

LEGISLATIVE COUNCIL BRIEF

**BANKING ORDINANCE
(CHAPTER 155)**

**BANKING (AMENDMENT) ORDINANCE 2018
(COMMENCEMENT) NOTICE 2018**

BANKING (EXPOSURE LIMITS) RULES

INTRODUCTION

Following the enactment of the Banking (Amendment) Ordinance (Ord. No. 6 of 2018) (“BAO”) in January 2018—

- (a) The Secretary for Financial Services and the Treasury has made the Banking (Amendment) Ordinance 2018 (Commencement) Notice 2018 (“Commencement Notice”), at **Annex A**, to appoint 13 July 2018 as the date on which the following sections of the BAO will come into operation -
 - (i) sections 5, 9, 12, 15, 16(1), 17, 18, 19(2), 23, 25;
 - (ii) section 16(2) in so far as it relates to sections 81A, 81C, 86, 87 and 90 of the Banking Ordinance (“BO”); and
 - (iii) section 24 in so far as it relates to the repeal of section 150(10) of the BO to the extent of the reference to sections 87(1), 87(3), 90(1) and 90(3) of the BO; and

- (b) The Monetary Authority (“MA”) has made the Banking (Exposure Limits) Rules (“BELR”), at **Annex B**, to replace section 87 of the BO in relation to a prescribed limit on equity exposures incurred by authorized institutions (“AIs”), which will come into operation on 13 July 2018.

JUSTIFICATIONS

2. For the purposes of strengthening the resilience of the banking system and implementing the latest international standards on banking regulation in Hong Kong, the BAO was enacted by the Legislative Council (“LegCo”) in January 2018. Among other things, the BAO repeals the core provisions in Part XV of the BO pertaining to limitations on financial exposures incurred by AIs, many of which have become outdated after decades of operation. In lieu of the repealed provisions, the BAO empowers the MA to make rules to prescribe limits on the exposures of AIs in accordance with the revised standards of the Basel Committee on Banking Supervision (“BCBS”) on large exposure limits, and taking into account modern risk management and measurement approaches.

3. Among the repealed provisions in Part XV of the BO, the BELR deals with section 87 of the BO, which imposes certain restrictions on the shareholding of AIs. There is an urgency to modernise the provision in section 87 so as to remove the obsolete regulatory barrier discouraging the development of banks’ equity derivative business in Hong Kong. To this end, the relevant provisions of the BAO will have to commence operation to allow new rules to be made to replace section 87 of the BO. For the other sections of Part XV of the BO, rules will be made to replace them in due course after consulting the industry.

4. Under section 87 of the BO, a locally incorporated AI shall not acquire or hold any part of the share capital of any other companies to an aggregate value in excess of 25 per cent of the capital base of the institution. The provision has been in operation since 1960s without major revision. It does not capture equity exposures which might be incurred other than through the direct holding of shares, or take into account the effect of possible risk mitigating measures such as hedging and offsetting positions which are commonly adopted in AIs’ trading activities nowadays. As such, it is inhibiting the development of certain business lines (notably equity derivative business) in Hong Kong, whilst not providing a credible equity exposure limit that covers all possible types of equity exposure.

5. The BELR updates section 87 of the BO by capturing equity exposures more comprehensively and recognising certain risk mitigation techniques commonly used in the industry in measuring equity exposures. Under the BELR, the meaning of equity exposure is extended to cover all instruments that give rise to equity risk, by reference to the equity exposures provided under section 145 of the Banking (Capital) Rules. Netting and offsetting of exposures in the same equity will be allowed under the BELR to better reflect the risk level. These changes will facilitate the further development of equity business in the local market.

THE SUBSIDIARY LEGISLATION

Banking (Amendment) Ordinance 2018 (Commencement) Notice

6. The Commencement Notice seeks to bring into effect certain provisions of the BAO relating to the rule-making power of the MA provided under the new section 81A of the BAO, the repeal of section 87, and the making of the BELR to replace section 87 of the BO with effect from 13 July 2018.

7. Section 90 of the BO will also be repealed at the same time incidental to the repeal of section 87. Section 90 prescribes an aggregate limit on an AI's exposures in four areas¹ under Part XV of the BO. The aggregate limit has been rendered obsolete over time, and will be replaced by separate limits on individual types of exposures vide the BELR² and other rules³ to be introduced at a later stage.

¹ The four types of exposures include connected party exposures under section 83(1) of the BO, equity exposure under section 87(1) of the BO, exposure in the interests in land other than bank premises under section 88(1) of the BO and the exposure in bank premises under section 88(2) of the BO.

² The new individual limit on equity exposure will be dealt with in the BELR.

³ A new limit on aggregate exposures of AIs in the interests in land and in bank premises will be introduced in other rules to replace section 88 of the BO. The current individual limits for exposure under section 83(1) and 88(1) of the BO will also be revised at the same time.

Banking (Exposure Limits) Rules

8. The BELR prescribes a limit on the aggregate equity exposures of an AI by reference to a ratio. Similar to section 87 of the BO, the BELR is applicable to all locally incorporated AIs. Compared with section 87 of the BO, the provisions in the BELR contain the following key features -

- (a) Widening the scope of equity exposures from only the direct holding of shares under section 87 of the BO to equity exposures generally (including exposures arising from equity derivative contracts);
- (b) Recognising risk mitigation measures (e.g. offsetting of a long position against a short position in each of the banking book and the trading book, and hedged position in the same equity);
- (c) Setting out details of valuation of different types of equity exposures, including exposures arising from equity derivative contracts and collective investment schemes; and
- (d) Providing that the limit on an AI's aggregate equity exposures, expressed as a percentage, to its capital base remains at 25%, but the denominator for the limit is changed from capital base to Tier 1 capital. The change in the denominator is to align with the construction of the exposure limit under the revised large exposures framework published by the BCBS. Tier 1 capital, in brief, is a component of the capital base that is of higher quality.

LEGISLATIVE TIMETABLE

9. The Commencement Notice and the BELR will be published in the Gazette on 18 May 2018 and tabled before LegCo at its sitting of 23 May 2018. Subject to negative vetting by LegCo, the provisions of the BAO as specified in the Commencement Notice and the BELR will come into operation on 13 July 2018.

IMPLICATIONS OF THE PROPOSALS

10. The BELR introduces a more flexible equity exposure limit which is expected to enhance the resilience of the banking system in Hong Kong and at the same time ensure competitiveness of the banking industry, thereby reinforcing Hong Kong's status as an international financial centre.

11. The Commencement Notice and the BELR are in conformity with the Basic Law, including the provisions concerning human rights. The Commencement Notice and the BELR will not affect the binding effect of the BO.

PUBLIC CONSULTATION

12. At the meeting of the LegCo Panel on Financial Affairs on 5 February 2018, the Hong Kong Monetary Authority ("HKMA") briefed members on the key features of the BELR.

13. HKMA consulted the industry on the policy intent to reform section 87 of the BO in March 2016 and on the details of the proposed BELR in March 2018. The comments received from those consultations have been taken into account in preparing the draft BELR. In addition, pursuant to section 81A of the BO, HKMA conducted a statutory consultation of the draft BELR in April 2018 and received general support from consultees⁴. The relevant technical or drafting comments have been addressed in the finalised BELR as appropriate, and the intent of certain provisions has been clarified.

PUBLICITY

14. A press release will be issued upon gazettal of the subsidiary legislation. HKMA will also issue a circular letter to all AIs.

⁴ Including the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks and the Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies.

ENQUIRIES

15. Enquiries should be directed to Ms Eureka Cheung, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) at 2810 2067, or Mr Frank Leung, Head (Banking Policy) of HKMA at 2878 1457.

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
16 May 2018**

**Banking (Amendment) Ordinance 2018
(Commencement) Notice 2018**

Under section 1(2) of the Banking (Amendment) Ordinance 2018 (6 of 2018), I appoint 13 July 2018 as the day on which the following provisions of the Ordinance come into operation—

- (a) sections 5, 9, 12, 15 and 16(1);
- (b) section 16(2) (except in so far as it relates to the repeal of the reference to sections 80, 81, 83, 85 and 88 of the Banking Ordinance (Cap. 155) (*Cap. 155*));
- (c) sections 17, 18, 19(2) and 23;
- (d) section 24 in so far as it relates to the repeal of section 150(10) of Cap. 155 to the extent of the reference to the following provisions of Cap. 155—
 - (i) section 87(1);
 - (ii) section 87(3) (wherever it appears);
 - (iii) section 90(1);
 - (iv) section 90(3) (wherever it appears);
- (e) section 25.

Secretary for Financial Services and
the Treasury

2018

Banking (Exposure Limits) Rules

Contents

Rule	Page
Part 1	
Preliminary	
1. Commencement	1
2. Interpretation	1
3. General provisions	2
4. Valuation of exposures at fair value	2
5. Monetary Authority may require applying these Rules on unconsolidated or consolidated basis	3
6. Notifiable event—prescribed notification requirement under section 81C of Ordinance	4
Part 2	
Equity Exposures	
Division 1—General	
7. Interpretation of Part 2	5
8. Interpretation: <i>equity exposure</i>	6
9. Application of Part 2	8
Division 2—Limit on Equity Exposures	
10. Equity exposure limit for authorized institution	8

Rule	Page
11. Monetary Authority’s power to vary equity exposure limit	8
Division 3—Calculation of Equity Exposure Ratio	
12. Aggregate equity exposures	10
13. Certain equity exposures not taken into account	11
Division 4—Valuation of Equity Exposures	
14. General provisions for Division 4	14
15. Equity exposure arising from shares of company	14
16. Equity exposure arising from equity derivative contract	14
17. Alternative valuation of equity exposure arising from equity derivative contract	15
18. Equity exposure arising from repo-style transaction	16
19. Equity exposure arising from CIS	17
Part 3	
Transitional and Savings Provisions	
20. Interpretation of Part 3	22
21. Notice given under section 79A of Ordinance	22
22. Certain approval under section 87 of Ordinance	22

Banking (Exposure Limits) Rules

(Made by the Monetary Authority under section 81A of the Banking Ordinance (Cap. 155) after consultation with the Financial Secretary, the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, The Hong Kong Association of Banks and The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)

Part 1

Preliminary

1. Commencement

These Rules come into operation on the day on which section 9 of the Banking (Amendment) Ordinance 2018 (6 of 2018) comes into operation.

2. Interpretation

(1) In these Rules—

Capital Rules (《資本規則》) means the Banking (Capital) Rules (Cap. 155 sub. leg. L).

(2) In these Rules, an expression specified below has the meaning given by section 2(1) of the Capital Rules—

Additional Tier 1 capital (額外一級資本);

banking book (銀行帳);

CET1 capital (CET1 資本);

collective investment scheme (集體投資計劃);

fair value (公平價值);

forward contract (遠期合約);

futures contract (期貨合約);

option contract (期權合約);

repo-style transaction (回購形式交易);

swap contract (掉期合約);

Tier 1 capital (一級資本);

trading book (交易帳).

3. General provisions

- (1) An approval or consent of the Monetary Authority in respect of any matter under these Rules may only be sought by making an application in a specified form (if any) to the Monetary Authority.
- (2) A notice given by the Monetary Authority under these Rules to all authorized institutions, or to a class of authorized institutions, may be given by publishing it in the Gazette.
- (3) In determining whether anything meets the description of “appropriate”, “competent”, “prudent”, “reasonable”, “relevant” or “reliable” in any provision of these Rules, regard must be had to any guidelines or codes of practice issued under the Ordinance that are applicable to the provision.

4. Valuation of exposures at fair value

- (1) An authorized institution must establish and maintain effective valuation systems, controls and procedures for valuing its exposures at fair value under these Rules to ensure that the valuation is prudent and reliable.
- (2) An authorized institution must make adjustments (if appropriate) to the valuation of its exposures at fair value to factor in—
 - (a) the limitations of the valuation model or methodology and the data used in the valuation process;
 - (b) the liquidity of the exposures; and

- (c) other relevant factors that may reasonably be expected to affect the prudence and reliability of the valuation.
- (3) To avoid doubt, adjustments made under subrule (2) may exceed the adjustments made by the authorized institution in accordance with the financial reporting standards adopted by it.

5. Monetary Authority may require applying these Rules on unconsolidated or consolidated basis

- (1) For applying any provision of these Rules to an authorized institution incorporated in Hong Kong that has any subsidiary, the Monetary Authority may, by notice in writing to the institution, require it to apply the provision—
 - (a) on an unconsolidated basis in respect of the institution;
 - (b) on a consolidated basis in respect of the institution and one or more of its subsidiaries specified in the notice; or
 - (c) on an unconsolidated basis in respect of the institution, and on a consolidated basis in respect of the institution and one or more of its subsidiaries specified in the notice.
- (2) For subrule (1)—
 - (a) applying a provision on an unconsolidated basis means applying the provision on the basis that the business of the authorized institution includes all of its 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; and
 - (b) applying a provision on a consolidated basis means applying the provision on the basis that the business of the authorized institution includes those referred to in

paragraph (a), and the business of its local subsidiaries or subsidiaries outside Hong Kong as may be specified in the notice given to the institution.

- (3) An authorized institution must comply with a notice given to it under subrule (1).
- (4) Any duty of confidentiality of an authorized institution's subsidiary is not regarded as contravened by reason of the supply of any information by the subsidiary to the institution for the purposes of enabling or assisting the institution to comply with a notice given to the institution under subrule (1).

6. Notifiable event—prescribed notification requirement under section 81C of Ordinance

- (1) If a notifiable event occurs in relation to an authorized institution, it must—
 - (a) immediately notify the Monetary Authority of the event; and
 - (b) provide the Monetary Authority with any particulars of the event that the Monetary Authority requests.
- (2) In subrule (1)—

notifiable event (須通報事件) means—

 - (a) a failure to comply with rule 10, or that rule as varied by the Monetary Authority under rule 11(1); or
 - (b) a failure to comply with any conditions imposed under rule 13(3)(b).

Part 2**Equity Exposures****Division 1—General****7. Interpretation of Part 2**

(1) In this Part—

CIS means a collective investment scheme;

delta (得爾塔) has the meaning given by section 281 of the Capital Rules;

delta-weighted position (得爾塔加權持倉) has the meaning given by section 281 of the Capital Rules;

equity derivative contract (股權衍生工具合約) means a futures contract, forward contract, swap contract, option contract or similar derivative contract the value of which is determined by reference to the value of, or any fluctuation in the value of, one or more than one underlying equity or an underlying equity index (being an index calculated by reference to a basket of equities);

equity exposure (股權風險承擔)—see rule 8;

equity exposure ratio (股權風險承擔比率), in relation to an authorized institution, means the ratio, expressed as a percentage, of the sum of the institution's aggregate equity exposures (calculated in accordance with Division 3 and expressed in Hong Kong dollars), to the amount (expressed in Hong Kong dollars) of the institution's Tier 1 capital.

(2) A reference in this Part to the weight of an equity in an equity index is the weight of that equity in the equity index as specified by the index provider that compiles the index.

(3) A reference in this Part to the weight of an equity in a basket of equities is the ratio of the fair value of that equity to the aggregate fair value of all the equities in the basket of equities.

8. Interpretation: equity exposure

(1) If—

(a) a direct or indirect interest (whether voting or non-voting) of an authorized institution is a specified interest set out in subrule (2); and

(b) the interest is not consolidated for determining the institution's capital base in accordance with Part 3 of the Capital Rules,

the institution's exposure arising from that interest is an equity exposure of the institution for the purposes of this Part.

(2) For subrule (1), a specified interest is—

(a) the holding of any share capital issued by a company;

(b) the holding of any equity derivative contract;

(c) the holding in the equity components of a CIS that is engaged in the business of investing in equity or the acquisition and disposal of equity interests;

(d) the holding of any instrument that would satisfy the requirements for inclusion in the authorized institution's CET1 capital or Additional Tier 1 capital under Division 2 of Part 3 of the Capital Rules if the instrument were issued by the institution;

(e) the holding of any instrument—

(i) that is irredeemable;

(ii) that does not embody an obligation on the part of the issuer except an obligation falling within the

- description of any subparagraph of paragraph (f); and
- (iii) that conveys a residual claim on the assets or income of the issuer;
- (f) the holding of any instrument that embodies an obligation on the part of the issuer that falls within the description of any of the following subparagraphs—
- (i) the issuer may indefinitely defer the settlement of the obligation;
 - (ii) the obligation requires (or permits at the issuer's discretion) settlement by issuing a fixed number of the issuer's equity shares;
 - (iii) the obligation requires (or permits at the issuer's discretion) settlement by issuing a variable number of the issuer's equity shares and, other things being equal, any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in the value of a fixed number of the issuer's equity shares;
 - (iv) the authorized institution has the option to require that the obligation be settled in equity shares unless the institution demonstrates to the satisfaction of the Monetary Authority that—
 - (A) for a traded instrument—the instrument trades more like a debt of the issuer than equity; or
 - (B) for an instrument other than a traded instrument—the instrument should be treated as a debt holding;
- (g) the holding of any debt obligation, share, derivative contract, investment scheme or instrument that is

- structured with the intent of conveying the economic substance of equity interests;
- (h) any of the authorized institution's liabilities the return on which is linked to the return on equity interests (including but not limited to short selling positions in relation to stock borrowing); or
 - (i) any commitment to acquire any holding described in paragraph (a), (b), (c), (d), (e), (f) or (g), or to incur the liabilities described in paragraph (h).
- (3) To avoid doubt—
- (a) an equity exposure can be a long position or a short position; and
 - (b) the classification of an interest that falls within the description of any paragraph of subrule (2) as a liability for accounting purposes does not in itself prevent the interest from being treated as an equity interest.

9. Application of Part 2

This Part applies to an authorized institution incorporated in Hong Kong.

Division 2—Limit on Equity Exposures

10. Equity exposure limit for authorized institution

Subject to any variation under rule 11(1), an authorized institution must at all times maintain an equity exposure ratio not exceeding 25%.

11. Monetary Authority's power to vary equity exposure limit

- (1) Subject to subrules (3), (4), (5) and (6), the Monetary Authority may, by notice in writing served on an authorized institution, vary the limit prescribed under rule 10 for the

institution if the Monetary Authority, after taking into account the considerations set out in subrule (2), is satisfied on reasonable grounds that it is prudent to make the variation.

- (2) The considerations are—
 - (a) the risks associated with the level or concentration of the authorized institution's equity exposures;
 - (b) any risk mitigation measures taken by the institution to manage those risks;
 - (c) the risks associated with those measures;
 - (d) any prevailing or reasonably anticipated market conditions that may affect the risks associated with the level or concentration of the institution's equity exposures; and
 - (e) any other factors that the Monetary Authority considers relevant.
- (3) If the Monetary Authority proposes to serve a notice (*proposed notice*) under subrule (1) on an authorized institution, the Monetary Authority must serve a draft of the notice (*draft notice*) on the institution.
- (4) A draft notice must—
 - (a) specify—
 - (i) the proposed variation of the limit concerned; and
 - (ii) the circumstances pertaining to, and the grounds for, the proposed variation; and
 - (b) contain a statement that the authorized institution may, within 14 days (or a longer period as the Monetary Authority may allow in any particular case) from the date of service of the draft notice, make written representation to the Monetary Authority on any or all of the matters specified in the draft notice.

- (5) If an authorized institution makes any written representation in relation to a draft notice served on it, the Monetary Authority may, after considering the representation—
 - (a) serve a notice on the institution under subrule (1) in substantially the same terms as the draft notice;
 - (b) serve a notice on the institution under subrule (1) in terms modified to take account of the representation on being satisfied that the modification should be made; or
 - (c) elect not to serve a notice on the institution under subrule (1) if satisfied by the representation that the proposed notice should not be served on the institution.
- (6) If no representation is made by an authorized institution in relation to a draft notice served on it, the Monetary Authority may serve a notice on the institution under subrule (1) in substantially the same terms as the draft notice.
- (7) A decision of the Monetary Authority under subrule (1) is a decision to which section 101B(1) of the Ordinance applies.
- (8) To avoid doubt—
 - (a) the Monetary Authority may serve a draft notice on an authorized institution to supersede an earlier draft notice served on the institution; and
 - (b) the reference to “same terms” in subrule (5)(a) or (6) does not include the statement referred to in subrule (4)(b).

Division 3—Calculation of Equity Exposure Ratio

12. Aggregate equity exposures

- (1) Subject to subrules (2), (3), (4) and (5) and rule 13, for calculating an authorized institution's equity exposure ratio, the aggregate equity exposures of the institution is the sum of

the value of the institution's equity exposures, arising from items in its banking book and trading book, valued in accordance with Division 4.

- (2) In each of the banking book or the trading book of an authorized institution, the long position and short position in the same equity exposure may be offset, irrespective of the instrument from which the position is derived.
- (3) An authorized institution must not, in relation to an equity exposure arising from an item in the banking book of the institution, offset an equity exposure arising from an item in the trading book of the institution.
- (4) An authorized institution must not, in relation to an equity exposure arising from an item in the trading book of the institution, offset an equity exposure arising from an item in the banking book of the institution.
- (5) In calculating the aggregate equity exposures under subrule (1), a net short position in an equity exposure arising from an item in the banking book or the trading book is treated as if it were a net long position in the equity exposure.

13. Certain equity exposures not taken into account

- (1) An authorized institution's equity exposures arising from its following interests are not to be taken into account for calculating the institution's equity exposure ratio—
 - (a) the holding of any share capital as security for facilities granted by the institution;
 - (b) the holding of any share capital, acquired by the institution in the course of the satisfaction of debts due to it, if the following period has not expired—
 - (i) the period from the date of the acquisition of the share capital to the date on which the share capital

may be disposed of at the earliest suitable opportunity, or the period of 18 months after the acquisition of the share capital, whichever period expires first; or

- (ii) a longer period that the Monetary Authority may approve in writing in any particular case;
- (c) the holding of any share capital of any company or companies acquired under an underwriting or subunderwriting contract, if—
 - (i) the following period has not expired—
 - (A) the period of 7 working days after the acquisition of the share capital; or
 - (B) a longer period that the Monetary Authority may approve in writing in any particular case; and
 - (ii) if subparagraph (i)(B) applies—the institution complies with the conditions that the Monetary Authority may attach to the approval;
- (d) any commitment to acquire the share capital of any company or companies under an underwriting or subunderwriting contract that falls within an equity exposure under rule 8(2)(i);
- (e) the holding, approved in writing by the Monetary Authority, of any share capital of—
 - (i) another authorized institution (whether incorporated in Hong Kong or elsewhere); or
 - (ii) a company carrying out nominee, executor or trustee functions, or other functions related to banking business, the business of taking deposits, insurance business, investments or other financial services;

- (f) the holding, approved in writing by the Monetary Authority, of any share capital that is deducted in determining the capital base of the institution under Part 3 of the Capital Rules;
 - (g) any equity exposure up to the amount incurred by the institution specifically to offset any holding described in paragraph (a), (b), (c), (e) or (f) or any commitment described in paragraph (d);
 - (h) any equity exposure arising from the holding of assets, or incurring of liabilities, in relation to a defined benefit pension fund or plan;
 - (i) any equity exposure that is specified in a consent given under subrule (2) and in relation to the consent any conditions imposed under subrule (3)(b) are complied with.
- (2) The Monetary Authority may give a consent to allow an equity exposure not to be taken into account for calculating an authorized institution's equity exposure ratio if the Monetary Authority considers that it is reasonable to do so, having regard to—
- (a) the nature of, and the risks associated with, the equity exposure;
 - (b) any risk mitigation measures taken by the institution to manage those risks;
 - (c) the risks associated with those measures; and
 - (d) any other factors that the Monetary Authority considers relevant.
- (3) The Monetary Authority may—
- (a) give a consent under subrule (2) to an authorized institution, or a class of authorized institutions, or generally to all authorized institutions; and

- (b) impose conditions on the consent.

Division 4—Valuation of Equity Exposures

14. General provisions for Division 4

- (1) An authorized institution's equity exposure arising from an on-balance sheet item (other than the shares of a company, a repo-style transaction, an equity derivative contract, an item with an embedded equity derivative contract or a CIS) must be valued at the current book value of the item.
- (2) An authorized institution's equity exposure arising from an off-balance sheet item (other than an equity derivative contract) must be valued at the contracted amount of the item.
- (3) If an authorized institution's equity exposure must be valued in accordance with this Division at fair value, rule 4 applies in determining the fair value.

15. Equity exposure arising from shares of company

The value of an authorized institution's equity exposure arising from the shares of a company is the sum of—

- (a) the current book value of the shares; and
- (b) the amount for the time being remaining unpaid on the shares that is not counted under paragraph (a).

16. Equity exposure arising from equity derivative contract

- (1) An authorized institution's equity exposure arising from each of its futures contracts, forward contracts and option contracts must be valued, with respect to the underlying equity—
 - (a) for a futures contract or forward contract relating to an individual equity or a basket of equities—at the fair value of the underlying equity or underlying basket of equities, as may be appropriate, under the contract;

- (b) for a futures contract relating to an equity index—
 - (i) at the current index value multiplied by the monetary value of one index point set by the futures exchange (where the futures contract is traded); or
 - (ii) at the fair value of the underlying basket of equities by reference to which the index is compiled;
 - (c) for an option contract relating to an individual equity, a basket of equities or an equity index—at the delta-weighted position of the contract.
- (2) In valuing an authorized institution's equity exposure arising from an equity swap contract, the contract must be regarded as—
- (a) if the institution is receiving under the contract an amount based on the change in value of a particular equity, basket of equities or equity index—a long position; or
 - (b) if the institution is paying under the contract an amount based on the change in value of a different equity, basket of equities or equity index—a short position.

17. Alternative valuation of equity exposure arising from equity derivative contract

- (1) This rule applies to the valuation of an authorized institution's equity exposure arising from an equity derivative contract if there is an underlying basket of equities or equity index under the contract.
- (2) If the authorized institution has access to daily information for valuing its equity exposure with respect to the individual underlying equities under the equity derivative contract, the institution may, despite rule 16 and subject to subrule (3),

- break down the value of the equity exposure into values of equity exposures in the individual underlying equities in the basket of equities or equity index.
- (3) For subrule (2), the value of the authorized institution's equity exposure with respect to an individual underlying equity is calculated as the weight of that equity in the basket of equities or equity index multiplied by the value of the equity derivative contract valued in accordance with rule 16.
- (4) A position of an authorized institution in the individual underlying equities derived in accordance with subrule (2) may be offset against the institution's opposite position in the same equities under rule 12(2) for the purposes of calculating the institution's aggregate equity exposures.

18. Equity exposure arising from repo-style transaction

In valuing an authorized institution's equity exposure arising from a repo-style transaction—

- (a) if the transaction falls within the description of paragraph (a) or (b) of the definition of *repo-style transaction* in section 2(1) of the Capital Rules—the institution must treat the equity sold or lent under the transaction as an on-balance sheet item as if the institution had never entered into the transaction and, accordingly, the institution must include the value of the equity exposure in the calculation of its aggregate equity exposures; or
- (b) if the transaction falls within the description of paragraph (d) of the definition of *repo-style transaction* in section 2(1) of the Capital Rules, and the institution has provided any equity as collateral under the transaction—the institution must treat the equity as an on-balance sheet item as if the institution had never

entered into the transaction and, accordingly, the institution must include the value of the equity exposure in the calculation of its aggregate equity exposures.

19. Equity exposure arising from CIS

- (1) An authorized institution's equity exposure, arising from an on-balance sheet item relating to the equity components of a CIS, must be valued—
 - (a) at the current book value of the institution's holding of interests arising from the CIS;
 - (b) by using Formula A; or
 - (c) by using Formula B.
- (2) For subrule (1)(b), Formula A may be used if the maximum value of equity exposures permitted to be incurred by the CIS under its investment mandate is known to the authorized institution.
- (3) Formula A is as follows—

Formula A

$$E_{\text{CIS}} = \text{Min} [V, V \times \text{CIS}_{\text{max}}]$$

where—

- E_{CIS} = value of the authorized institution's equity exposure arising from an on-balance sheet item relating to the equity components of the CIS;
- V = current book value of the institution's holding of interests arising from the CIS; and
- CIS_{max} = the ratio of the maximum value of equity exposures permitted to be incurred by the

CIS under its investment mandate to the total net asset value of the CIS as reported in the CIS's latest financial report (the maximum value of equity exposures permitted to be incurred by the CIS under its investment mandate must include the values of equity exposures converted from the CIS's holding of equity derivative contracts, and be determined on the assumption that the CIS borrows to the maximum value permitted under the mandate).

- (4) For subrule (1)(c), Formula B may be used if—
 - (a) the authorized institution has access to information with respect to the underlying exposure of the CIS and the following requirements are satisfied—
 - (i) the frequency of financial reporting of the CIS is not less frequent than that of the institution; and
 - (ii) the information is sufficient to allow the institution to value its equity exposure arising from the CIS by using that Formula; and
 - (b) the information provided to the institution under paragraph (a) is verified by an independent third party such as the depository, the custodian or the manager of the CIS, or the information is subscribed information provided by a competent and reliable third party market data provider.
- (5) Formula B is as follows—

Formula B

$$E_{\text{CIS}} = \text{Min} [V, V \times (\text{CIS}_{\text{actual}} / \text{CIS}_{\text{NAV}})]$$

where—

E_{CIS} = value of the authorized institution's equity exposure arising from an on-balance sheet item relating to the equity components of the CIS;

V = current book value of the institution's holding of interests arising from the CIS;

CIS_{actual} = total value of equity exposures arising from interests held by the CIS as reported in the CIS's latest financial report (the CIS's holding of equity derivative contracts must be converted into values of equity exposures with respect to the underlying equity for inclusion in this total value); and

CIS_{NAV} = total net asset value of the CIS as reported in the CIS's latest financial report.

- (6) If an authorized institution uses Formula B under subrule (1)(c), the institution may break down the value of its equity exposure arising from an on-balance sheet item relating to the equity components of a CIS calculated in accordance with that Formula into positions in the individual underlying equities in the CIS by using Formula C, if the total value of the exposures arising from the interests held by the CIS does not exceed the total net asset value of the CIS as reported in the CIS's latest financial report.
- (7) For subrule (6), the total value of the exposures arising from the interests held by a CIS is the sum of all exposures arising from interests held by the CIS with respect to any asset class (including cash and exposures converted from the CIS's holding of derivative contracts).

- (8) A position of an authorized institution in the individual underlying equities calculated by using Formula C may be offset against the institution's opposite position in the same equities under rule 12(2) for the purposes of calculating the institution's aggregate equity exposures.
- (9) Formula C is as follows—

Formula C

$$E_u = E_{CIS} \times CIS_u / CIS_{actual}$$

where—

E_u = value of the authorized institution's equity exposure with respect to the underlying equity held by the CIS;

E_{CIS} = value of the institution's equity exposure arising from an on-balance sheet item relating to the equity components of the CIS calculated by using Formula B;

CIS_u = value of the equity exposure with respect to the underlying equity held by the CIS as reported in the CIS's latest financial report; and

CIS_{actual} = total value of equity exposures arising from interests held by the CIS as reported in the CIS's latest financial report (the CIS's holding of equity derivative contracts must be converted into values of equity exposures with respect to the underlying equity for inclusion in this total value).

- (10) If an authorized institution has any off-balance sheet unfunded commitment to invest in a CIS, the value of the commitment

must be valued at the contracted amount and included in the calculation of the institution's aggregate equity exposures.

Part 3

Transitional and Savings Provisions

20. Interpretation of Part 3

In this Part—

commencement date (生效日期) means the date on which these Rules come into operation.

21. Notice given under section 79A of Ordinance

- (1) This rule applies to a notice given to an authorized institution under section 79A of the Ordinance requiring section 87 of the Ordinance to apply to the institution on the basis specified in the notice.
- (2) If a notice described in subrule (1) (*previous notice*) is in effect immediately before the commencement date, a notice is deemed to have been given under rule 5(1) to the authorized institution on that date requiring it to calculate its aggregate equity exposures on the basis specified in the previous notice.

22. Certain approval under section 87 of Ordinance

- (1) If a further period was approved by the Monetary Authority in relation to any share capital (under the circumstances referred to in the proviso to section 87(1) of the Ordinance) and the commencement date falls in that period, the portion of that period after that date is deemed to be a longer period approved by the Monetary Authority on that date in relation to the share capital (under the circumstances referred to in rule 13(1)(b)(ii)).
- (2) If a further period was approved by the Monetary Authority in relation to any share capital (under the circumstances referred

to in section 87(2)(a) of the Ordinance) and the commencement date falls in that period—

- (a) the portion of that period after that date is deemed to be a longer period approved by the Monetary Authority on that date in relation to the share capital (under the circumstances referred to in rule 13(1)(c)(i)(B)); and
- (b) if the Monetary Authority attached any condition to the approval of the further period—the same condition is deemed to be attached to the deemed approval under paragraph (a).

(3) If—

- (a) an approval was given by the Monetary Authority, in relation to any share capital, under the circumstances referred to in section 87(2)(b) of the Ordinance; and
- (b) the approval was in effect immediately before the commencement date,

the approval is deemed to be an approval given on that date by the Monetary Authority, in relation to the share capital, under the circumstances referred to in rule 13(1)(e).

(4) If—

- (a) an approval was given by the Monetary Authority, in relation to any share capital, under the circumstances referred to in section 87(2)(c) of the Ordinance; and
- (b) the approval was in effect immediately before the commencement date,

the approval is deemed to be an approval given on that date by the Monetary Authority, in relation to the share capital, under the circumstances referred to in rule 13(1)(f).

Monetary Authority

2018

Explanatory Note

Section 9 of the Banking (Amendment) Ordinance (6 of 2018) (*BAO*) added new sections 81A, 81B and 81C to the Banking Ordinance (Cap. 155) (*BO*).

2. These Rules are made under the new section 81A of the BO—
 - (a) to prescribe a limit on the equity exposures arising from interests held by an authorized institution (*AI*); and
 - (b) to mitigate the risks that an AI may become heavily concentrated in its equity exposures which could pose a threat to the financial stability of the institution.
3. The Rules contain 3 Parts.

Part 1—Preliminary

4. Rule 1 provides for the commencement of the Rules, which is to tally with the commencement date of section 9 of the BAO.
5. Rules 2 to 6 contain preliminary provisions that apply to all Parts of the Rules in relation to the following matters—
 - (a) the interpretation of certain expressions that carry the same meaning as that in the Banking (Capital) Rules (Cap. 155 sub. leg. L);
 - (b) the general provisions on the requirements imposed on an AI and the Monetary Authority;
 - (c) the valuation of exposures at fair value;
 - (d) the requirements to apply a provision in the Rules on an unconsolidated or a consolidated basis;
 - (e) notifiable events.

Part 2—Equity exposures

6. Part 2 is divided into 4 Divisions and 13 rules. This Part aims at replacing the outdated section 87 of the BO.
7. Rule 8 sets out the meaning of *equity exposure* of an AI. It extends the scope of an equity exposure on shareholdings in section 87 of the BO to cover other interests that may give rise to equity risks.
8. Rule 9 provides that Part 2 of the Rules applies to an AI incorporated in Hong Kong.
9. Rule 10 prescribes a limit on the equity exposures of an AI by reference to an equity exposure ratio.
10. Rule 11 empowers the Monetary Authority to vary the limit prescribed by rule 10 subject to the compliance of specified procedures.
11. Rule 12 provides for the calculation of the aggregate equity exposures of an AI.
12. Rule 13 provides that certain equity exposures are not to be counted for the calculation of the equity exposure ratio of an AI.
13. Rules 14 to 19 provide for the valuation of equity exposures arising from different equity interests.

Part 3—Transitional and Savings Provisions

14. Rules 21 and 22 provide for transitional and savings provisions to deal with—
 - (a) notice given previously by the Monetary Authority under section 79A of the BO (in relation to section 87 of the BO); and
 - (b) approval given previously by the Monetary Authority (as referred to in section 87 of the BO).