Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel large exposures regulations – Hong Kong SAR

March 2020

BANK FOR INTERNATIONAL SETTLEMENTS

This publication is available on the BIS website (www.bis.org).

ISBN 978-92-9259-347-6 (online)

Contents

Glossary

AI	Authorised Institution
BCB	Central Bank of Brazil (Banco Central do Brasil)
BCBS	Basel Committee for Banking Supervision
BELC	Banking (Exposure Limits) Code
BELR	Banking (Exposure Limits) Rules
BIS	Bank for International Settlements
BO	Banking Ordinance
C	Compliant (grade)
CEM	Current exposure method
GDP	Gross domestic product
HKD	Hong Kong dollar
HKMA	Hong Kong Monetary Authority
HKMC	Hong Kong Mortgage Corporation Limited
IPO	Initial Public Offering
LERS	Linked Exchange Rate system
LC	Largely compliant (grade)
LEX	Large exposures
MNC	Materially non-compliant (grade)
NC	Non-compliant (grade)
RCAP	Regulatory Consistency Assessment Programme
SA-CCR	Standardised approach to counterparty credit risk
SAR	Special Administrative Region
SPM	Supervisory Policy Manual
SIG	Supervision and Implementation Group

Preface

The Basel Committee on Banking Supervision (Basel Committee) places a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits from adopting Basel standards can only fully accrue if these are implemented fully, consistently and in a timely manner by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework.

This report presents the findings of an RCAP Assessment Team (the Assessment Team) on the domestic adoption of the Basel large exposures (LEX) framework in the Hong Kong Special Administrative Region (SAR). The assessment focused on the completeness and consistency of the domestic regulations in force on 31 December 2019 with the Basel large exposures framework, as applied to internationally active banks in Hong Kong SAR. Issues related to prudential outcomes, the resilience of the banking system or the supervisory effectiveness of the Hong Kong authorities were not in the scope of this assessment. The assessment relied on regulations, as well as other information and explanations provided by the Hong Kong authorities, and ultimately reflects the view of the Basel Committee.

The Assessment Team was led by Mr Ricardo Franco Moura, Head of the Prudential and Foreign Exchange Regulation Department at the Central Bank of Brazil (BCB) and consisted of four technical experts, from Kazakhstan, Korea, the Netherlands and Sweden (see Annex 1). The counterpart for the assessment was the Hong Kong Monetary Authority (HKMA). The work was coordinated by the Basel Committee Secretariat with support from staff from the BCB.

The assessment began in the middle of 2019 and comprised (i) a self-assessment by the assessed jurisdiction's authorities (June to August 2019); (ii) an assessment phase (August to December 2019), including an on-site assessment involving discussions with the HKMA and banks; and (iii) a review phase (December 2019 to February 2020), including a technical review of the Assessment Team's findings by a separate RCAP Review Team, the Committee's Supervision and Implementation Group, the RCAP Peer Review Board and the Basel Committee. More information on the RCAP assessment process is available on the Committee's website.[1]

The Assessment Team wishes to sincerely thank the staff of the HKMA for the efficient, professional and constructive engagement throughout the assessment process. The Assessment Team is hopeful that the RCAP exercise will contribute to refining the sound initiatives that have been undertaken in Hong Kong SAR and to strengthening further the prudential effectiveness of the large exposure framework.

1 See www.bis.org/HKMAs/implementation.htm.

Executive summary

The Hong Kong SAR framework for large exposures was implemented through Banking (Exposure Limits) Rules (Cap.155S) (BELR), which are subsidiary legislation under the Banking Ordinance (BO). The BELR came into force on 1 July 2019 and, after a grace period of six months, became effective on 1 January 2020.

In Hong Kong SAR, the LEX framework applies to 11 banks classified as Category A institutions, which includes banks that are internationally active or are significant to the general stability and effective working of Hong Kong's banking system.

Overall, as of 31 December 2019, the large exposures regulations in Hong Kong are assessed as compliant with the Basel LEX standards. This is the highest possible grade. One of the three components assessed was deemed to be largely compliant, and others are assessed as compliant.

The Assessment Team identified five findings in total and considered one of them as a potentially material deviation from the Basel LEX framework. The latter relates to exposures of a receiving bank in an initial public offering (IPO) to other banks from placing the subscription monies received on the interbank market. These exposures are exempted under the current HKMA regulations, while the Basel LEX framework allows only the exemption of interbank exposures that are intraday. This finding is raised as an issue for follow-up RCAP assessments (Annex 5).

In response to technical discussions with the Assessment Team during the on-site visit, the HKMA has agreed to make several changes to the Supervisory Policy Manual (SPM) on Large Exposures and Risk Concentrations (CR-G-8), Letters of Comfort: BELR Rule 57(1)(d) (CR-L-3) and Consolidated Supervision of Concentration Risks: BELR Rule 6 (CR-L-1). These changes are listed in Annex 4.

At the same time, the Assessment Team noted that the LEX framework in Hong Kong SAR is in some areas more conservative than the Basel LEX framework. The super-equivalent areas are listed in Annex 6.

Response from HKMA

The HKMA appreciates the efforts taken by the Assessment Team to understand and evaluate Hong Kong's large exposures framework. We acknowledge the engagement made by the Assessment Team members when comparing our rules with the Basel large exposures framework and we thank them for the rigour in their assessment.

We welcome the overall rating of "compliant". When developing our large exposure requirements, the HKMA took into account locally specific conditions where necessary, and also incorporated feedback from industry consultation; we acknowledge the Assessment Team's consideration of these features in its assessment.

The HKMA will continue to ensure the effective operation of the Basel large exposure requirements in Hong Kong through its supervisory processes.

1 Assessment context

1.1 Status of implementation of the large exposures framework

The Hong Kong Monetary Authority is the monetary and banking authority of Hong Kong. The Basel large exposures framework standards were adopted on 1 July 2019 and, after a grace period of six months, went into effect on since 1 January 2020. The LEX rules were implemented via the Banking (Exposure Limits) Rules (Cap.155S) (BELR), which are subsidiary legislation under the Banking Ordinance (BO).

The Basel LEX rules are applied to Category A institutions. These are institutions that are internationally active or significant to the general stability and effective working of the local banking system.[2] The HKMA has designated 11 institutions that exceed any of the relevant benchmarks as Category A institutions.

1.2 Regulatory system

The HKMA, established on 1 April 1993, is charged with maintaining monetary and banking stability. The HKMA's monetary policy objective is to maintain currency stability within the framework of the Linked Exchange Rate system (LERS). In its role as Hong Kong's banking regulator, the HKMA is charged with promoting financial stability and the effective functioning of the banking system, as well as helping to maintain Hong Kong's status as an international financial centre, in part through the maintenance and development of Hong Kong's financial infrastructure.

1.3 Structure of the banking sector

With total exposures at locally incorporated Authorised Institutions (AIs) of HKD 17.7 trillion,[3] equivalent to 623% of GDP, Hong Kong's banking system is one of the largest in the world, serving as a regional financial centre and a gateway to Mainland China.[4] In March 2019, 186 AIs[5] operated in Hong Kong, 51 of which were locally incorporated AIs, and 135 branch entities. The total exposures of the five locally incorporated internationally active banks accounted for 72.4% of the total exposures of locally incorporated AIs in Hong Kong.

1.4 Scope of the assessment

The Assessment Team considered the large exposure limits applicable to commercial banks in Hong Kong as of 31 December 2019. The assessment had two dimensions:

- a comparison of domestic regulations with the Basel large exposures framework to ascertain that all the required provisions have been adopted (*completeness* of the regulations); and

2 The benchmark for "internationally active" is when the amount of total external claims and liabilities equals or exceeds HKD 250 billion. The criterion for being considered significant to the general stability and effective working of the local banking system is that an authorised institution's total assets equal or exceed HKD 250 billion.

3 Total exposures used in the leverage ratio, which include both on- and off-balance sheet exposures.

4 See IMF 2018 Article IV Consultation at www.imf.org/en/Publications/CR/Issues/2019/01/25/People-s-Republic-of-China-Hong-Kong-Special-Administrative-Region-2018-Article-IV-46539.

5 This excluded three virtual banks that were locally incorporated AIs licensed in early 2019 but had yet to commence business as at 31 March 2019.

- whether there are any differences in substance between the domestic regulations and the Basel large exposures framework and, if so, their significance (*consistency* of the regulations).

In its assessment, the Assessment Team considered all binding documents that effectively implement the Basel large exposures framework in Hong Kong. Annex 2 lists the Basel standards used as the basis for the assessment. The assessment did not evaluate the resilience of the banking system in Hong Kong or the supervisory effectiveness of the HKMA.

As set out in the RCAP methodology, the Assessment Team evaluated the materiality and potential materiality of identified deviations between the Basel large exposures framework and the local regulations. The quantification was limited to a sample of banks. In addition, the Assessment Team reviewed the non-quantifiable aspects of identified deviations and applied expert judgment as to whether the domestic regulations meet the Basel framework in letter and in spirit. The materiality analysis is summarised in Annex 3, which also lists the sample of banks.

The Assessment Team noted that, in some areas, the assessed jurisdiction's rules go beyond the minimum Basel standards. Although these elements (listed in Annex 6) provide for a more rigorous implementation of the Basel framework, they have not been taken into account for the assessment of compliance.

The outcome of the assessment is summarised using a four-grade scale, both at the level of each of the three key components of the Basel large exposures framework and the overall assessment of compliance. The four grades are: compliant, largely compliant, materially non-compliant and non-compliant.

2 Assessment findings

2.1 Assessment grades and summary of findings

Overall, the Assessment Team finds the implementation of the large exposures framework in Hong Kong to be compliant with the Basel standards. This grade is based on the materiality assessment (summarised in Annex 3) and takes into account the rectifications issued by the assessed authorities in December 2019, as described in Annex 4.

Assessment grades — Table 1

Component of the Basel NSFR framework	Grade
Overall grade	C
Scope and definitions	LC
Minimum requirements and transitional arrangements	C
Value of exposures	C

Assessment scale: C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant).

2.1.1 Scope and definitions

The scope and definition requirements of the HKMA regulations are largely compliant with the Basel LEX framework. The HKMA applies the LEX framework to a wider range of financial institutions than just internationally active banks. These institutions are required to comply with the framework on a proportional basis, taking into account their size and complexity.

Four findings were identified under the scope of application: (i) exemption of interbank exposures of IPO receiving banks; (ii) exemption of foreclosed asset exposures; (iii) exemption of underwriting exposures; and (iv) exemption of exposures to the Hong Kong Mortgage Corporation (HKMC).

The Basel LEX framework exempts from its scope only the exposures to sovereigns and central banks. The HKMA regulations allow for the exemption of interbank exposures of IPO receiving banks from the scope of the LEX framework. In Hong Kong SAR, the monies for subscribing to new issuances of securities are placed with IPO receiving banks. Given the size of the IPOs and, in particular, the number of times those transactions can be oversubscribed, which is a characteristic of Hong Kong's market, the amounts involved may be significant. Hence, an IPO receiving bank places the subscription monies received back on the interbank market to ensure sufficient market liquidity. This finding is assessed as potentially material.

The HKMA regulations also allow for the exemption of exposures to counterparties resulting from the acquiring of foreclosed assets in the course of the satisfaction of debts from the LEX framework. The acquired assets need to be disposed of at the earliest opportunity but no later than 18 months after the acquisition. This finding is assessed as not material.

The HKMA regulations allow for the exemption of exposures arising from any share capital or debt securities acquired under an underwriting/sub-underwriting contract for a period of seven working days after the acquisition. This finding is assessed as not material.

The HKMA regulations allow for the exemption of exposures to the HKMC, which is not a sovereign entity. As the HKMA provided numbers confirming that its credit risk and amount of exposures has little impact on the large exposure ratio, this finding is assessed as not material.

2.1.2 Minimum requirements and transitional arrangements

The HKMA regulations on the minimum requirements and transitional arrangements are compliant with the Basel LEX framework. No findings were identified.

2.1.3 Value of exposures

The HKMA regulations on the value of exposures are compliant with the Basel LEX framework.

One finding was identified under the component of value of exposures. The Basel LEX framework allows supervisors to exceptionally accept a breach of an interbank limit (ex post) in stressed circumstances. The HKMA regulations do not restrict the exercise of this mandate in relation to interbank exposures only ex post. The HKMA confirmed that this power is exercised only to prevent or manage crises situations more actively, and taking up another bank's financial assets under resolution was stated as an example of such situations. As the probability of the HKMA exercising this power for exemption is considered to be very low, this finding is assessed as not material.

2.2 Detailed assessment findings

2.2.1 Scope and definitions

Section grade	**Largely compliant**
Basel paragraph number	13, 61: exemption of sovereign exposures
Reference in the domestic regulation	BELR rule 48(1)(l)
Finding	The Basel LEX framework exempts exposures to sovereigns and their central banks. This exemption also applies to public sector entities treated as sovereigns according to the risk-based capital framework. The HKMA regulations extend the list of exemptions to the exposures of a receiving bank in an IPO to other AIs from placing the received subscription monies on the

	interbank market. The exemption was provided to account for the specificities of the IPO process in Hong Kong, where all the subscription money of clients participating in an IPO goes to the receiving bank during the IPO period. This can lead to a situation, especially during large IPOs, where the IPO receiving bank has a very large liquidity surplus while the client banks lack this liquidity. Hence, the IPO receiving bank lends the money (inflated due to the IPO oversubscription issue) back to the client banks during the IPO process, leading to large exposures. Once the specific IPO shares are assigned, those exposures from oversubscriptions automatically vanish. The HKMA emphasised the need for this exemption from the LEX, as during the IPO period the banks sending the subscription money might face liquidity problems, while the IPO receiving bank will have excess liquidity. The HKMA finds it necessary to stay on the liquidity side in this risk trade-off issue to maintain the stability of the financial system. The HKMA provided granular data on the daily evolution of the interbank exposure of each of the four sample banks to specific counterparties starting five days before the starting date of specific IPOs up to five days after the IPOs' closing dates (including the whole IPO period). The IPOs chosen were the ones involving the highest interbank exposure observed for the sample banks. One of the sample banks reported high variations in exposures to two of its counterparties during two IPOs in 2017. The change in interbank exposures due to the IPOs flows ranged from 17 to 32 percentage points of Tier 1 capital and lasted for around four days as exposures returned to their average levels after the closing of the IPOs. While such an increase in exposures can vary across IPOs – the size of IPOs tends to be positively correlated with market conditions – and is very limited in time – the exposures reverse in a few days with the closing of IPOs – the size of movement described above suggests that, at least for one of the sample banks, the effect of this exemption can be material. Against this background, the finding is not considered to be currently material but is assessed as potentially material.
Materiality	Potentially material
Basel paragraph number	13, 61: exemption of sovereign exposures
Reference in the domestic regulation	BELR rule 48(1)(e)
Finding	The Basel LEX framework exempts exposures to sovereigns and their central banks. This exemption also applies to public sector entities treated as sovereigns according to the risk-based capital framework. The HKMA regulations extend the list of exemptions to exposures arising from any share capital, debt securities or investment structure acquired by the institution in the course of the satisfaction of debts due to it. The exemption is applied, if the assets are disposed of at the earliest suitable opportunity or during a period of 18 months after their acquisition (whichever period expires first); or in a longer period approved by the HKMA in writing in any particular case. The HKMA stated that the policy intent of this exemption is to avoid fire sales in order to mitigate any potential negative impact on an AI and the financial system as a whole. The seemingly long exemption period of 18 months seeks to cater to private equity investments. The sales of private equity investments typically include a due diligence process for valuation and identification of potential buyers, which takes a long time. Marketable securities can be disposed of very quickly. Based on the data provided by the HKMA in the past three years, only one sample bank reported a case of foreclosure on securities (HKD 10,000) in satisfaction of a debt. The asset was disposed of in 41 days. And the HKMA confirmed that sample banks have small amounts of exposures covered by collateral in the form of securities: the maximum reported amount of a loan was 3.7% of Tier 1 capital. Some of the loans are covered by securities issued by the same issuer. However, even in the case of a simultaneous default on such loans, the maximum potential exposure to the same securities issuer reported by sample banks would be 4.1% of Tier 1 capital. Given that this potential exposure to the securities issued by same issuer as collateral benefits from a strong diversification effect of loans to different counterparties, the deviation is considered to be not material.
Materiality	Not material
Basel paragraph number	13, 61: exemption of sovereign exposures

Reference in the domestic regulation	BELR rule 48(1)(f)
Finding	The Basel LEX framework exempts exposures to sovereigns and their central banks. This exemption also applies to public sector entities treated as sovereigns according to the risk-based capital framework. The HKMA regulations extend the list of exemptions to exposures arising from any share capital or debt securities acquired under an underwriting or sub-underwriting contract subject to a disposal within seven working days after their acquisition or for a longer period if approved by the HKMA in writing. Based on the information provided by the HKMA, only one of the four sample banks has reported in the past three years an acquisition of securities under underwriting. Furthermore, this has happened only once and the securities were a sovereign issue that accounted for 0.1% of Tier 1 capital and were disposed of within 11 days. Additionally, data for the most relevant bank in the sample show that its share in each of the top 20 underwriting transactions is small when compared with its capital base (maximum of 1.5% of Tier 1 capital in the last three years). Although the exemption under BELR 48(1)(f) is not applicable to the other three banks of the sample, a hypothetical exercise using conservative assumptions was also done using the available data. The results show that an eventual acquisition of securities left over by the other three banks in the sample would also not represent a relevant amount when compared with their capital base. Interviews held with banks also indicated that the probability of acquiring any securities left over is very low and that this exemption is not expected to be used normally. Hence, the deviation is considered to be not material.
Materiality	Not material
Basel paragraph number	13, 61: exemption of sovereign exposures
Reference in the domestic regulation	BELR rule 48(1)(i)
Observation	The Basel LEX framework exempts exposures to sovereigns and their central banks. This exemption also applies to public sector entities treated as sovereigns according to the risk-based capital framework. Under the HKMA large exposures framework, the scope of the sovereign exemption includes exposures to the HKMC, its subsidiaries and related special purpose vehicles, which are not formally sovereign entities. This represents a deviation from the Basel LEX standard. However, the HKMC is wholly owned by the government, similar to the guarantee of the Housing Authority, which is considered to be a sovereign entity. According to the data obtained from the HKMA, sample banks' exposures to the HKMC are considered not significant, ranging from 0.9 to 2.8% of Tier 1 capital. Considering the low exposures and the fact that the HKMC is a de facto sovereign entity, this finding is considered not material.
Materiality	Not material

2.2.2 Minimum requirements and transitional arrangements

This component was assessed to be compliant with the Basel framework. No findings were identified.

2.2.3 Value of exposures

Section grade	**Compliant**
Basel paragraph number	66: supervisory discretion to accept breach
Reference in the domestic regulation	BELR rule 48(1)(n), 48(2) and SPM CR-G-8 2.11.2
Finding	The Basel LEX framework allows supervisors accepting a breach related to interbank limit ex post and only under stressed circumstances, in order to help ensure stability in the interbank market. The HKMA regulations grant a broad power to the supervisor to decide on an exposure not to be taken into account for determining an aggregate single counterparty exposure or aggregate connected counterparty group exposure based on certain conditions set out in the BELR rule. The SPM specifies that the exemption power is to

	be exercised only in exceptional scenarios of significant financial instability and to avert adverse developments. The Assessment Team considers this as a deviation from the Basel LEX since BELR expands the scope of supervisor's discretionary power for situations beyond the cases related to interbank exposures accepted ex post. The HKMA confirmed that its discretionary power is intended only to prevent or manage crisis situations more actively. SPM (CR-G-8) states that the HKMA will rarely exercise the general exemption power unless under exceptional situations, such as taking over a bank during its resolution process. The HKMA will exercise this power very rarely, taking into account that this kind of exemption will be applied only in stress situations and after thorough consideration. The deviation is therefore similar in spirit to the Basel standard and is not expected to have a material impact on the financial stability and the international level playing field. Hence, the deviation is considered to be not material.
Materiality	Not material

2.3 Observations on the implementation of the large exposures framework in Hong Kong SAR

The following observations highlight certain special features of the regulatory implementation of the Basel large exposures framework in Hong Kong SAR. These are presented to provide additional context and information. Observations are considered compliant with the Basel standards and do not have a bearing on the assessment outcome.

2.3.1 Scope and definitions

Basel paragraph number	12: application of the framework at a consolidated level
Reference in the domestic regulation	BELR rule 6(1), SPM CR-L-1 2.1.1 and 2.2.1
Finding	The Basel LEX framework specifies that the LEX should follow the existing scope of application set out in the Basel framework and be applied to banks at the consolidated level. The BELR specifies that the HKMA may decide the scope of consolidation by written notice to the institution. The HKMA clarified that the reason for stating "may" in the BELR is to provide the flexibility of consolidation scope, which allows banks not to consolidate subsidiaries, provided that special considerations apply, such as dormant or non-financial entities. The HKMA confirmed that, in practice, any subsidiary regulated by BELR will be consolidated. And the SPM stated that AIs with subsidiaries are required to comply with the statutory limits on both a solo and consolidated basis, which is aligned with the Basel LEX.
Basel paragraph number	26: establishing connectedness based on economic interdependence
Reference in the domestic regulation	BELC rule 6(4)(iii)

Observation	According to the Basel LEX framework, economic interdependence among counterparties is assumed, among other criteria, if 50% or more of one counterparty's gross receipts is derived from transactions with another counterparty. Another case of interdependence is when a significant part of one counterparty's production or output is sold to another counterparty, which cannot be easily replaced by other customers. In this context, instead of using "significant part", the HKMA treats two counterparties as connected if "50% or more" of one counterparty's production that cannot be easily replaced is sold to another. The HKMA considers that, in order to provide banks with more transparent criteria, setting a specific value for "significant" is more desirable than largely judgment-based criteria. Comparing the two criteria suggests that the spirit of the standard was to set a threshold lower than 50% for defining interdependence in the case when there is no easy substitute for a firm's clients. However, it does indeed make sense that a hard limit could be preferable to a judgmental one, although it is not clear what this number should be.

2.3.2 Minimum requirements and transitional arrangements

Basel paragraph number	93, 94: implementation date and transitional arrangements
Reference in the domestic regulation	BELR rule 1, 112–113
Observation	The Basel LEX framework requires implementation in full by 1 January 2019 and banks must adjust their exposure limit by that date. In Hong Kong SAR, the new large exposures framework came into force on 1 July 2019. The HKMA also granted a grace period of six months (until 31 December 2019) to comply with the new rules.

2.3.3 Value of exposures

Basel paragraph number	33: counterparty credit risk
Reference in the domestic regulation	BELR rule 59
Observation	As stated in the Basel LEX framework, the exposure value for instruments that give rise to counterparty credit risk and are not securities financing transactions must be measured according to the standardised approach for counterparty credit risk (SA-CCR). However, since the SA-CCR is not yet implemented in Hong Kong, the current regulation provides that an AI should use the same method that it uses under the Basel Capital Rules to calculate CCR exposures, provided that this method is not an internal modelling approach. If the internal modelling approach is used under the Capital Rules, the HKMA policy is to require the AI to employ the current exposure method (CEM) under the BELR. SA-CCR implementation in Hong Kong is planned for 2020. After that, the SA-CCR should be the default method for calculating counterparty credit risk exposures under the BELR.

Annexes

Annex 1: RCAP Assessment Team and Review Team

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Annex 2: List of Basel standards and implementing regulations issued by the HKMA

The following Basel standards were used as the basis of this RCAP assessment:

- *Supervisory framework for measuring and controlling large exposures*, September 2016
- *Frequently asked questions on the supervisory framework for measuring and controlling large exposures*, September 2016

Table A.1 lists the regulations issued by the HKMA to implement the large exposures framework in Hong Kong. Previous RCAP assessments of implementation of the Basel standards in Hong Kong considered the binding nature of the HKMA's regulatory documents.[6] This Assessment Team did not repeat that assessment, but instead relied on the previous assessments' findings. Those assessments concluded that the types of instrument described in Table A.1 could be considered as binding on banks and supervisors for the purposes of an RCAP assessment.

Overview of relevant regulations on large exposures — Table A.1

Domestic regulations	Type, version and date
Banking (Exposure Limits) Rules	Hong Kong Subsidiary Legislation Chapter 155S, published on 16 Nov 2019
Banking (Exposure Limits) Code	Code of Practice, published on 21 June 2019
CR-G-8 "Large Exposures and Risk Concentration"	Supervisory Policy Manual, V3, published on 27 December 2019
CR-L-1 "Consolidated Supervision of Concentration Risks: BELR Rule 6"	Supervisory Policy Manual, V3, published on 27 December 2019
CR-L-3 "Letters of Comfort: BELR Rule 57(1)(d)"	Supervisory Policy Manual, V2, published on 27 December 2019

Source: HKMA.

6 See Annex 7 of the RCAP assessment of the Basel III risk-based capital regulations in Hong Kong SAR, March 2015, www.bis.org/bcbs/publ/d313.pdf.

Annex 3: Materiality assessment

The outcome of the RCAP assessment is based on the materiality of the findings described in Section 2.2 and summarised in Table A.2. Assessment Teams evaluate the materiality of findings quantitatively where possible, or using expert judgment when the impact cannot be quantified.

The materiality assessment for quantifiable gaps is based on the cumulative impact of the identified deviations on the reported large exposures of banks in the RCAP sample. These banks are listed in Table A.3.

Number of deviations by component — Table A.2

Component	Not material	Potentially material	Material
Scope and definitions	3	1	0
Minimum requirements and transitional arrangements	0	0	0
Value of exposures	1	0	0

RCAP sample banks — Table A.3

Banking group	Share of banks' assets in the total assets of the banking system in Hong Kong (per cent)
Bank A	45.02
Bank B	15.21
Bank C	6.72
Bank D	5.48
Total	72.3

Source: HKMA. For this purpose, banking assets are based on the measure of total exposures used in the leverage ratio, which includes both on- and off-balance sheet exposures.

Annex 4: Rectifications made by the HKMA

List of rectifications by the HKMA — Table A.4

Basel paragraph	Reference in HKMA's regulations	Description of the rectification
12	SPM CR-L-1 paragraph 2.1.1	The Assessment Team considered that the original requirements in para 2.1.1, that AIs with subsidiaries will normally be required to comply with the statutory limits on both a solo and consolidated basis, were not sufficiently clear. The HKMA rectified the issue by replacing the phrase "will normally be required to" by "are required to" and by adding a footnote to make it beyond doubt that Part 7 should always be applied on a consolidated basis.
13, 61	SPM CR-L-3 paragraph 1.9	The Assessment Team was concerned that the BELR provides an exemption to exposures covered by a letter of comfort, although in practice only a letter of comfort issued by the government would be accepted and the relevant exposures would actually resemble risks on the government. To alleviate the Assessment Team's concern, the HKMA revised para. 1.9 of the SPM CR-L-3 by stating that in future the HKMA will not approve a letter of comfort under Rule 57(1)(d) with respect to the exposures of a Category A institution. The only exception is a government-issued letter of comfort that supports exposures to the Hong Kong Mortgage Corporation Limited or its subsidiaries. In that case, the government takes on the credit risk fully and ultimately.
66	SPM CR-G-8 paragraph 2.11.2	The Assessment Team expressed concerns over the general exemption power, although it is the HKMA's stated policy that such power will be used only rarely and in exceptional circumstances. The HKMA rectified the issue by revising para 2.11.2 of the SPM CR-G-8 to clearly restrict the general exemption power to exceptional scenarios of significant financial instability and to avert adverse developments.

Source: HKMA.

Annex 5: Issues for follow-up RCAP assessments

The Basel LEX framework exempts exposures to sovereigns and their central banks. This exemption also applies to public sector entities treated as sovereigns according to the risk-based capital framework. The HKMA regulations extend the list of exemptions to exposures of a receiving bank in an IPO incurred to other AIs from placing the subscription monies received to the interbank market.

Given that the interbank exposure was until recently out of the scope of the large exposure limit in Hong Kong SAR, the Assessment Team has concluded that this deviation is potentially material based on the currently available data. However, the Assessment Team believes that it would be worth reassessing a materiality of this deviation in future once more granular data are available.

Also to help the HKMA to systematise and communicate its monitoring efforts at the national level on this issue, the Assessment Team is of the view that this item should be reassessed in future RCAP assessments.

Annex 6: Areas where the HKMA's rules are stricter than the Basel standards

In some areas, the HKMA has adopted a stricter approach than the minimum standards prescribed by the Basel Committee. These are listed below for information. The stricter rules have not been taken into account as mitigants for the overall or component-level assessment of compliance.

- Regulations in Hong Kong SAR are applied to Category A institutions, which include not only internationally active banks but non-internationally active banks that are significant to stability and the effective working of the local banking system.
- Regulations in Hong Kong SAR do not allow for banks to demonstrate the absence of "economic dependence" and "control" in certain circumstances when the criteria do not automatically imply that.
- Regulations in Hong Kong SAR include additional criteria (priority to claim on the issuer's income or assets) to allow offset positions in the trading book.
- Regulations in Hong Kong SAR recognise a greater exposure value (30%) for eligible covered bonds than the Basel standard (20%) does.
- Regulations in Hong Kong SAR do not allow a covered bond consisting of claims secured by commercial real estate to be assigned an exposure value of less than 100%.