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:

- ***BELR*** means the Banking (Exposure Limits) Rules (Cap. 155S);
- unless otherwise specified, a reference to a Rule or a Part means a Rule or a Part respectively of the BELR

Purpose

To set out the general principles regarding the application of consolidated supervision of concentration risks and to explain how the HKMA applies these principles

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §7(3)

Previous guidelines superseded

Guideline 5.2.1A "Consolidated Supervision of Concentration Risks under Part XV" dated 18.10.91; Guideline 5.2.1B "Consolidated Supervision of Concentration Risks under Part XV (Solo Consolidation: Exceptions on De Minimis Grounds)" dated 19.11.91; CR-L-1 "Consolidated Supervision of Concentration Risks under Part XV: §79A" (V.1) dated 31.08.01; CR-L-1 "Consolidated Supervision of Concentration Risks: BELR Rule 6" (V.2) dated 09.08.19; CR-L-1 "Consolidated Supervision of Concentration Risks: BELR Rule 6" (V.3) dated 27.12.19

Application

To all locally incorporated AIs which have any subsidiary

Structure

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1. Introduction

1.1 Implementation of BELR

1.1.1 In July 2018, §87 of the Banking Ordinance ("the Ordinance") on equity exposure limit was replaced by the previous Banking (Exposure Limits) Rules (Cap. 155R). Such rules were subsequently repealed and replaced by the new BELR (Cap. 155S) in July 2019, which replaced all exposure limits that were previously set out under Part XV of the Ordinance.

1.1.2 §79A(1) of the Ordinance sets out the MA's power to require an AI to comply with the provisions under Part XV of the Ordinance on different bases of consolidation. Following the implementation of the BELR, §79A(1) is only applicable to the remaining provisions in Part XV that are not related to exposure limits.

1.1.3 The BELR contain provisions comparable to §79A(1) of the Ordinance under Rule 6. Specifically,

(a) Rule 6(1AA) provides that an AI must comply with the requirements of any provision of the BELR applicable to it on an unconsolidated basis, unless otherwise required in a notice given to it under Rule 6(1) ("Rule 6 notice");

(b) Rule 6(1) provides that, subject to Rule 6(1A) (see paragraph (c) below), for the purpose of applying any provision of the BELR to a locally incorporated AI that has any subsidiary, the MA may, by written notice to the AI, require it to apply the provision:

- on an unconsolidated basis in respect of the AI;
- on a consolidated basis in respect of the AI and one or more of its subsidiaries specified in the notice; or
- on an unconsolidated basis in respect of the AI, and on a consolidated basis in respect of the AI and one or more of its subsidiaries specified in the notice.

(c) Rule 6(1A) provides that for the purpose of applying any provision of the BELR to a locally incorporated AI

that has any subsidiary on an unconsolidated basis, the MA may, in a Rule 6 notice, require the AI to apply the provision on a solo-consolidated basis instead of a solo basis in respect of those of its subsidiaries specified in the Rule 6 notice. Please refer to section 2.4 for more details.

1.1.4 For the sake of smooth transition, Part 9 provides to the effect that a former section 79A notice given to an AI is deemed, if it was in effect immediately before 1 July 2019, to be a Rule 6 notice given to the institution on that date requiring it to comply with the requirements of Part 3, Part 6, Part 7 and Part 8 (cf. former §87A, 88, 81 and 83 of the Ordinance respectively) on the basis specified in the notice.

1.1.5 Similarly, Part 9 also provides for carrying over the effect of a consolidation basis notice given under former Rule 5(1) of the repealed Banking (Exposure Limits) Rules (Cap. 155R) to be deemed as a Rule 6 notice in relation to compliance with Part 2 (equity exposure) of the BELR.

1.1.6 Pursuant to Rule 6(5)[1], in respect of a Rule 6 notice given to an AI, applying a provision of the BELR on the following bases means applying the provision on the basis that the business of the institution includes:

(a) for unconsolidated (solo) basis: all of the institution's business in Hong Kong (being the business of its principal place of business in Hong Kong and its local branches (if any)) and the business of its branches (if any) outside Hong Kong;

(b) for unconsolidated (solo-consolidated) basis: the business of the institution as mentioned in paragraph (a), and the business of its subsidiaries as may be specified in the Rule 6 notice;

(c) for consolidated basis: the business of the institution as mentioned in paragraph (a), and the business of its subsidiaries as may be specified in the Rule 6 notice.

1.1.7 In respect of a Rule 6 notice, the provision that is the subject matter of the notice is to be applied on the basis specified in the notice.

[1] See Rule 6(5) for the definitions of "consolidated basis", "solo basis", "solo-consolidated basis" and "unconsolidated basis".

1.1.8 A subsidiary of an AI is not regarded as contravening any duty of confidentiality because of its supply of any information to the institution for enabling or assisting the institution to comply with a Rule 6 notice.

1.1.9 In respect of an AI that is required by a Rule 6 notice to apply any provision of the BELR on a solo-consolidated basis and/or a consolidated basis, Rule 6(3A) imposes a notification requirement on the AI to enable the HKMA's timely assessment of the impact of potential changes in the structure or business activities of the AI's group on the AI's compliance with the BELR. Under Rule 6(3A), the AI must give written notice to the MA of any of the following matters as soon as practicable after the AI is aware of the matter, or ought to be aware of the matter:

(a) a subsidiary specified in the Rule 6 notice ceasing to be a subsidiary of the AI;

(b) an entity becoming a subsidiary of the AI;

(c) the principal activities of a subsidiary referred to in paragraph (b);

(d) any significant changes to the principal activities of the AI or any of its subsidiaries (including a subsidiary specified in the Rule 6 notice and a subsidiary referred to in paragraph (b)).

1.2 Principles

1.2.1 AIs should control risks arising from the concentration of exposures on a group basis, given that they may be affected by, and have to provide financial support to, any subsidiary which gets into difficulty.

1.2.2 The regulatory intent of the BELR would not be achieved if an AI could circumvent the statutory limits, and thereby take undue risks, by incurring exposures through its subsidiaries. The MA should therefore be able to apply such limits on a group basis, as is the case with the calculation of the capital adequacy ratio, in respect of an AI.

1.2.3 Regulating concentration risks on a group basis also ensures that AIs have adequate systems in place for controlling such risks.

2. Supervisory approach

2.1 Application

2.1.1 AIs with subsidiaries may be required to comply with the statutory limits on both a consolidated and unconsolidated basis, particularly those under Part 7 [2]. The types of subsidiary to be included are set out in section 2.2 below.

2.1.2 Consolidated supervision complements, but does not replace, the assessment of an AI on an unconsolidated basis because:

(a) the AI is the entity which is authorized and takes deposits. The front line protection of depositors should therefore lie with the AI; and

(b) it is necessary to have a conservative measure of an AI's standalone capitalisation to withstand concentration risks, as it would be imprudent to rely on the transfer of resources or the provision of financial support from other group entities in case of need. These may turn out not to be freely transferable or available when needed. Only in exceptional circumstances and with thorough justifications will an AI be allowed not to follow solo limits.

2.2 Subsidiaries to be included

2.2.1 It may be neither practical nor meaningful to require an AI to consolidate all of its subsidiaries (particularly dormant or inactive subsidiaries) for regulatory purposes. The MA is therefore empowered under Rule 6(1) to decide which subsidiaries of an AI are to be included for the purposes of consolidation.

2.2.2 As a general rule, consolidation for the purpose of the BELR will include subsidiaries which:

[2] Requirements under Part 7 are generally expected to be applied on a consolidated basis in respect of an AI that has a subsidiary of the type set out in section 2.2 below, in line with the Basel Committee's large exposures framework (i.e. the LEX standard in the Basel Framework) that should be applied to all internationally active banks on a consolidated basis. The HKMA has discretion to apply consolidation requirements to other Parts as appropriate.

(a) undertake financial business[3], as they are more likely to draw on the AI's capital should their business get into difficulty; and

(b) incur risks regulated by the BELR, mainly large exposures to single parties, connected lending, shareholdings and interests in land.

2.2.3 Under the capital adequacy regime, subsidiaries which are supervised by other financial regulators may be exempted from consolidation because they are subject to separate capital adequacy requirements of these regulators. Consolidation under the BELR may include them, however, because such financial subsidiaries are likely to incur credit exposures.

2.2.4 Notwithstanding the above, it is recognised that insurance underwriting activities and the associated risks are fundamentally different from those of banks and most other financial entities. It is thus acceptable to not consolidate a subsidiary of an AI that engages in insurance underwriting activities for BELR purposes. For such an AI group, the HKMA will exercise oversight by way of the group-wide approach to supervision of locally incorporated AIs (see SPM module CS-1 "Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions"); and rely on, and cooperate with, the relevant insurance supervisor for the day-to-day prudential supervision of the AI's subsidiary that engages in insurance underwriting activities (including its risk governance and controls in respect of concentration risk).

2.2.5 Normally, consolidation will also include overseas subsidiaries of an AI which fall within the categories mentioned in section 2.2.2, unless there is strong justification for exclusion based on matters that are expected to be beyond the control of the AI. For example, where an overseas subsidiary is not allowed by local law to disclose customer information, exemption from consolidation may be given to it provided that the parent AI has adequate internal controls and limits in place to guard against concentration of risks in respect of both the subsidiary and the AI group as a

[3] Financial business normally includes factoring, banking, insurance, hire purchase, leasing, trade finance, securities trading, foreign exchange and bullion trading and other financial activities which give rise to credit exposure in a banking group.

whole. Such controls should enable the parent AI to monitor and assess the exposures of the subsidiary with reasonable accuracy, timeliness and frequency against any statutory and internal limits applicable to it, and to cause the subsidiary to take timely action to avoid incurring additional exposure which would breach any of those limits and to reduce any exposure which has exceeded those limits. There should also be an established mechanism to regularly monitor and validate that the necessary systems and controls, and any remedial actions, required of the subsidiary are in place and functioning as effectively as intended.

2.2.6 A subsidiary which adds little to the size of an AI's balance sheet could still incur substantial risks that may impact the AI's wider banking group (e.g. due to spillover of risks financially, operationally or reputation-wise). It is therefore inappropriate to exclude subsidiaries for consolidation based merely on size criteria.

2.2.7 The HKMA will discuss with a newly authorized locally incorporated AI if any of its subsidiaries will be included for consolidation before a Rule 6 notice is given to the AI to effect the requirement. As mentioned in section 1.1.9 above, an AI that is required by a Rule 6 notice to apply any provision of the BELR on a consolidated basis and/or solo-consolidated basis are required under Rule 6(3A) to inform the HKMA of any subsequent changes in group structure, etc..

2.2.8 Rule 6(3A) requires that the AI must make the required notification to the MA as soon as practicable after the AI is aware of the matter or ought to be aware of the matter. In assessing an AI's timeliness in complying with the notification requirements, the HKMA expects that the notification timeframe will be case-dependent, taking account of the circumstances of the matter (e.g. whether it is a fast-moving event or a slow-moving one), related AI-specific factors and any other relevant factors prevailing at the time.

2.3 Tier 1 Capital

2.3.1 Tier 1 capital is generally the basis for applying the statutory limits under the BELR. Under Rule 2(2), the term "Tier 1 capital" for the purposes of the BELR has the meaning given by §2(1) of the Banking (Capital) Rules ("BCR").

However, the determination of Tier 1 capital under the BELR should be subject to the basis of consolidation required under a Rule 6 notice. The subsidiaries consolidated for BELR purposes may differ from those for the calculation of the capital adequacy ratio as required under §3C of the BCR (see section 2.2 above).

2.3.2 For the purposes of determining compliance with statutory limits under the BELR, AIs should base their calculations on the Tier 1 capital prevailing at the close of business on the same day. For the sake of convenience, however, AIs may use the figure at the last quarter end as the basis, provided that there has been no significant reduction in the amount of their Tier 1 capital during the relevant period.

2.3.3 Where the MA requires a provision of the BELR to apply to an AI on a solo-consolidated/consolidated basis, it will be the solo-consolidated/consolidated Tier 1 capital of the AI, not the solo Tier 1 capital, that should be used for assessing compliance.

2.3.4 An AI's investments in subsidiaries which are not the subject of consolidation as specified in the MA's Rule 6 notice must be deducted from the AI's consolidated Tier 1 capital in accordance with the BCR requirements.

2.4 Solo-consolidation

2.4.1 As in the calculation of its capital adequacy ratio, an AI may be permitted to consolidate only certain subsidiaries for the purpose of compliance with exposure limits under the BELR on a solo-consolidated basis. Normally, a subsidiary of an AI will only be accepted for solo-consolidation if all of the following criteria apply:

(a) the subsidiary is wholly owned by, and managed as if it were an integral part of, the AI;

(b) the subsidiary is wholly financed by the AI such that the subsidiary has no depositors or other external creditors, except external creditors for audit fees, company secretarial services and sundry operating expenses; and

(c) there are no regulatory, legal or taxation constraints on the transfer of the subsidiary's capital to the AI.

2.4.2 The purpose of the criterion set out in section 2.4.1(b) above is to ensure that the assets of the subsidiary will be available, if necessary, to meet the claims of depositors and other creditors of the parent AI in a liquidation.

2.4.3 An AI may apply to the HKMA to include a subsidiary for solo-consolidation for the purposes of the BELR. The HKMA may also require certain subsidiaries of an AI to be subject to solo-consolidation where considered appropriate. The HKMA will discuss with the AI concerned which of its subsidiaries will be included for solo-consolidation before a Rule 6 notice is given to the AI to effect the requirement.

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