

COMMISSIONER OF BANKING
HONG KONG



香 港
銀 行 業 監 理 處

BANKING ORDINANCE

Consolidated Supervision of Concentration Risks under Part XV

A Guideline issued by the Commissioner of Banking under Section 7 (3)

Introduction

Section 79A of the Banking Ordinance (the Ordinance) empowers the Commissioner of Banking (the Commissioner) to require authorized institutions incorporated in Hong Kong to comply with the statutory limits under Part XV of the Ordinance on -

- (a) an unconsolidated basis;
- (b) a consolidated basis; or
- (c) both bases.

2. This guideline sets out the general principles governing the application of consolidated supervision of concentration risks and explains how the Office of the Commissioner of Banking envisages it will apply these principles.

Principles

3. Part XV of the Banking Ordinance deals with the concentration of risks of authorized institutions by setting limits on loans by, and interests of, institutions.

4. These risks should be controlled by an authorized institution on a group basis, given that the institution is liable to be affected by, and to have to support, a subsidiary or close affiliate which gets into difficulty. The regulatory regime should follow suit : it would not be effective if an institution could circumvent the limits, and thereby take undue risks, by incurring exposures through its subsidiaries. The Commissioner should therefore be able to apply the regulatory limits on a group basis, as is already the case with the capital adequacy ratio. This is in line with the Basle Committee's best practices paper on the control of large credit exposures.

5. Regulating concentration risks on a group basis will also ensure that institutions will, if they have not already done so, put in place systems of control which ensure that management also recognises and controls these risks.

Application

6. The Ordinance only requires subsidiaries* of institutions to be consolidated. Institutions with subsidiaries will normally be required to comply with the statutory limits on both a consolidated and unconsolidated basis. (The types of subsidiary to be included are set out in paragraphs 8 to 10 below.)

7. Consolidated supervision complements and does not replace the assessment of an institution on an unconsolidated, or solo, basis. It is the solo entity which is authorized and which actually takes deposits: it is there where the first, front-line protection of depositors must lie. It would be imprudent to rely on the transfer of resources from other entities, since these may not turn out to be freely transferable or available when most needed. Exceptional justification will be required in order that solo limits are not followed. The need for consolidated supervision has been explained in paragraphs 4 and 5.

Subsidiaries to be included

8. It is not always necessary, and there are practical difficulties, to consolidate all subsidiaries. The Commissioner has a discretion under section 79A(2) to decide which subsidiaries of an authorized institution are to be included in the consolidation.

9. As a general rule, consolidation for the purpose of Part XV will include -

- (a) subsidiaries which undertake financial business, as they are more likely to draw on the institution's capital should their business run into difficulty; and
- (b) those which incur risks regulated by Part XV, mainly large exposures to single parties, connected lending, shareholding and interests in land.

Financial business includes, for example, factoring, banking, insurance, hire-purchase, leasing, trade financing, securities trading, foreign exchange and bullion trading, and other financial activities which give rise to credit exposure in the banking group.

* Subsidiary is defined in section 2 of the Banking Ordinance to have the same meaning in the Companies Ordinance.

10. The following points should also be noted -

- (a) Consolidation for Part XV will, unlike the regime for capital adequacy, normally include subsidiaries which are supervised by other financial services regulators. These subsidiaries are exempted for capital adequacy purposes mainly because they are subject to separate capital adequacy requirements of other regulators. They are likely to incur credit exposures and should be consolidated for Part XV purposes.
- (b) Consolidation will normally include overseas subsidiaries which fall within the categories mentioned in paragraph 9, unless there is strong justification for exclusion. Where an overseas subsidiary is restricted by local laws from disclosing customer information, exemption will be given to such subsidiaries from consolidation under section 79A(2) provided that the parent institution has adequate internal controls and limits in place to guard against the concentration of risks in these subsidiaries. Such controls should enable the parent to assess exposure with reasonable accuracy and timeliness against limits set by it, and to cause the subsidiary to take action to avoid incurring additional exposure which will breach those limits and to reduce any exposure which has exceeded those limits.
- (c) A subsidiary which adds little to the size of the balance sheet could incur substantial risks. It is therefore inappropriate to exclude subsidiaries for consolidation based on the size of the company. Authorized institutions with an extensive group structure may have difficulties in calculating their exposure to individual counterparties at all times. Such institutions may discuss with the Commissioner arrangements to overcome difficulties in meeting the reporting and compliance requirements e.g. through the use, for reporting purposes, of internal limits on counterparty exposure. The Commissioner will need to be satisfied that its control systems are such that its exposure to a counterparty may reliably be taken as being no higher than its adopted limit for that counterparty.

11. The Commissioner will discuss with individual authorized institutions and notify them in writing as to which subsidiaries will be included for consolidation. Institutions should inform the Commissioner of any subsequent changes, including additions and deletions of subsidiaries, as well as changes to the principal activities of the subsidiaries.

Capital base

12. Capital base, as defined in the Third Schedule of the Ordinance, has replaced capital and reserves as the basis for applying the statutory limits under Part XV of the Ordinance. In normal circumstances, the "capital base" derived from the most recent audited accounts of an institution will be used as the basis for assessing its compliance with the statutory limits under Part XV. However, the Commissioner may require an institution to use its latest "capital base" figure for this purpose, if there has been a significant fall in its capital base compared with that shown in its last audited accounts.

13. Where the Commissioner requires under section 79A(1) a provision of Part XV to apply to an institution on a consolidated basis, it will be the consolidated capital base of the group, not the solo capital base of the institution that should be used for assessing compliance.

14. Unlike the regime for capital adequacy, the net worth of subsidiaries which are supervised by other financial services regulators and are subject to separate capital requirements (see paragraph 10(a)) will normally be included in the calculation of the consolidated capital base. The institution's investments in other subsidiaries not specified in the Commissioner's notice will be deducted from the consolidated capital base.

Solo Consolidation

15. Like the regime for capital adequacy, it may be permissible to consolidate certain subsidiaries when calculating the solo capital base of the institution (and its exposure to individual counterparties). Such "solo consolidation" will only be allowed for subsidiaries where all of the following apply -

- (a) the subsidiary is wholly owned by, and managed as if it were a division of, the institution;
- (b) the subsidiary is wholly financed by the institution (i.e. the subsidiary should have no external creditors including depositors);

- (c) the capital of the subsidiary is freely transferable up to the institution, taking account of regulatory, legal and taxation problems.

The Commissioner will discuss with individual authorized institutions and notify them in writing as to which subsidiaries will be included for "solo consolidation".