New Banking Exposure Limit Rules: Large Exposure
March 2019

On 7th December 2017, the Basel Committee on Banking Supervision (‘BCBS’) published the final standard of its reforms for the calculation of risk weighted assets (‘RWA’) and capital floors. These papers complete the work that BCBS has been undertaking since 2012 to recalibrate the Basel III framework. Basel III was introduced to address the most pressing deficiencies that emerged from the 2007-08 crisis and aims at making banks more resilient.

The supervisory framework for measuring and controlling Large Exposures was finalized by the BCBS in 2014. Thus, these requirements will come into force sooner than most of the Basel III rules, combined with additional requirements by the HKMA. The new Large Exposure framework will not only change a bank’s exposure limits, but also affect its lending business and its processes, data and systems. This includes the assessment of both new and existing credit exposures with respect to the new rules.

Focus: Large Exposure limits
Limits for exposures to single counterparties and group of linked counterparties

Key changes to the Large Exposure framework

Exposure limit ratios relate to Tier 1 capital
The exposure limit ratios will be calculated based on Tier 1 capital; Tier 2 capital is removed from the capital base

Grouping of counterparties considers economic dependency
Grouping of linked counterparties based on control and based on economic dependency (e.g. same source of revenues or funding)

Calculation of the exposure value more complex
Application of credit risk mitigation incl. exposure shifting, counterparty credit risk (CCR), new and changed exemptions for certain counterparties

Grace period
Grace period of 3 to 6 months is granted for certain BELR exposure limits for excesses of new BELR limits if there was no breach under the old rules

Implementation timeline (Large Exposure framework)

BELR gazetted
Code of Practice and new return to be published soon
First application of BELR by 1st July
First reporting of new Return of Large Exposures
Grace period for limit breaches under the new rules expires on 31st Dec.
Measuring and controlling Large Exposures – Timeline and thresholds

One of the key lessons from the financial crisis was that banks did not always consistently measure and control large exposures across their books and operations. The new Large Exposure framework which comes into force on 1st July 2019 aims at eliminating this weakness: It introduces new identification and calculation rules and reduces the capital base to Tier 1 capital.

Implementation timeline for Hong Kong AIs

- BCBS 283 sets 1st January 2019 as application date
- The new Banking (Exposure Limits) Rules (“BELR”) in relation to Equity Exposures was already set into force on 13th July 2018
- The BELR will take effect on 1 July 2019
- Transitional provisions in the Rules grant authorized institutions a grace period of 3 to 6 months starting from the effective date for excesses of certain limits

Strategic considerations

- Identification of new threshold excesses after removal of Tier 2 capital from the capital base
- In-depth assessment and new data required for exposures exceeding 5% of Tier 1 capital (e.g. sources of revenue) to identify ‘economic dependency’
- Incorporation of new limit amounts and data needs in business and reporting processes and IT systems
- The mandatory consideration of credit risk mitigation and indirect exposures might ‘shuffle’ a bank’s current Large Exposure portfolio

Key thresholds and requirements

<table>
<thead>
<tr>
<th>Threshold in % of Tier 1 Capital</th>
<th>Counterparties and exposures</th>
<th>Regulatory requirements</th>
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<tbody>
<tr>
<td><strong>25%</strong></td>
<td>Single counterparty or group of linked counterparties*</td>
<td>General Large Exposure limit</td>
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<td></td>
<td>Exemptions, e.g. sovereign, central bank, and interbank intraday exposures</td>
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<td>Aggregated equity (and equity-related) exposure</td>
<td>Aggregated Equity Exposure limit for banks in Hong Kong (Section 87 under Part XV of the Banking Ordinance)</td>
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<td>Set into force on 13 July 2018</td>
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<td><strong>15%</strong></td>
<td>Inter-G-SIBs only: Single counterparty or group of linked counterparties*</td>
<td>Large Exposure limit for exposures between G-SIBs</td>
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<td><strong>10%</strong></td>
<td>Single counterparty or group of linked counterparties*</td>
<td>Classification as ‘Large Exposure’</td>
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<td>Reporting of such exposures before and after credit risk mitigation (if exceeding the 10%-threshold in one of both cases)</td>
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<td>Reporting of exempted exposures that exceed the 10%-threshold</td>
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<td>(In general, banks have to report their largest 20 exposures, regardless of their value relative to the banks’ Tier 1 capital)</td>
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<tr>
<td><strong>5%</strong></td>
<td>Single counterparty</td>
<td>Identification of linked counterparties</td>
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<td>This includes an assessment of potentially linked counterparties based on control as well as economic interdependence</td>
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*The term “group of linked counterparties” relates to the concept of “connected counterparties” in BCBS 283 and describes counterparties that are connected either by a control-based or an economic dependency.
Measuring and controlling Large Exposures – Scope and calculation changes

The new Large Exposure rules will increase the data requirements for Banks as well as require them to identify linkages between their clients. One of the greatest challenge will be to identify the legally independent clients’ economic inter-connection and flag those who are economically dependent on each other.

Key Changes

<table>
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<th>In Scope Exposures</th>
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<tbody>
<tr>
<td>Single counterparties</td>
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<td>Linked counterparties</td>
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<tr>
<td>Linked investments</td>
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</tbody>
</table>

New requirements for identification and grouping of linked counterparties
- by control relationship (amendments to current rules)
- by economic dependency (new)

New and changed exemptions for certain counterparties, e.g. bank exposures now in scope

Key Challenges

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<tr>
<th>Implementation of new identification and grouping requirements in processes and IT systems for exposures ≥ 5% of Tier 1 Capital</th>
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<td>Grouping of legally independent clients based on their economic dependencies which requires an assessment of clients’ business relations</td>
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The changed counterparty grouping requirements have to be reflected in the existing exposure calculating engines
The calculating engine has to take indirect exposure amounts into account while computing the scope of exposures and their value

Consideration of new and changed input data for the exposure calculation
BSC and IRB user will have to implement the STC credit risk mitigation rules

Assessment and projection of changes to the Large Exposure portfolio with respect to the lowered limit
Revision of processes, internal controls and IT systems to set Tier 1 Capital as calculation basis, as well as to remove Tier 2 capital reference
G-SIBs only: Consideration of the new Inter G-SIB limit for exposures to G-SIBs

Reporting of the following exposures
- Exposures ≥ 10% of Tier 1 capital
- Exposures ≥ 10% of Tier 1 capital without CRM
- Exempted exposures ≥ 10% of Tier 1 capital
- Largest 20 exposures

How to identify economically dependent counterparties

Three sample criteria for economic interdependence:

- 50% of one bank client’s gross receipts or gross expenditures stem from relations with another bank client (e.g. revenues or rental income)
- Economic dependency on one customer (significant part of the goods sold to one customer)
- Two or more bank clients rely on the same source for the majority of their funding and are unable to identify alternative funding source

Counterparties that meet the criteria of control relations or economic dependency have to be grouped together.

New and existing exposures need to be assessed for economic dependency or control relationship. Therefore, processes and IT systems need to be adjusted.
How PwC can support you

Supporting several HK banks with the implementation of the new Banking Exposure Limit Rules, we have a deep expertise and proven experience with the analysis and implementation of the new requirements. We are happy to assist you with your strategic impact assessment, your gap analysis, your implementation and testing!

If you like to discuss the Large Exposure framework or any other Basel III component in greater depth, please reach out to one of the following Basel III team members in Hong Kong.

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**PwC Materials**

- Dedicated PwC Basel III Webpage: [https://www.pwc.com/baseliv](https://www.pwc.com/baseliv)
- Dedicated PwC Basel III channel – The channel is a new medium to give you a periodical overview on current topics around Basel III reforms. It comprises a series of online lectures supported by slides:  
  [https://www.youtube.com/channel/UCosEew32uLF9ApURO488g]
- Register for the Basel III channel: [https://www.pwc.com/gx/en/services/advisory/basel-iv/register-basel-iv.html](https://www.pwc.com/gx/en/services/advisory/basel-iv/register-basel-iv.html)

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