Research Office
Legislative Council Secretariat

Fact Sheet

International standards for measuring and controlling large exposures

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1. Introduction

1.1 In April 2014, the Basel Committee on Banking Supervision ("BCBS")[1] published a new supervisory framework for measuring and controlling large exposures (the "Large Exposure Framework"). The Large Exposure Framework aims to protect banks from significant losses caused by the sudden default of an individual counterparty or a group of connected counterparties. The Framework is scheduled to take effect from January 2019. As a member jurisdiction of BCBS, Hong Kong plans to implement the Large Exposure Framework by amending the Banking Ordinance to empower the Hong Kong Monetary Authority ("HKMA") to issue rules in relation to large exposures.

1.2 At its meeting to be held on 16 March 2017, the Panel on Financial Affairs will discuss, among other things, the implementation of BCBS' Large Exposure Framework in Hong Kong. To facilitate Members' discussion, this fact sheet provides information on (a) the background of introducing the Large Exposure Framework, (b) major features and requirements under the Framework, and (c) the current developments of Hong Kong concerning large exposure limits.

2. Prelude to the introduction of the Large Exposure Framework

2.1 Proper control of large credit exposures of banks is crucial to the stability of the financial system. Especially where the bank's counterparty is another bank, large exposure limits can directly contribute towards the

[1] Established in 1974, BCBS is the global standard setter for the prudential regulation of banks. Since its inception, BCBS has expanded its membership from a group of 10 countries to 45 members from 28 jurisdictions consisting of central banks and authorities with formal responsibility for the supervision of banking business.

reduction of system-wide contagion risk. The need for banks to measure and limit the size of large exposures in relation to their capital has long been recognized by BCBS, the global standard setter for the prudential regulation of banks. Back in 1991, BCBS reviewed the supervisory practices and issued the first supervisory guidance on large exposures titled "Measuring and controlling large credit exposures" (the "1991 Guidance"), which provided for an exposure limit equal to 25% of a bank's total capital.[2] The 1991 Guidance has formed the basis for making large exposures rules in many jurisdictions, including Hong Kong.

2.2 Likewise, BCBS' Core Principles for Effective Banking Supervision, which set out the minimum standards for sound prudential regulation and supervision of banks, also provide for the need of setting out prudent limits to restrict banks' exposures to single counterparties or groups of connected counterparties. Nevertheless, according to BCBS, neither the 1991 Guidance nor the Core Principles have set out how banks should measure or aggregate their exposures to a single counterparty. As such, there were great variations in practice across the jurisdictions in such areas as the definition of capital on which exposure limits were based and methods for calculating exposure values.

2.3 With a view to ensuring greater consistency in the way which banks and supervisors measure, aggregate and control exposures to single counterparties, BCBS published a proposed supervisory framework for measuring and controlling large exposures in 2013. After consulting the industry, BCBS in 2014 issued the final Large Exposure Framework as the new standard for measuring and controlling large exposures. The Framework seeks to protect banks from significant losses caused by the sudden default of an individual counterparty or a group of connected counterparties.

2.4 The Large Exposure Framework, providing detailed guidance on the calculation of exposure measures, will supersede the 1991 Guidance when coming in force in January 2019. According to BCBS, the Large Exposure Framework is constructed to serve as a backstop and complement to BCBS' risk-based capital standard. The latter prescribes the minimum capital requirements a bank must maintain based on the bank's risk-weighted assets; but it is not designed specifically to protect banks from large losses resulting from sudden default of a single counterparty.

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2 See Bank of International Settlements (2013).

3. Supervisory framework for measuring and controlling large exposures

3.1 The Large Exposure Framework is applicable to all internationally active banks.[3] Yet member jurisdictions have the option to set more stringent standards and extend the application to a wider range of banks. The Framework prescribes the requirements in a number of key aspects from the definition of large exposures and connected counterparties, exposure limits, scope and calculation of large exposures, to specific treatments on certain exposures and regulatory reporting.

Definition of large exposures

3.2 Under the Large Exposure Framework, if a bank's exposure to a single counterparty, or to a group of connected counterparties, equals or exceeds 10% of the eligible capital base, it will be considered as a large exposure.

3.3 Eligible capital base mentioned above is defined as Tier 1 capital under the Basel III framework.[4] Tier 1 capital is the core component of the regulatory capital with the capability to absorb losses on a going concern basis. It encompasses Common Equity Tier 1 and Additional Tier 1.[5] The former predominantly includes common shares issued by banks and retained earnings, whereas the latter comprises instruments that are subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.[6]

Definition of connected counterparties

3.4 Under the Large Exposure Framework, a group of connected counterparties must be treated as a single counterparty. Two or more

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[3] According to BCBS, the term "internationally active" is not specifically defined. It is left to the discretion of individual supervisory authorities.

[4] Basel III is the international regulatory framework developed by BCBS to strengthen the regulation, supervision and risk management of the banking sector. Introduced in 2010, Basel III introduced reforms to the Basel II capital adequacy framework and new standards for bank funding liquidity. Member jurisdictions under BCBS are expected to take full implementation of Basel III by 1 January 2019.

[5] Under the Basel III framework, total regulatory capital consists of Tier 1 capital and Tier 2 Capital. Tier 1 capital is loss-absorbing on a "going concern" basis (i.e. the financial institution is solvent), whereas Tier 2 capital absorbs losses on a "gone concern" basis (i.e. following insolvency and upon liquidation).

[6] See Bank of International Settlements (2011a) and Bank of International Settlements (2011b).

natural or legal persons shall be deemed a group of connected counterparties if there is a control relationship or economic interdependence among them. A control relationship will exist when one counterparty has direct or indirect control over the others, for instance, one counterparty owns more than 50% of the voting rights of the other counterparty. In determining economic interdependence, a list of minimum criteria are prescribed in the Framework, e.g. when 50% or more of one counterparty's gross receipts/expenditures are derived from transactions with the other counterparty. According to BCBS, there are cases where thorough investigation of economic interdependence will not be proportionate to the exposure size. So banks are expected to identify possible connected counterparties when the sum of all exposures to one individual counterparty exceeds 5% of Tier 1 capital.

Exposure limits

3.5 The following limits on large exposures are laid down in the Large Exposure Framework:

(a) **general exposure limit** – a bank's exposures to a single counterparty, or to a group of connected counterparties, will be subject to an exposure limit of 25% of the bank's Tier 1 capital at all times; and

(b) **limit for exposures between global systemically important banks**[7] – for exposures between banks that have been designated as global systemically important banks, a tighter limit of 15% of a bank's Tier 1 capital will apply.

Coverage and calculation of large exposures

3.6 The scope of the Large Exposure Framework cover all exposures that attracts a capital requirement under the risk-based capital standard, which include both on- and off-balance sheet exposures in either the banking or trading book. The banking book generally consists of assets and items not

[7] Global systemically important banks are banks that are capable of having a significant negative impact on the global financial system. BCBS has put in place a methodology and framework to identify these banks and impose requirements on them to address the specific risks they pose. According to HKMA, currently 29 of the 30 global systemically important banks have a presence in Hong Kong but they are not incorporated and headquartered locally. See Hong Kong Monetary Authority (2015b).

intended to be traded, while the trading book shows positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book.

3.7 Guidance is given on the measurement of different types of exposures. In general, the exposure value varies by book and asset type such as:

(a) banking book, on-balance sheet non-derivative assets: calculated as the accounting value of the exposure;

(b) banking book, traditional off-balance sheet commitments like trade finance activities: equal to the credit exposure equivalents calculated by multiplying the committed but undrawn amount by an appropriate credit conversion factor[8] used for the standardized approach for credit risk[9] with a floor of 10%; and

(c) trading book exposures in financial instruments like straight debt instruments and equities: calculated as the accounting value (i.e. the market value).

3.8 Both long and short positions in a single name may be present within a trading book. It is therefore necessary to consider to what extent short positions should offset long positions, when calculating the net exposure that is subject to the large exposure limit. In the Large Exposure Framework, the criteria and treatments are set out for offsetting between long and short positions within the same issue (i.e. with exactly the same issuer, coupon, currency and maturity) and between different issues respectively.

3.9 Besides, banks typically use a number of credit risk mitigation techniques to mitigate the credit risks to which they are exposed. For example, a loan exposure may be guaranteed by a third party, or a bank may

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8 Generally, a credit conversion factor is the expected future drawdown as a proportion of the undrawn amount.

9 Under the risk-based capital framework, banks are permitted to choose between two broad methodologies for calculating their risk-based capital requirements for credit risk: standardized ("SD") approach and Internal Ratings-Based ("IRB") approach. Under SD approach, different types of exposures are risk-weighted according to external credit ratings or risk weights assigned by the bank supervisor. For IRB approach, banks are allowed to use their internal rating systems to determine credit risk, subject to the approval of the bank supervisor.

buy a credit derivative to offset various forms of credit risk.[10] Under the Large Exposure Framework, an exposure can be reduced by the amount of eligible credit risk mitigation techniques, such as guarantees and credit derivatives as well as financial collateral (e.g. cash or securities) permitted under standardized approach for credit risk. However, when a risk mitigation technique reduces the value of an exposure, the bank must recognize an exposure to the provider of the credit risk mitigation technique (e.g. the guarantor).

Specific treatments

3.10 The Large Exposure Framework has also set out specific treatments for certain types of exposure. For example, there are exemptions from the large exposure limit to (a) banks' exposures to sovereigns and their central banks; (b) intraday interbank exposures; and (c) exposures to qualifying central counterparties (i.e. entities licensed to operate as central counterparties) related to clearing activities.[11]

3.11 In addition, for certain financial assets or vehicles where losses can arise from the underlying assets, specific treatments are set out to capture the additional risk arising from exposure to underlying assets such as equities. Financial assets or vehicles that are subject to specific treatments include covered bonds, collective investment undertakings and securitization vehicles.

Regulatory reporting

3.12 It is prescribed in the Large Exposure Framework that banks must report the following to the bank supervisor:

(a) all exposures with values equal to or above 10% of the bank's Tier 1 capital;

(b) all other exposures with values, measured without taking into account the effect of credit risk mitigation, equal to or above 10% of the bank's Tier 1 capital;

[10] See Bank of International Settlements (2005).
[11] See Bank of International Settlements (2016).

(c) all exempted exposures with values equal to or above 10% of the bank's Tier 1 capital; and

(d) the largest 20 exposures to counterparties irrespective of their size relative to the bank's Tier 1 capital.

4. Measuring and controlling large exposure limits in Hong Kong

4.1 In Hong Kong, the large exposure rules were developed on the basis of the 1991 Guidance. Under section 81(1) of the Banking Ordinance, all authorized institutions (licensed banks, restricted licence banks and deposit-taking companies) incorporated in Hong Kong are subject to a statutory limit of 25% of the capital base[12] on its financial exposure to any one person or group of related persons.[13] HKMA has issued a supervisory policy manual on "Large Exposures and Risk Concentrations", setting out the minimum standards and requirements that authorized institutions are expected to follow. Among others, the manual has set out that any exposure to a counterparty or a group of related counterparties greater than or equal to 10% of an authorized institution's capital base is regarded as a large exposure and reporting to HKMA on such large exposure is required.

4.2 During the first half of 2016, HKMA consulted the industry on (a) local implementation of BCBS' Large Exposure Framework, and (b) updating of other current regulations on exposure limits which are not directly related to the Framework.[14] According to the Government, the feedback received from the industry on the proposals was generally positive.[15] Local implementation of the Framework will require an amendment to the Banking Ordinance to incorporate a rule-making power enabling HKMA to issue rules prescribing limits on authorized institutions' concentration risk regarding their exposures to counterparties. Based on BCBS' timeline, all aspects of the Large Exposure Framework should be implemented in full by member jurisdictions by 1 January 2019.

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[12] Based on the Banking (Capital) Rules (Cap. 155L), the capital base of an authorized institution is the sum of the institution's Tier 1 Capital and Tier 2 Capital.

[13] See Section 81(1) of the Banking Ordinance.

[14] See Hong Kong Monetary Authority (2016).

[15] See Financial Services and the Treasury Bureau (2017).

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