



Supervisory Policy Manual

CR-L-1

Consolidated Supervision of Concentration Risks under Part XV: §79A

V.1 - 31.08.01

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.

Purpose

To set out the general principles governing the application of consolidated supervision of concentration risks and to explain how the MA will apply 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Previous guidelines superseded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

Application

To all locally incorporated AIs which have any subsidiaries

Structure

1. Introduction
 - 1.1 §79A
 - 1.2 Principles



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 - 2.4 Solo consolidation
 - 2.5 De minimis exemption

1. Introduction

1.1 §79A

1.1.1 Under §79A(1) of the Banking Ordinance, the MA may issue written notice to a locally incorporated AI which has any subsidiary, requiring it to comply with the statutory limits under Part XV of the Ordinance:

- on a consolidated instead of an unconsolidated (or solo) basis; or
- on both a solo and consolidated basis.

1.1.2 Under §79A(2), the MA may specify in the written notice which subsidiaries of the AI are to be included in the consolidation.

1.1.3 §79A(3) provides that a subsidiary of an AI is not regarded as contravening any duty to which it is subject, if it submits information to the parent AI for the purpose of enabling or assisting it to comply with the MA's written notice.

1.2 Principles

1.2.1 Part XV of the Banking Ordinance deals with the concentration of risks of AIs by setting limits on their loans and other interests.



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- 1.2.2 AIs should control these risks on a group basis, given that they may be affected by, and have to provide financial support to, any subsidiary which gets into difficulty.
- 1.2.3 The regulatory regime under Part XV of the Banking Ordinance would not be effective 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 capital adequacy ratio.
- 1.2.4 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 The Banking Ordinance only requires subsidiaries of AIs to be consolidated. AIs with subsidiaries will normally be required to comply with the statutory limits on both a solo and consolidated basis. The types of subsidiary to be included are set out in subsection 2.2 below.
- 2.1.2 Consolidated supervision complements, but does not replace, the assessment of an AI on a solo basis because:
- the AI is the entity which is authorized and takes deposits. The front line protection of depositors should therefore lie with the AI; and
 - it would be imprudent to rely on the transfer of resources or the provision of financial support from other group entities. 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.



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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 §79A(2) 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 Part XV will include subsidiaries which:
- undertake financial business¹ as they are more likely to draw on the AI's capital, should their business get into difficulty; and
 - incur risks regulated by Part XV, 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 Part XV will normally include them, however, because such financial subsidiaries are more likely to incur credit exposures than others.
- 2.2.4 Normally consolidation will include overseas subsidiaries which fall within the categories mentioned in para. 2.2.2, unless there is strong justification for exclusion. 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 the concentration of risks in it. Such controls should enable the

¹ 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.



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parent AI 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 would breach those limits and to reduce any exposure which has exceeded those limits.

- 2.2.5 A subsidiary which adds little to the size of an AI's balance sheet could still incur substantial risks. It is therefore inappropriate to exclude subsidiaries for consolidation based merely on size criteria.
- 2.2.6 AIs with an extensive group structure may have difficulty in knowing their exposure to individual counterparties at any given time. Such AIs may discuss with the HKMA arrangements to overcome difficulties in meeting the reporting and compliance requirements, e.g. through the use of internal limits on counterparty exposure for reporting purposes. The HKMA will need to be satisfied that an AI's control systems are such that its exposure to a counterparty may reliably be taken as being no higher than the limit it adopts for that counterparty.
- 2.2.7 The HKMA will discuss with individual AIs and notify them in writing which subsidiaries will be included for consolidation. AIs should inform the HKMA of any subsequent changes in group structure, e.g. additions or deletions of subsidiaries and of changes to their subsidiaries' principal activities.

2.3 Capital base

- 2.3.1 Capital base is the basis for applying the statutory limits under Part XV of the Banking Ordinance. Under §79(2), the term "capital base" for the purposes of Part XV refers to the capital base of an AI that is calculated in accordance with the Third Schedule to the Ordinance but subject to the basis of consolidation required under §79A. The subsidiaries consolidated for Part XV purposes may differ from those for the calculation of the capital adequacy ratio under §98(2) (see subsection 2.2 above).



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- 2.3.2 For the purposes of determining compliance with statutory limits under Part XV, AIs should base their calculations on the capital base 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 capital base during the relevant period.
- 2.3.3 Where the MA requires a provision of Part XV to apply to an AI on a consolidated basis, it will be the consolidated capital base of the AI, not the solo capital base, that should be used for assessing compliance.
- 2.3.4 An AI's investments in subsidiaries which are not specified in the MA's notice under §79(2) will be deducted from the consolidated capital base.

2.4 Solo consolidation

- 2.4.1 As with the capital adequacy regime, AIs may be permitted to consolidate certain subsidiaries when calculating their solo capital base and their exposure to individual counterparties. Such solo consolidation will only be allowed for subsidiaries where all of the following apply:
- the subsidiary is wholly owned by, and managed as if it were a division of, the AI;
 - the subsidiary is wholly financed by the AI, i.e. the subsidiary should have no depositors or other external creditors; and
 - the capital of the subsidiary is freely transferable to the AI, after taking account of any regulatory, legal and taxation problems.
- 2.4.2 The HKMA will discuss with individual AIs and notify them in writing which subsidiaries will be included for solo consolidation.

2.5 De minimis exemption



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- 2.5.1 The purpose of the second condition set out in para. 2.4.1 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.
- 2.5.2 The HKMA is prepared to consider exceptions to this requirement on de minimis grounds, i.e. when the subsidiary's external liabilities (e.g. accounts payable for audit fees, company secretarial services or sundry expenses) are very small in relation to its assets. Requests for such exceptions will be considered on a case by case basis.

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