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)

Purpose

To explain the MA's policy towards the underwriting and subunderwriting of securities by locally incorporated AIs in relation to Parts 2, 3 and 7 of the BELR[1]

Classification

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

Previous guidelines superseded

Guideline 5.2.4 "Underwriting of Securities: §§81 and 87" dated 13.10.91; CR-L-4 (V.1) "Underwriting of Securities: §§81 and 87" dated 31.08.01; CR-L-4 (V.2) "Underwriting of Securities: BELR" dated 27.12.19

Application

To all locally incorporated AIs

Structure

1. Application

   1.1 General

[1] The guidance of this module may also be relevant to Part 8 of the BELR, which cross-refers to exposure amounts calculated under Part 7 of the BELR.

2. Regulatory policy
2.1 Supervisory approach
2.2 Underwriting policy
2.3 Maximum underwriting commitments
3. Statutory requirement
3.1 Limit on exposure to single counterparty and group of linked counterparties
3.2 Limit on equity exposure
3.3 Limit on acquisition of share capital of company
3.4 Seven-working day exemption period
3.5 Policy on extension of exemption period

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1. Application

1.1 General

1.1.1 This module applies to an AI that undertakes or intends to enter into the underwriting business.

1.1.2 It covers underwriting and subunderwriting activities which give rise to commitments under a contractual agreement in respect of new securities and existing securities, where the AI will only be called upon to purchase the securities if end-investors or subunderwriters fail to do so.

1.1.3 It does not cover "bought deals" where the AI acquires the securities from the outset as a principal for subsequent sale in the market or "block trades" in the secondary market. Holdings of securities in these circumstances constitute an exposure covered by Part 7 of the BELR and, if the securities in question meet the definition of "equity exposure" under Part 2 of the BELR or are shares, an equity exposure under Part 2 and share acquisition under Part 3 of the BELR, respectively.

2. Regulatory policy

2.1 Supervisory approach

2.1.1 An AI is expected to have adequate and effective internal controls over its underwriting business. The HKMA may review the relevant internal control systems and processes in the course of undertaking its risk-based supervisory processes.

2.2 Underwriting policy

2.2.1 Any AI wishing to engage in underwriting activity should prepare an underwriting policy which has to be approved by its Board of Directors. The policy will need to contain, inter alia:

- approved types of underwriting transactions;
- individual and aggregate limits applying to underwriting commitments. Such limits should also take account of cases where the AI has other financial exposures to the counterparty concerned (see section 2.3 for details);
- where no such limits are in place but transactions are to be approved case by case, clear instructions about the type and size of transactions which will be contemplated;
- arrangements applying to the subunderwriting of commitments taken on by the AI, including the degree of commitment which should be obtained from the subunderwriter; and
- arrangements for the disposal of securities acquired under an underwriting contract, in particular to avoid a financial exposure exceeding any statutory concentration limit applicable to the AI after the expiry of any available exemption period (see section 3).

2.2.2 It is not necessary to agree the underwriting policy (including the maximum underwriting commitments set out in the next paragraph) with the HKMA in advance. However, as mentioned above, these are subject to review in the course of the HKMA's risk-based supervisory processes.

2.3 Maximum underwriting commitments

2.3.1 The underwriting policy should include the maximum size and type of underwriting and subunderwriting transactions, measured on an aggregate basis per issuer, that an AI can take on. An AI may also establish limits for different categories of issuers, e.g. according to their credit ratings.

2.3.2 The limits will apply to the maximum amount of securities an AI is committed to taking up, i.e. after deduction of amounts to be subunderwritten by other parties under firm and binding agreements.

2.3.3 In formulating the maximum underwriting commitment allowed, an AI should have regard to:

- types of securities to be underwritten – for example, the limits should reflect the relative risks of different types of securities and issuers (e.g. with reference to their credit ratings, where applicable);
- the AI's underwriting expertise and previous experience and track record (e.g. whether it has been "stuck" with any issues);
- the AI's capability to dispatch and dispose of the issue (including "stuck position") such as market standing, placing network, etc.; and
- risk control systems in place.

2.3.4 Monitoring of the maximum underwriting commitment to a particular issuer should take into account the aggregate amount of underwriting commitment incurred against the issuer at any point of time.

3. Statutory requirement

3.1 Limit on exposure to single counterparty and group of linked counterparties

3.1.1 Part 7 of the BELR limits a locally incorporated AI's aggregate exposures to a single counterparty or group of linked counterparties to 25% of its Tier 1 capital[2]. Aggregate exposures include the value of an AI's holdings of shares, debentures and other debt securities issued by these parties (see section 2.3 of CR-G-8 "Large Exposures and Risk Concentrations").

3.1.2 For closer alignment with the large exposures standard under the Basel Framework[3], the local exemption under rule 48(1)(f) of the previous BELR in respect of an AI's exposures arising from any share capital or debt securities acquired under an underwriting or subunderwriting contract has been repealed by Part 3 of the Banking (Exposure Limits) (Amendment) Rules 2023. AIs should thereafter monitor and control exposures arising from their underwriting and subunderwriting activities such that the AIs' aggregate exposures to each counterparty or group of linked counterparties will not exceed the applicable statutory limits under Part 7 of the BELR.

3.2 Limit on equity exposure

3.2.1 Part 2 of the BELR provides that a locally incorporated AI's aggregate equity exposure must not exceed 25% of its Tier 1 capital.

3.2.2 Under rule 14(1)(c) of the BELR, any equity exposure arising from the holding of capital interest[4] acquired under an underwriting or subunderwriting contract can be excluded, for up to seven working days after the acquisition, from the calculation of an AI's aggregate equity exposure for the

[2] For locally incorporated AIs that are local G-SIBs (as defined in rule 39 of the BELR), a lower limit of 15% of Tier 1 capital applies as required by rule 44(2) of the BELR.
[3] See the LEX standard of the Basel Framework (https://www.bis.org/basel_framework/timeline.htm?st=LEX).
[4] Capital interest under Part 2 of the BELR generally refers to share capital issued by a company and CET1 and Additional Tier 1 capital instruments. For details, see the definition of "capital interest" under rule 14(4) of the BELR.

purposes of Part 2 of the BELR (also see section 3.4.3 below).

3.2.3 A related exemption is provided under rule 14(1)(d) of the BELR in respect of an AI's equity exposure arising from a commitment to acquire any capital interest under an underwriting or subunderwriting contract.

3.3 Limit on acquisition of share capital of company

3.3.1 Part 3 of the BELR provides that a locally incorporated AI must not, except with consent given by the MA, acquire (whether by one acquisition or a series of acquisitions) all or part of the share capital of a company to a value equivalent to 5% or more of the amount of the AI's Tier 1 capital at the time of the acquisition.

3.3.2 An exemption from calculation towards the 5% limit similar to that of rule 14(1)(c) of the BELR is available under rule 23(2)(a)(ii) of the BELR.

3.4 Seven-working day exemption period

3.4.1 The seven-working day exemption period available under rules 14 and 23 of the BELR runs from the time when an AI acquires the securities being underwritten.

3.4.2 The main reasons for the short exemption period are to make the HKMA aware of an exposure at an early stage and to deter AIs from taking on too large underwriting commitments with which they may not have the necessary experience, skills and systems in place to deal.

3.4.3 The MA has discretion to approve a longer exemption period beyond seven working days, and may attach conditions to such approval.

3.5 Policy on extension of exemption period

3.5.1 The HKMA expects that an AI which does not intend to maintain the securities acquired from its underwriting or subunderwriting commitment should endeavour to dispose of the holdings by the end of the seven-working day exemption period. The HKMA will consider approving an extension of the exemption period only in special situations, including:

(a) operations of the AI to dispose the securities have been disrupted by unanticipated incidents during the seven-working day exemption period, e.g. typhoon, system failure, etc.

(b) extreme market condition has been causing any fire sales of the securities not being able to realise their "fair value". An extension is warranted because fire sales of the securities may not be in the best interests of the depositors.

(c) any other situations considered acceptable by the MA.

3.5.2 In the above situations, an AI may write to its usual contact at the HKMA to apply for the MA's approval for the AI to hold the securities beyond the seven-working day exemption period. The MA will consider giving an approval that normally does not exceed a period of three months.

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