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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation on Supervisory Framework for Measuring and Controlling Large Exposures

We refer to the above consultative document published by the Basel Committee on Banking Supervision (BCBS) in March 2013.

On behalf of our members, we write to provide our views on the proposals in the consultative document as set out in the Appendix.

We hope you would find our comments useful. Should you have any questions, please do not hesitate to contact our Assistant Manager, Mr Timothy Tam, at (852) 2526 6080.

Yours faithfully

Boey Wong
Secretary

Enc.

HKAB's comments on the BCBS consultative document on supervisory framework for measuring and controlling large exposures

Specific comments:

1. **The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting. (Para. 22-25)**

   Given the tightening of the definition of eligible capital (from Total Capital to CET1/Tier 1) and the tightening of the definition of large exposures (from 10% to 5%) for large exposure reporting purposes, there will be an increase in the number of exposures that are required to be reported. This will definitely increase the reporting burden for banks.

   The gap between the threshold defining a large exposure (5%) and the large exposure limit (LE limit) (25%) is considered as too wide and the benefits of understanding a wider population of large exposures may be outweighed by the cost and additional burden of tracking and reporting such exposures.

   Furthermore, inconsistency could exist between the definition of large exposure and the definition of capital calculation as certain derivatives trades with corporates, pension funds and sovereigns could have been exempted by European regulators from the CVA capital charge under Basel III.

2. **The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk. (Para. 26-36)**

   We believe that it is very difficult to investigate for economic dependencies to determine connected counterparties and the qualitative criteria is very broad, could be very subjective and could create extreme operational burden for such information to be captured in systems.

   For example, according to the 3rd bullet point in paragraph 34, banks have to judge whether the amount of the borrower's production/output for a single customer represents a "significant part" and whether the customer can be easily replaced.

   More detailed guidelines with illustrative examples should be formulated by the regulator to ensure these criteria can be practically applied and to avoid inconsistency across banks.

   In terms of execution, among the criteria/guidance proposed by the Committee, it is more practical to determine connected counterparties using control and making reference to criteria specified in appropriate internationally recognised accounting standards for further qualitative guidance.

3. **The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1. (Para.37-44)**

   Views are varied between the members. Some members support the use of Tier 1 capital as the basis of the LE Limit but some members tend to support the use of total regulatory capital base.

Since the proposed large exposure framework has been substantially increased in scope, it will be extremely penal to use CET1 as the basis of the LE limit. Instead, some members suggest the Committee to use Tier 1 capital as the basis of the LE limit as all the capital in this category should be able to absorb unexpected losses on a going concern basis, which is in line with the Committee's rationale for setting the LE limit based on CET1 or Tier 1 capital as stated in the consultative document. Nevertheless, it is further proposed to have investment holdings that are currently deducted from CET1/Tier 1 to be included in the definition of capital for large exposures purposes.

Some members propose the continued use of the total regulatory capital base as the appropriate basis for the LE limit rather than CET1 or Tier 1. Importantly, total capital includes eligible subordinated debt. Based on Basel III, subordinated debt is required to be "bail-inable". In such event, this capital would be recognised as CET1. It would be incongruous to require bail-in conditions for such instruments, yet not recognise them within the capital base with which to absorb potential losses.

Subordinated debt, by definition, is a medium to long-term instrument. It must be issued for a minimum period of 5 years. In comparison, the tenor of most commercial lending is generally far shorter in duration. Accordingly, eligible subordinated debt remains a relatively stable means of loss absorption.

4. **The Committee welcomes views on the extent and nature of the use of internal models (when they have received supervisory approval for being used for Pillar 1 capital requirements purposes) to measure large exposures. (Para. 45-49)**

All the members support the use of internal models.

The BCBS should recognise internal models, as approved by national supervisors for use in the estimation of Pillar 1 regulatory capital requirements, under the large exposures framework.

Those models approved for use in the estimation of Pillar 1 capital requirements, including Loss Given Default ("LGD"), Exposure at Default ("EAD") and Internal Model Method ("IMM") models, are subject to regulatory scrutiny and rigorous oversight, including independent validation and periodic performance monitoring. They should be used in the definition of exposures for consistency with both risk management and capital calculation. Furthermore, LGD is a better measure since it articulates the loss incurred by the bank when an obligor defaults.

Instead of introducing the new exposure measurement approaches (such as the proposals with respect to the measurement of exposures on options and the recognition of credit risk mitigation) under the large exposures framework, the same approaches used for the existing risk based capital requirements should be adopted. Otherwise it would introduce complexity and additional burden for banks which conflict with the BCBS' objective of establishing a consistent and relatively simple framework for the management of large exposures.

5. **The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives. (Para. 50-58)**

   We believe that as the OTC derivatives counterparty risk models have been approved by national supervisors, they should be eligible for use in the large exposures framework. It should also be noted that peak loss exposure (refer paragraph 57) can be calculated by the IMM approach.

   We would also like to clarify whether the Current Exposure Method (CEM) is calculated on a gross or net basis.

6. **The Committee welcomes views on the proposal for how the exposure values of banks' investments in securities financing transactions should be calculated, in particular on the need to deviate from the risk-based capital requirement rules given the objectives of a large exposures framework. (Para. 59-62)**

   We propose that the bank's own estimates of haircuts under approved internal models, instead of supervisory haircuts, should be adopted for the comprehensive approach for securities financing transactions. This is to ensure consistency of definition of exposures with both risk management and capital calculation as mentioned in item 4 above.

   Currently, some regulators require a "case by case" approval of reduction of exposure by the collateral value. We propose that banks can apply mitigation and deduction of exposure according to the same criteria as the risk-based capital requirement rules, i.e. no national discretion on the application of the mitigation rules.

7. **The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments. (Para. 63-66)**

   We believe that it is more reasonable to set the standardised CCFS (20%, 50% or 100%) under the risk-based capital treatment.

   In addition, we would like to clarify if the same 0% CCF applies for the purpose of large exposure calculations for those off balance sheet items which attract a 0% CCF under the standardised approach.

   We believe that it would be inappropriate to apply a flat 100% CCF to specific types of exposures as this could have material adverse consequences on certain areas such as trade financing.

8. **The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals. (Para.67-73)**

   We welcome the proposal to recognise unfunded credit protection and financial collateral to measure large exposures but would like to seek clarifications on:

   1. Whether unfunded credit protection includes unfunded risk sub-participation and credit insurance?

2. How to "risk-weight" the reduced amount using the risk weight of the credit risk mitigation provider as stated in paragraph 69?

We also recommend consideration of physical collaterals as risk mitigation to be permitted to reduce exposure values for large exposures purposes given physical collaterals have also been taking into account in the LGD estimates in the risk-based capital calculation.

9. The Committee welcomes views on whether the approach proposed for calculating exposure values for trading book positions raises specific issues. (Para. 74-85)

Large exposure for derivatives should take into account the exposure of issuer credit risk of the underlying and the counterparty credit risk of the derivatives. Clarification is requested on the Committee's position as inconsistencies are noted in the examples provided in paragraph 82 (which considers issuer credit risk of the underlying and counterparty credit risk) and paragraph 84 (which considers the counterparty credit risk only).

10. The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues. (Para.86-95)

We have no objection to the proposals.

11. The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted. (Para. 96-103)

With regards to the Committee's proposal to apply the large exposure limit to interbank exposures in the same way that it is applied to any other exposures to third parties, there may be an unintended consequence that banks have to place their surplus funds with other banks with lower credit quality in order to comply with the requirement in the proposed large exposures regime. Given that placements in the interbank market are primarily for the purpose of deploying surplus liquidity, it is recommended that a higher limit be given for such exposures so as not to penalise highly liquid banks and that netting is allowed for these exposures as well.

The consultative document allows exemptions for bank balances relating to certain types of services including provision of money transmission services and client activity flows. In this regard, we recommend that all nostro balances including but not limited to intraday and overnight balances should be exempted from the large exposure framework. In fact, there is a view that too narrowly defined exemptions will create great difficulties and will increase the cost in application.

12. **The Committee welcomes comments on the calibration of the granularity threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues. (Para.104-109)**

Members generally have concern regarding the setting of the 1% threshold for granularity test for fund investment.

It is considered that the threshold of 1% of the total value of the transaction for granularity testing is too low. Assuming that a bank's exposure to a particular CIU/securitisation transaction reaches the large exposure limit of 25% of CET1/Tier 1 capital, 1% of the total value of the transaction would represent only 0.25% (25% x 1%) of the CET1/Tier 1 capital that would need to be included for a particular counterparty that the bank also has direct exposures with.

In relation to the treatment of securitization, the look through approach does not work for the purpose of aggregating exposures to a single counterparty involving vehicles with tranching of cashflows. This is because the impact, of a default of an underlying exposure in the vehicle, on the value of an exposure to the vehicle, depends on the structure of the cashflows from the vehicle, e.g. waterfall, seniority etc. Take for example a $10 exposure to a securitisation vehicle with $100 total underlying exposure out of which $20 is to counterparty A. A total loss of the counterparty A exposure does not necessarily result in a $2 loss in the exposure to the securitisation vehicle if there are tranching of the cashflows.

Moreover, members expect the Committee to recognize that it is industry practice that underlying exposures can be changed at the discretion of the fund manager which cannot be controlled by banks. The proposal should also widely seek comments from the fund management industry. As fund investment can diversify concentration risk, it may not be appropriate to add the unknown exposure to each of the existing large exposures.

Given the immateriality and the significant effort that would be required to perform the look through granularity test, members recommend the following:

- setting a higher threshold for example, 20% of the total value of the transaction
- only underlying assets above this threshold are treated as large exposures
- if the exposure to a particular collective investment undertaking (CIU) or securitisation is below the large exposure threshold (i.e. 5% as proposed in the document), no large exposure reporting is required and the look-through approach would not apply to the exposure.

13. **The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the large exposures framework. (Para.110-120)**

Members have no objection to exercise additional risk control but recommend regulators to consider excluding fraud risk arising from fund manager and originator as all the underlying assets are kept in segregated accounts and not to set too restrictive rules that create excessive difficulties and cost in implementation.

14. The Committee welcomes views on the options for the treatment of banks' exposures to CCPs. (Para.121-130)

All members tend to accept the second option for Q-CCP.

It is worth highlighting the concentration risks introduced by regulatory initiatives that encourage the use of CCPs, and the contradiction between such initiatives with the potential establishment of limits on exposures to CCPs. Rather than imposing limits on exposures to CCPs, whether in the form of 'hard' or 'soft reporting' limits, national supervisors are encouraged to consider the fundamental questions of CCP supervision, risk management and resolution.

15. Section V - Large exposures rules for global systemically important banks (Para. 131-134)

We believe that the proposed 10% - 15% limit for G-SIBs will be too tight and not practical for genuine business needs.

We would query the appropriateness of using the large exposures framework as a means by which to address contagion risk between G-SIBs. As G-SIBs are already subject to additional capital requirements in the form of the G-SIB buffer (1% to 2.5% at CT1 level), and recovery and resolution requirements that are designed to improve their resilience, the imposition of tighter limits on exposures to G-SIBs would duplicate such measures.

The BCBS should also be encouraged to consider the potential unintended consequences on interbank markets and liquidity of the proposed limits on exposures between G-SIBs, with one potential consequence highlighted by the Institute of International Finance ("IIF") being that tighter limits on exposures between G-SIBs may exacerbate a crisis situation in which banks would normally seek a "flight to quality". The proposal may also encourage larger amounts to be deposited with smaller and lower rated banks. Alternatively, it could encourage a shift away from interbank placement of surplus funds to increased placements with sovereigns. Both effects could possibly disrupt local liquidity markets and dampen the effectiveness of government policies to encourage lending within local markets.

While the BCBS consultation paper notes that the G-SIB limits are intended to be applied at a consolidated Group level, additional complications may arise if local regulators use national discretion to apply similar legislation at a Domestic Systemically Important Banks ("D-SIBs") level in line with the increasing regulatory trend towards national protectionism.

G-SIBs are already required to hold additional loss-absorbency capital, which in principle offsets part of the risk caused by their inter-connectivity with the rest of the financial market. In this regard, we suggest the large exposure limit for G-SIBs should be consistent with other large exposures.

It is also worth noting that the existing Basel III treatment on AVC already requires higher risk weights for exposures to sizeable banks with assets over US$100 billion. From this perspective, there would be additional measures for controlling large exposures to FIs.

Appendix

General Comments:

The proposal requires significant cost for implementation given the complexity and additional/new requirements:

- Capture of additional data for the identification of connected counterparties
- Exposure calculation methodology which is different from that under Basel as well as that used internally by banks for large exposure measurement
- Methodology & infrastructure needed to identify the additional risks associated with such vehicles that may result from third parties linked to the structure e.g. through fund managers, liquidity providers and credit protection providers

Given material system changes will be required to accommodate the new rules. Implementation timing mentioned in the consultative document is 2019, we would suggest the Committee to encourage regulators to publish guidelines soon after the Basel document is finalised so that the banks can plan ahead the system development and implementation.