- IRB approach;
- Securities financing transaction;
- Securitization transaction;
- SFT;
- Sovereign foreign public sector entity;
- STC approach;
- Tier 1 capital.

Part A

Overview

Purposes

1. The purposes of the BELAR are to replace (and thereby effectively update) the BO sections 80, 81, 83, 85, 87A and 88 in order to keep pace with market developments and contemporary risk management practices; and to implement the BCBS LE standards (which will essentially replace the single/linked counterparty large exposure limits currently set out in BO section 81). The BAO section 9 amends the BO for the purpose of enabling the MA to make rules limiting concentrations of AIs' exposures and for connected purposes, and the BAO sections 7, 8 10, 11, 13 and 14 repeal the BO sections 80, 81, 83, 85, 87A and 88 respectively. Upon commencement of the BELAR, these BO sections will be repealed.

Structure

2. The BELR currently under negative vetting by the Legislative Council consist of three parts (Part 1 to Part 3, which cover limitations on equity exposures)
3. Part 4 to Part 10 will be inserted into the Rules by the BELAR. It should be noted that the aggregate limit under current BO section 90 should have been repealed upon the commencement of the BELR. Our intention is not to reinstate this aggregate limit in the Rules. It should also be noted that we are still working on the transitional arrangements for Part 4 to Part 9 to be set out in Part 10. We will consult the industry separately once the proposals for the transitional arrangements are ready. Consideration will also be given to merge the existing transitional provisions in Part 3 (i.e. for the equity exposure limit under Part 2) into Part 10 to make the Rules neater.

Background

4. Part 1 to Part 3 of the current BELR contain the revision of BO section 87. The remaining parts of the Rules, i.e., Part 4 to Part 10 (to be inserted by the BELAR), are expected to come into operation no earlier than 1 January 2019 to reflect the

international timeline for implementing the BCBS LE standards on that date and given that the industry has expressed difficulties to comply with the revised standards earlier than 1 January 2019. The other provisions are intended to take effect at the same time because the revisions to these provisions have also taken into account the new BCBS LE standards (e.g. exposure calculation method under section 83 and the rebasing of the exposure limit ratios from the capital base to Tier 1 capital generally, etc).

Part 4 (to be inserted by the BELAR) – Limitation on acquisition of share capital in companies by authorized institutions incorporated in Hong Kong (replacing content of BO section 87A)

5. The limitation set out in BO section 87A, which restricts the acquisition of share capital in companies by authorized institutions incorporated in Hong Kong, is a local requirement and not part of the BCBS LE standards.
6. Pursuant to the MA's rule-making power under BO section 81A (as inserted by the BAO section 9), the limitation currently set out in section 87A will be relocated to Part 4 of the Rules without major changes, except that the limitation will now make reference to an AI's Tier 1 capital instead of its capital base. This follows the policy intent to make reference to Tier 1 capital for all limitations throughout the Rules as far as possible.

Part 5 (to be inserted by the BELAR) – Limitation on advance against security of own shares, etc. (replacing content of BO section 80)

7. The limitation set out in BO section 80 is a local requirement and not part of the BCBS LE standards. In brief, section 80 prohibits a locally incorporated AI from granting credit facilities against the security of its own shares or the shares of its holding companies, subsidiaries and fellow subsidiaries. The primary objective of section 80 is to prevent AIs from seeking to create share capital only in form but not in substance by returning the proceeds from the share issuance to the capital providers through loans secured by the shares. Furthermore, it is precisely when the institution gets into difficulties that it would want to ensure that any credit enhancement applicable to its assets is adequate in case it needs to liquidate its assets. However, if the collateral of the assets are securities issued by the institution itself, this will run counter to that objective because when an institution gets into difficulties, the securities issued by the institution will likely

deteriorate in value.

8. To prevent AIs from circumventing section 80, the proposed Rules, to be made pursuant to the MA's rule-making power under BO section 81A, expand the restricted security from shares to other instruments eligible for inclusion in the capital base under the BCBS capital framework.

Part 6 (to be inserted by the BELAR) – Limitation on exposures to a single counterparty or group of linked counterparties (replacing content of BO section 81)

9. Note that the term 'linked counterparty' is used here instead of 'connected counterparty' used in the BCBS LE standards to differentiate the term "linked counterparties" from the term "connected parties" used in Part 7 of the Rules in relation to BO section 83).

Overview

10. The current BO section 81 sets a limit on large exposures to single/linked counterparties based on a set of earlier standards issued by the BCBS in 1991. These standards are to be replaced by the BCBS LE standards which should be implemented from 1 January 2019 onward. As explained in the BCBS LE standards, the primary purpose of the LE regulation is for limiting the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's own solvency. Pursuant to the MA's rule-making power under BO section 81A, Part 6 of the Rules will replace the BO section 81 to reflect the BCBS LE standards.

Application

11. The BCBS LE standards are applicable to all internationally active banks, subject to national discretion for any broader application (BCBS standards are "minimum" standards and it is always open to individual jurisdictions to impose more stringent or wide-ranging standards at their national discretion). As with the current BO section 81, the policy intent is to require all locally incorporated AIs to comply with the new Rules which replace the current BO section 81. Nonetheless, locally incorporated AIs will be classified into two groups, i.e. category 1 AIs and category 2 AIs. Category 1 AIs must comply with Rules encapsulating the BCBS LE standards in full, while category 2 AIs should comply with simplified requirements in certain aspects. The MA will designate an AI as belonging to category 1 or 2 subject to criteria similar to the designation

of category 1 AIs under the Liquidity Rules (e.g. in case the AI is internationally active or systemically important). An AI that does not meet the designation criteria for category 1 may nevertheless apply to become a category 1 AI if it prefers to comply with the BCBS LE standards fully.

Standard LE limit

12. The LE limit set out in the current BO section 81 is expressed as 25% of a locally incorporated AI's capital base. This limit applies to an AI's exposures to a single counterparty and group of linked counterparties. The revised limit is still 25% but rebased from capital base to Tier 1 capital. The proposed Rules will include more elaborate provisions for the calculation of exposures and the grouping of linked counterparties. In addition, the exposure value under the current BO section 81 in general does not take into account credit risk mitigation except for certain specified credit risk mitigation techniques with the approval of the MA. Under the proposed Rules, compulsory risk shifting applies to category 1 AIs so that they must reduce an exposure to the extent it is covered by acceptable credit risk mitigation techniques and, at the same time, recognise an exposure to the credit protection provider. Further details are set out in paragraphs 44 to 54 below.

Additional (stricter) limit for exposures between systemically important banks

13. In addition, an AI that is a local G-SIB is required to comply with a stricter LE limit of 15% with respect to its exposures to another G-SIB and a group of linked counterparties including a G-SIB. (This applies in addition to its need to comply with the standard 25% limit with respect to its exposures to counterparties that are not G-SIBs or groups of linked counterparties not including any G-SIBs.)
14. It should be noted that at the international level, G-SIBs are designated by the FSB. In November every year, the FSB will announce an updated list of G-SIBs. G-SIBs are subject to additional capital requirements under the BCBS capital framework. At the local level, the MA may also designate an AI as a G-SIB under section 3S of the Capital Rules. To avoid confusion in the BELAR between a G-SIB designated only by the FSB and a G-SIB designated by the MA, we propose to refer to the former as an international G-SIB and to the latter as a local G-SIB. Moreover, the FSB designation is made to a name representative of a group of companies. For ease of reference the proposed Rules will refer the expression "international G-SIB" to the holding company of the group of

companies the name representative of which falls under the current list of G-SIB published by the FSB.

15. The proposed Rules will provide that a local G-SIB's exposures to a group of linked counterparties which is representative of an international G-SIB (alone and on group basis) will be subject to the stricter limit of 15% (It should be noted that such a group of linked counterparties should include a local G-SIB and its linked counterparties if the MA has also designated an entity within the group of companies representative of the international G-SIB as a local G-SIB. The local G-SIB designation will always come after the relevant FSB designation). For example, Bank X is an international G-SIB. It operates a subsidiary in Hong Kong known as Bank X1. X1 is not required to comply with the stricter limit of 15% with respect to its exposures to other G-SIBs as long as X1 is not designated by the MA as a local G-SIB. Bank Y is designated as a local G-SIB. Its exposures to Bank X on a group basis (i.e. group of linked counterparties) and each individual entity within this group, including X1, will be subject to the stricter limit of 15%. See paragraph 17 below for further information on the grouping of linked counterparties. See Annex 3 to Part B of this set of proposal for an example.
16. Based on the BCBS LE standards, the proposed Rules will provide a 12-month grace period for the stricter limit of 15% to apply after a bank is newly designated as an international or a local G-SIB. Locally, we will grant the MA flexibility to shorten the grace period to not less than 6 months. To clarify, a current local G-SIB must comply with the stricter 15% limit with respect to its exposure to a newly designated international G-SIB (individually and the international G-SIB as a group) by the end of the grace period applicable to that international G-SIB [i.e. the clock starts to tick from the time when the international G-SIB is designated by the FSB]. This rule does not change even if the international G-SIB is also designated as a local G-SIB afterwards. Separately, if an AI is newly designated as a local G-SIB, it must comply with the stricter 15% limit with respect to its exposure to an international G-SIB or another local G-SIB (again, individually and as a group) by the end of the grace period applicable to the AI [i.e. the clock starts to tick from the time when the local G-SIB is designated by the MA].

Grouping of linked counterparties

17. As mentioned above, the LE limit is applicable to a single counterparty or group

of linked counterparties. In general, two or more counterparties of an AI are required to be grouped if the default of one is expected to affect the financial soundness of the others such that the group constitutes a “single risk” to an AI. The grouping of linked counterparties will be based on two principles i.e. (i) controlling interest and (ii) economic interdependence (“EI”, as elaborated under paragraph 21).

18. The proposed Rules will provide, that the persons below, being counterparties of the AI, will be regarded as a group of linked counterparties based on controlling interest and EI:

- (a) a counterparty;
- (b) any person which controls the given counterparty;
- (c) any other person which is also controlled by the person in (b);
- (d) any person which is controlled by the given counterparty;
- (e) any person, which is not related to the given counterparty by the control relationship in (b) to (d) above, but is so interconnected with any entity mentioned in (a) to (d) that if one of them was to experience financial problems, in particular funding or repayment difficulties, such a person would also be likely to encounter funding or repayment difficulties;
- (f) any other person which is controlled by the person in (e);
- (g) any other person which controls the person in (e) and is so interconnected with the person in (e) that if the person in (e) was to experience financial problems, in particular funding or repayment difficulties, that person would also be likely to encounter funding or repayment difficulties.

19. Items (b), (c) and (d) under paragraph 18 operate to capture counterparties by virtue of the “controlling interest” principle whereas item (e) operates to capture counterparties by reference to the EI principle. Please see paragraph 21 below in relation to items (f) and (g).

20. The proposed Rules will provide that for the purpose of grouping counterparties by controlling interests, one counterparty is regarded as having control over another counterparty if it–

- (a) owns more than 50% of the voting rights in the other counterparty;
- (b) has control of a majority of the voting rights in the other counterparty pursuant to an agreement with other shareholders;
- (c) has the right to appoint or remove a majority of the members of the other

counterparty's board of directors or management committee, or a majority of the members in the other counterparty's board of directors or management committee have been appointed solely as a result of the first counterparty exercising its voting rights; or

- (d) has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of the other counterparty (e.g. through consent rights over key decisions).

21. The operation of the EI principle is envisaged to be more technical and complicated. To enable further explanation and examples to be provided, we will adopt a practice similar to that used in respect of the Liquidity Rules and issue a code of practice (under BO section 97L as amended by BAO section 18) to supplement the proposed Rules. Further details of the policy proposals in relation to EI can be found in Annex 1 to Part B of this set of proposals. It is worth mentioning that if, say, counterparty A is linked to group X by EI, the subsidiaries of A are also required to be included in group X but the holding companies will only be included in certain cases. The policy thinking behind this is that the financial problems of an entity will very likely knock on to its subsidiaries but this will be less likely with respect to its holding companies. A holding company is only required to be included if it is also “economically dependent” on A. Items (f) and (g) under paragraph 18 above serve to reflect this policy intent. This approach is not explicit in the BCBS LE standards but based on a similar policy proposal released by a major jurisdiction⁴.

22. The proposed Rules will include special treatment for the grouping of linked counterparties related to a sovereign or central bank(it should be noted that “sovereign” under the BCBS LE standard has a different meaning from the term used under the Capital Rules). See Annex 1 to Part B of this set of proposals for further details.

Holdings of investment structures linked to a person

23. The proposed Rules should provide that if a person constitutes a common risk factor for more than one investment structure in which an AI invests, the AI should include its exposure to the aggregate current book value of its investments/holdings linked to such person in its aggregate exposure to that person. Examples of a person constituting a common risk factor for investment

⁴ See pp 37-38 of [Final Report Guidelines on connected clients under Article 4\(1\)\(39\) of Regulation \(EU\) No 575/2013 \(dated 14/11/2017\)](#).

structures include:

- the fund manager of more than one collective investment scheme (or basket of securities) held by the AI (except where the custodian of the assets in the scheme or basket is a separate legal entity),
- the liquidity support provider of more than one asset-backed commercial paper programme where commercial paper issued under the programme is held by the AI,
- the sponsor of more than one asset-backed commercial paper programme where commercial paper issued under the programme is held by the AI,
- the credit protection provider (through credit default swaps or guarantees) of more than one synthetic securitization transaction in which the AI invests,
- 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 invests.

Exposures

24. Basically, exposures under the LE framework include all exposures captured under the capital framework. Accordingly the LE framework covers on- and off-balance sheet exposures included in either the banking book or the trading book of an AI. It also includes indirect exposures to credit protection providers if the credit protection is acceptable to reduce the protected exposures. Nevertheless, the proposed Rules will provide exemptions for certain exposures based on the BCBS LE standards and local considerations.

Calculation of aggregate exposures to a single counterparty

25. The proposed Rules will divide exposures into two broad categories i.e. those that are exposures to counterparty credit risk (“CCR exposures”) and those that are not (“non-CCR exposures”). The intention is that the proposed Rules will cross-refer to the methods specified under the Capital Rules for the calculation of CCR exposures, and will explicitly provide for the methods for calculation of non-CCR exposures.

CCR exposures

26. Counterparty credit risk is only relevant to derivative contracts and SFTs. A derivative contract or a SFT may give rise to two types of credit risks. For

example, assume that an AI holds a long position in a call option issued by counterparty B, on stock X. This leads to (i) a risk to the equity underlying of the option (i.e. the potential loss if company X goes into liquidation) and (ii) a risk to counterparty B (i.e. the potential loss if counterparty B fails to honour its obligation under the option contract). The second risk is referred to as counterparty credit risk.

27. The proposed Rules will provide that in calculating counterparty credit risk, an AI should follow the same method that it adopts under the Capital Rules unless the method is an internal modelling method (which is not allowed under the BCBS LE standards). If an AI uses an internal modelling approach under the Capital Rules, it is required to use another approach available under the Capital Rules to calculate counterparty credit risk as notified by the MA after consultation with the AI.
28. The formulation in paragraph 27 above takes into account the fact that the BCBS has proposed revising the calculation methods for the counterparty credit risk of derivative contracts under the capital framework, but the revisions are not yet implemented locally in the Capital Rules (no earlier than January 2019). Therefore the proposed Rules cannot cross-refer to the revised methods explicitly as yet. When the changes are implemented in the Capital Rules, the methods acceptable for LE purposes will include the Standardised Approach for Counterparty Credit Risk (“SA(CCR)”) and a modified Current Exposure Method (“CEM”) (a local specific method introduced for the less sophisticated AIs). In future, AIs which use an internal modelling method, should use another approach available under the Capital Rules to calculate counterparty credit risk as notified by the MA after consultation with the AI, and (absent special circumstances) the policy intent will be to require them to use SA(CCR).
29. SFTs represent another type of transaction which gives rise to counterparty credit risk. Taking a repo transaction (where an AI has “sold” securities to a counterparty for a sum of money with a commitment to repurchase the securities at a specified price on a specified future date from the counterparty) for example, the securities that an AI has placed with the counterparty are another source of counterparty credit risk in that the counterparty may fail to return the securities to the AI.
30. Similar to the case of derivative contracts, the BCBS has also proposed revising

the calculation methods for the counterparty credit risk of SFTs under the capital framework. Therefore, the approach set out in paragraph 27 is similarly applicable to SFTs.

Non-CCR Exposures

31. For non-CCR exposures, in general the calculation methods differ depending on whether the exposures are booked in the banking book or the trading book. Nevertheless, there are also some situations where the same calculation methods will apply. The calculation methods for non-CCR exposures are elaborated below.

A) Banking book exposures

32. On-balance sheet exposures in the banking book are generally measured at the current book value. Nevertheless, exposures to shares in a company are measured as the total of the current book value and the amount for the time being remaining unpaid on the shares (if such amount is not counted under the current book value of the shares). This follows the definition of “value” applicable to shares under the current BO section 79(1).
33. The value of off-balance sheet exposures in the banking book basically follows the standardized credit risk (STC) approach under the Capital Rules i.e. it is the credit equivalent amount based on Table 10 of the Capital Rules, subject to the following adaptations:
 - (a) The credit conversion factors (CCF) are subject to a floor of 10% (this is an additional requirement going beyond the STC approach);
 - (b) In response to requests received during consultation, as a concession an AI will be allowed to apply a 100% CCF instead of the normally lower CCF to measure its loan commitments;
 - (c) The current definition of the off-balance sheet item “forward asset purchase” under the Capital Rules includes the writing of a put option. The BCBS LE standards are silent on the treatment of option contracts that are booked in the banking book. Nonetheless, applying the credit equivalent amount under the capital framework to an AI’s exposure in relation to a written put will deviate from the general principle of the BCBS LE standards to measure exposures assuming a “jump to default” of the obligor. For local implementation, it is proposed that options booked in the banking book will be measured by the same methods as options booked in the trading book.

Therefore, in the proposed Rules, there will be a different definition of “forward asset purchase” (from that in the Capital Rules) that does not cover the writing of put options.

B) Certain exposures common to both the banking book and the trading book

(a) SFTs – exposure to the underlying assets

34. The method to measure these exposures will be based on the same treatment as in the Capital Rules.

(b) Options

35. As mentioned above, exposures to the underlying of option contracts will be subject to the same prescribed treatments no matter whether the contracts are booked in the banking book or the trading book. The exposure measure is based on the loss in case of a “jump to default” of the underlying:

- Long call: V
- Long put: $-S+V$
- Short call: $-V$
- Short put: $S-V$

where S = strike price and V = market value of the option contract.

(c) Exposure to a CCP

36. In relation to exposures to a CCP, an AI must measure its exposure as a sum of both clearing-related exposures and exposures not related to clearing, which are subject to different treatments. The proposed Rules will prescribe treatments for clearing-related exposures whereas exposures not related to clearing (e.g. loans, other funding or credit facilities or guarantees granted to the CCP) will follow the normal calculation methods applicable to other counterparties. In addition, clearing-related exposures to a CCP that is a “qualifying CCP” (as defined in section 226V(1) of the Capital Rules) are exempted from the LE limitation.

37. If a group of linked counterparties includes a CCP, an AI should exclude clearing-related exposures to the CCP from its aggregate exposures to that group of linked counterparties. Nonetheless, the AI’s clearing-related exposures to the CCP should still be subject to the 25% limit applicable to the CCP as a single counterparty.

(d) Covered bonds

38. According to the BCBS LE standards, covered bonds that meet prescribed conditions may be assigned an exposure value of no less than 20% of the nominal value of the bank's covered bond holding. For the local implementation, the MA intends to exercise national discretion to adopt a more stringent standard in that the proposed Rules will measure covered bonds that meet prescribed conditions at 30% of the nominal value. International practices vary from 20% (e.g. Singapore) to no discount at all, i.e. 100% (e.g. US).

(e) Investment structures

39. The proposed Rules should require an AI to "look through" its holdings of investment structures (such as collective investment schemes, securitization transactions, etc.) under certain circumstances. Specifically–

- (i) an AI may assign the exposure amount to the structure itself, defined as a distinct counterparty, if its exposure to each underlying asset of the structure is smaller than 0.25% of its Tier 1 capital;
- (ii) an AI must look through the structure to identify those underlying assets for which the exposure value is equal to or above 0.25% of its Tier 1 capital. In that case the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The AI's exposure to the underlying assets that are below 0.25% of its Tier 1 capital may be assigned to the structure itself (i.e. partial look-through is permitted);
- (iii) if an AI is unable to identify the underlying assets of a structure:
 - where the total amount of its exposure does not exceed 0.25% of its Tier 1 capital, the bank must assign the total exposure amount to the structure;
 - otherwise it must assign the total exposure amount to an "unknown client". The AI must aggregate all exposures to the "unknown client" as if they were related to a single identified counterparty, to which the LE limit would apply.

40. If the look-through approach is not required in the circumstances described in paragraph 39(i) above, the AI must be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not – e.g. the AI has not circumvented the LE limit by investing in several individually immaterial transactions with identical underlying assets. If the look-through approach need not be applied, an AI's exposure to the structure must be the nominal amount it invests in the structure.

41. The proposed Rules should, based on the BCBS LE standards, provide for prescribed methods to look through an investment structure to the underlying assets. Different methods are to be applied to a structure in which all investors rank pari passu (e.g. collective investment schemes) and a structure in which there are different seniority levels among investors (e.g. securitization transactions).
42. An investment structure may be leveraged to increase the value of its underlying assets and exposures (e.g. the fund undertakes debt financing of its assets or enters into derivative contracts to increase the exposures). In that case, the proposed Rules should require an AI to measure its looked-through exposure to an underlying asset at the leveraged value (as disclosed in the latest financial report of the investment structure), subject to a cap equivalent to the value of its potential maximum loss from the investment in the structure (see the formula under paragraph 17.13 of Part B).

C) Trading book exposures

43. For instruments in an AI's trading book—
- (a) Straight debt instruments and equities are to be valued at current market value.
 - (b) Derivative contracts (other than option contracts) such as swaps, futures, forwards and credit derivatives must be decomposed into individual legs following the process used for calculating risk-based capital requirements under the Capital Rules. Only transaction legs representing exposures falling within the scope of the LE framework need to be considered (e.g. it is not necessary to recognise an exposure to a commodity or a currency).
 - (c) In the case of credit derivatives that represent protection sold by the AI, the exposure to the reference name must be the amount due in the case that the respective reference name triggers the instrument, minus the absolute fair value of the credit protection. In case the fair value of the credit derivative is positive from the perspective of the AI as protection seller, such a positive market value would also have to be added to the exposure of the AI (as protection seller) to the protection buyer (counterparty credit risk). Such a situation could typically occur if the present value of already agreed, but not yet paid, periodic premiums exceeds the absolute fair value of the credit

protection.

- (d) In response to requests for guidance during consultation, the proposed Rules will provide for the valuation treatment of nth-to-default swaps (a credit derivative). The treatment to be included in the Rules has been devised locally by the MA.
- (e) Derivative contracts not covered by an explicitly specified valuation methodology under (a) to (d) above should be valued according to the following principles: a long position in the underlying obligor should be measured as the amount of loss that would be sustained by the institution if the underlying obligor was to immediately default and a short position in the underlying obligor should be measured as the amount of gain to the institution if the underlying obligor was to immediately default.

Treatment of credit risk mitigation

- 44. The proposed Rules, in line with the BCBS LE standards, should recognize the reduction of an exposure by taking into account eligible credit risk mitigation (see paragraph 45 below).
- 45. The credit risk mitigation techniques acceptable for this purpose are recognized netting, recognized collateral, recognized guarantee and recognized credit derivative contract under the STC approach of the Capital Rules. 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 by the MA to use another approach. The other approaches available are the BSC approach and IRB approach. The STC approach applies supervisory prescriptions while the IRB approach applies internal modelling to calculate the risk-weighted amount for credit risk. The BSC 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.
- 46. Each of the BSC approach, STC approach and IRB approach carries its own provisions of acceptable credit risk mitigation, which are similar but may vary in the details. To reiterate, only the credit risk mitigation techniques used under the STC approach are to be used to calculate exposures taking into account credit

risk mitigation under the proposed Rules.

47. Given the foregoing, an “as if” formulation will be used in the proposed Rules to clarify that an AI which uses the BSC approach or IRB approach under the Capital Rules should use the credit risk mitigation techniques under the STC approach of the Capital Rules to calculate exposures in the proposed Rules as if the STC approach was applicable to the AI. A provision is also especially made in the proposed Rules (see paragraph 7.2(b) in Part B) for the purposes of clarifying that the “as if” formulation should not preclude an AI which does apply the STC approach under the Capital Rules to use the same method to calculate exposure taking into account credit risk mitigation under the proposed Rules.
48. Under the STC approach of the Capital Rules, two methods are acceptable to the treatment of exposures covered by collateral. They are the simple approach and the comprehensive approach. There are already provisions under the STC approach which specify when to use which approach (i.e. section 78 of the Capital Rules). The STC and IRB AIs are required to follow the same specification to determine which approach they have to use for recognizing collateral for credit risk mitigation purposes under these Rules. However, as BSC AIs are only allowed to use the simple approach under the Capital Rules, they should use that (simple approach under the STC approach) approach for the purposes of the proposed Rules.
49. The simple approach involves substituting the risk-weight of protected exposure by that of the issuer of the collateral under the Capital Rules. However, since the concept of risk-weight substitution does not apply to the LE framework, the proposed Rules only adopt the collateral recognition criteria under the simple approach but apply an “exposure deduction” approach to take into account recognized collateral.
50. The comprehensive approach applies “exposure deduction” to take into account recognized collateral, subject to a prescribed haircut to the value of collateral. This approach is by and large fully imported into these Rules.
51. As a general principle, where a maturity mismatch in respect of credit risk mitigants (collateral, on-balance sheet netting, guarantees and credit derivatives) is recognized in the Capital Rules and results in an adjustment to the extent to

which such credit risk mitigation is recognized, an adjustment in respect of the credit protection for the purpose of calculating LE is determined using the same approach as in the risk-based capital requirement. It is worth mentioning that if the “simple approach” to the treatment of recognized collateral applies to the collateral under the Capital Rules, the collateral cannot be pledged for less than the life of the exposure (section 77(g) of the Capital Rules).

52. As mentioned above, a category 1 AI is required to reduce an exposure to the extent covered by eligible credit risk mitigation techniques and at the same time recognize a risk exposure to the credit protection provider. In most cases, the exposure to the credit protection provider is equivalent to the amount of reduction in the protected exposure. One exception is, for an exposure in the trading book, when the credit protection takes the form of a credit default swap (CDS) and either the CDS provider or the reference entity is not a financial entity (i.e. a “financial sector entity” defined in section 2(1) of the Capital Rules). In such case, the amount to be assigned to the credit protection provider is not the amount by which the exposure covered by the CDS is reduced but, instead, the counterparty credit risk exposure of the CDS.
53. In relation to credit risk mitigation, an AI that is a category 2 AI will only be allowed to reduce an exposure secured by cash collateral or through on-balance sheet netting.
54. To be eligible for recognition, credit risk mitigation must meet the minimum requirements and eligibility criteria in the Capital Rules for the recognition of unfunded credit protection (i.e. guarantees and credit derivatives) and financial collateral that qualifies as eligible financial collateral under the STC Approach for risk-based capital requirement purposes. References can be made to the Capital Rules for recognized collateral (sections 77 and 79), recognized guarantees (section 98) and recognized credit derivative contracts (section 99). It should be noted that under the Capital Rules, recognized collateral includes real property under section 79(1)(p). As real property is not an acceptable form of collateral for LE purposes, this should be excluded in the proposed Rules.

On-balance sheet netting

55. An AI is allowed to offset its loans and deposits for the purposes of calculating its exposures provided that certain conditions are met. The proposed Rules will follow the BCBS LE standards in this regard.

Exemption for certain exposures

56. Exemptions are to be provided allowing the following exposures to be excluded from the LE limit:

- (a) Exposure amount that is deducted from the capital base of the AI;
- (b) Intragroup exposure;
- (c) Exposure in the trading book which is not associated with the default risk of a counterparty, e.g. commodity and currency exposures;
- (d) Exposure to the Government including exposure for the account of the Exchange Fund, through the holding of Exchange Fund Notes and Bills;
- (e) Exposure to any central government, central bank or sovereign foreign public sector entity – It should be noted that (i) notwithstanding the exemptions in (d) and (e), the Capital Rules will be revised so that an AI's concentration risk in respect of sovereign exposures will be subject to an additional capital requirement (BCBS refers to this as a “marginal risk-weight add-on”). See separate proposals in **Appendix 2** for amending the Capital Rules to address concentration sovereign exposures; and (ii) exposures related to a sovereign other than those exempted under (d) and (e) will still be subject to the standard 25% LE limit (for example, exposures to state-owned enterprises which are not sovereign foreign public sector entities). See Annex 1 to Part B of this set of proposals for further information on the grouping of exposures related to a sovereign or a central bank.
- (f) Exposure amount covered by recognized collateral or recognized guarantees issued by an entity stated in (d) and (e) above;
- (g) Exposure amount to the extent covered by a letter of comfort (current BO section 81(6)(b)(ii));
- (h) Any share capital or debt securities held as security for facilities granted by the institution, except for collateral in respect of which credit risk transfer is required by the proposed Rules [current BO section 81(6)(h) with necessary modification];
- (i) Any share capital or debt securities acquired by an AI in the course of the satisfaction of debts due to it, provided that all such share capital and debt securities shall be disposed of at the earliest suitable opportunity, and in any event not later than 18 months after the acquisition thereof, or within such further period as the MA approves in writing, and subject to such conditions as the MA may think proper to attach to his approval, in any particular case

- this replicates BO sections 81(6)(h) and 81(7);
- (j) Any share capital and debt securities acquired under an underwriting or subunderwriting contract for a period not exceeding 7 working days, or such further period as the MA approves in writing and subject to such conditions as the MA may think proper to attach to his approval, in any particular case – this replicates the current BO section 81(6)(i). It should be noted that the current exemption in relation to underwriting/subunderwriting commitments under BO section 81(6)(j) will be removed. As an off-balance exposure, the exposure under such commitments will be measured at the credit equivalent amount under the proposed Rules;
- (k) Exposure in relation to the indemnity under the current BO section 81(6)(k) relating to registration of transfer of shares in reliance on instruments purportedly issued by a subsidiary of the AI;
- (l) Exposure to the Housing Authority under the current BO section 81(6)(kb);
- (m) Exposure to the Hong Kong Mortgage Corporation Limited (HKMC) in relation to the Mortgage Insurance Programme (MIP) (current BO section 81(6)(kc) – following the recent restructuring of HKMC to transfer the MIP to one of its subsidiaries, the exemption will be modified to cover any company that grants insurance in connection with the Programme (reference may be made to the language of the current BO section 81(6)(m) in this regard);
- (n) Exposure to the HKMC in relation to the Guaranteed Mortgage-Backed Pass-Through Securitisation Programme under the current BO section 81(6)(m);
- (o) Exposure amount which has been written off (current section BO section 81(6)(l) – it should be noted that the proposed Rules on the calculation of exposures already require deduction of specific provisions (a specific provision refers to the same term under current BO section 81(6)(l). It refers to an allowance made by a bank usually on a loan in anticipation of the counterparty not able to repay the loan partly or fully. Specific provision is reflected as an expense in the accounts of a bank);
- (p) Exposure to an AI or to a bank incorporated outside Hong Kong (which is not an AI) if the exposure is settled within the same calendar day of the location where it has been incurred– it should be noted that exposures to AIs and banks are no longer fully exempted (current BO section 81(6)(a) and (g));
- (q) Exposure of an AI, where the AI acts as a receiving bank in the context of

an initial public offer (“IPO”), 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 – This is a new exemption intended to avoid interrupting normal operations of the local IPO market following the removal of the general interbank exemption referred to in (p) above;

- (r) Exposure to qualifying CCPs related to clearing activities;
- (s) Exposure 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 paragraphs 12 and 13.

57. For the sake of completeness, attention is drawn to the following:

- Trade finance related exposures under the current BO section 81(6)(c) and (d)
 - Trade finance exposures that are on-balance sheet exposures should be measured at the current book value while trade finance exposures that are off-balance sheet exposures should be measured at the credit equivalent amount under the proposed Rules;
- Exposures to a multilateral development bank (BO section 81(6)(ka)) – This exemption will be discontinued because such an exemption is not provided for in the BCBS LE standards.

PART 7 (to be inserted by the BELAR)– Limitation on exposures to connected parties (replacing content of BO section 83)

58. The limitation set out in BO section 83 is a local requirement and not part of the BCBS LE standards. The objective of section 83 is to prevent concentration risk in respect of exposures to parties connected to an AI.

59. Key changes to the content of section 83, which will be reflected in the “replacement” provisions to be included in the proposed Rules, are highlighted below:

- (a) Expansion of the scope of the limitation to “exposures” from “credit facilities” currently;
- (b) Refinement of the scope of the limitation to “exposures not covered by credit risk mitigation” from “unsecured facilities” currently: the effect will be two-fold – the industry will benefit from acceptance of a broader range of credit risk mitigation (i.e. guarantees and credit derivative contracts) but

collateral will be subject to new recognition tests;

- (c) Acceptance of real property as recognized collateral (in contrast to the position under the proposed new Part 6 where real property will not be accepted under the proposed Rules replacing BO section 81);
- (d) Revision of limit levels:
 - (i) limit of exposures to a single connected party being an individual (as presently covered by BO section 83(2)(b)) - increase from HK\$1m to **HK\$10m**;
 - (ii) limit of exposures to all connected parties, which are individuals, in aggregate (as presently covered by BO section 83(2)(a)) - rebase the limit to **5% of Tier 1 capital**.
 - (iii) limit of exposures to all connected parties (as presently covered by BO section 83(1)) - change from 10% of capital base to **15% of Tier 1 capital**.
- (e) Streamlining the definition of “relative” - the current definition in BO section 79(1) (which will be repealed by the BAO section 6) is too broad covering brother, sister, aunt, uncle, nephew, niece, cousin, etc. and has been the subject of complaint in being difficult to implement.

The existing definition is significantly broader than the minimum international standards which cover “close family members” of a connected individual. Taking into account international practices, in particular those of other regulators in the Asian Pacific region which cover “close relatives”, the proposed Rules will revise the definition of “relative” to mean a person’s:

- (a) lineal ancestor;
- (b) step-parent and adoptive parent;
- (c) brother and sister;
- (d) spouse (include anyone living as such);
- (e) spouse’s parent, step-parent and adoptive parent;
- (f) spouse’s brother and sister;
- (g) son and daughter; and
- (h) specified descendent;

and for the purposes of this definition, son includes step-son and adopted son and daughter includes step-daughter and adopted daughter;

- “**Lineal ancestor**” means a person’s parent, grandparent, great grandparent

and so on;

- “***Specified Descendent***” means a person’s grandson and granddaughter, great grandson and great granddaughter and so on.

60. The proposed limits under paragraph 59 have been formulated taking into account the results of a QIS undertaken by the HKMA.

PART 8 (to be inserted by the BELAR) – Limitation on advances to employees
(replacing content of BO section 85)

61. The limitation set out in BO section 85 is a local requirement and not part of the BCBS LE standards. The objective of section 85 is to prevent excessive secured lending to employees with attendant concerns of conflict of interests. The intention is to relocate the limitation set out in BO section 85 into the proposed Rules without major changes.

PART 9 (to be inserted by the BELAR) – Limitation on holding of interest in land by AIs
(replacing content of BO section 88)

62. The limitation set out in BO section 88 is a local requirement and not part of the BCBS LE standards. The objective of section 88 is to prevent concentration risk in relation to interests in land. The intention is to relocate the provision into the proposed Rules but change the exposure limit from 25% of an AI’s capital base to 25% of its Tier 1 capital. The proposed limit has been formulated taking into account the results of QIS undertaken by the HKMA.

63. In addition, we propose to introduce a new limit under BO section 88 on an AI’s aggregate exposures in the holding of interest in land under section 88(1) and section 88(2) at 50% of its Tier 1 capital.

64. The above limit is introduced incidental to the repeal of BO section 90 when BELR come into operation. Currently, section 90 imposes an aggregate limit (80% of capital base) on the following exposures:

- (i) s.83(1) connected parties (10% of capital base),
- (ii) s.87(1) equities (25% of capital base),
- (iii) s.88(1) interests in lands excluding bank premises (25% of capital base) and
- (iv) s.88(2) interests in bank premises (no separate limit).

65. The exposures (i) to (iii) above are regulated by separate limits individually. Therefore the repealing of s.90 will leave only exposures in bank premises not

subject to any exposure limit. The proposed aggregate limit under paragraph 63 is, therefore, proposed to regulate exposure in land including bank premises as compensation. Under that aggregate limit, if an AI's exposure under s88(1) is below 25%, it may incur exposure higher than 25% under s88(2), as long as the aggregate exposure amount is below 50%.

PART 10 (to be inserted by the BELAR) - Transitional arrangements

66. As mentioned before, we are still working on the transitional arrangements for Part 4 to Part 9 to be set out in Part 10. We will consult the industry separately once the proposals for the transitional arrangements are ready. Consideration will also be given to merge the existing transitional provisions in Part 3 (i.e. for the equity exposure limit under Part 2) into Part 10 to make the Rules neater (once amended by the BELAR).

Implementation

67. As mentioned in paragraph 10 above, it is proposed that the BELAR should take effect on 1 January 2019.