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.

### Timeline for Basel III in Hong Kong

While most Basel requirements go live in 2022, the new Large Exposure rules are applicable by 2019

Presumable initial application dates of the new standards in Hong Kong

#### Large Exposure framework

**2014 & 2016**
- 04/2014 Final BCBS Framework for Large Exposures (BCBS 283)
- 03/2016 HKMA Consultation Paper (CP 16.01) Exposure Limits

**2018**
- Consultations on Banking (Exposure Limits) Rules (changes to Section 87 of BO):
- Equity Exposure Limits (HKMA), applicable as of 13th July (presumably)

**2019**
- Expected first application of amended Large Exposure Rules by 1st January (presumably)
- Main CAR impact takes place as of 2022. However, today’s business and pricing decisions on long-term instruments determine the future capital requirement!

**2022**
- CR-SA
- IRB
- Funds
- Operational Risk
- Market risk
- Capital floor (Phase-in)

**2027**
- Capital Floor fully phased-in 72,5%

#### Pillar I ratios

**Overview**

**Large Exposures**

**Capital ratio**
- CET1
- RWA

**LCR**
- Liquidity buffer
- Net cash outflows

**NSFR**
- Available stable funding
- Required stable funding

**Leverage ratio**
- Tier 1 Capital
- Total exposure
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 is supposed to come into force in 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
- HKMA is working on the finalization of the new Banking (Exposure Limits) Rules (“BELR”) which shall come into force by 1st January 2019 (in consultation)
- The BELR in relation to Equity Exposures is currently under the negative vetting process by the Legislative Council. Proposed commencement date: 13th July 2018

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 interdependence’
- 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>
</tr>
</thead>
<tbody>
<tr>
<td>25%</td>
<td>Single counterparty or group of linked counterparts*</td>
<td>General Large Exposure limit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Exemptions, e.g. sovereign, central bank, and interbank intraday exposures</td>
</tr>
<tr>
<td></td>
<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>
</tr>
<tr>
<td></td>
<td></td>
<td>Currently under negative vetting by the Legislative Council</td>
</tr>
<tr>
<td>15%</td>
<td>Inter-G-SIBs only: Single counterparty or group of linked counterparties*</td>
<td>Large Exposure limit for exposures between G-SIBs</td>
</tr>
<tr>
<td>10%</td>
<td>Single counterparty or group of linked counterparties*</td>
<td>Classification as ‘Large Exposure’</td>
</tr>
<tr>
<td>5%</td>
<td>Single counterparty</td>
<td>Identification of linked counterparties</td>
</tr>
<tr>
<td></td>
<td></td>
<td>This includes an assessment of potentially linked counterparties based on control as well as economic interdependence</td>
</tr>
</tbody>
</table>

* 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 interdependence.
## Measuring and controlling Large Exposures – Scope and calculation changes

The new Large Exposure rules will increase the data requirements for Banks as well as challenge them to identify the connections 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 interdependent.

### Key Changes

<table>
<thead>
<tr>
<th>Scope</th>
<th>Exposure computation</th>
<th>Regulatory limits</th>
<th>Regulatory Reporting to HKMA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>In Scope Exposures</strong></td>
<td><em>Exposure value determination</em></td>
<td><em>Large Exposure limits:</em></td>
<td>Reporting of the following exposures</td>
</tr>
<tr>
<td>- Single counterparties</td>
<td>- Partially aligned with capital requirements (STC)</td>
<td>- Single counterparty/group of linked counterparties: 25% of Tier 1 Capital</td>
<td>- Exposures ≥ 10% of Tier 1 capital</td>
</tr>
<tr>
<td>- Linked counterparties</td>
<td>- Off-balance sheet exposures with prescribed credit conversion factors, incl. 10%-Floor</td>
<td>- Inter G-SIB (G-SIB to another G-SIB): 15% of Tier 1 Capital</td>
<td>- Exposures ≥ 10% of Tier 1 capital without CRM</td>
</tr>
<tr>
<td>- Linked investments</td>
<td>- Calculation of counterparty credit risk under the new SA-CCR (when set into force)</td>
<td>Tier 2 not eligible as part of the capital base anymore</td>
<td>- Exempted exposures ≥ 10% of Tier 1 capital</td>
</tr>
<tr>
<td><strong>New requirements for identification and grouping of linked counterparties</strong></td>
<td><em>Credit Risk Mitigation techniques</em></td>
<td></td>
<td>- Largest 20 exposures</td>
</tr>
<tr>
<td>- by control relationship (amendments to current rules)</td>
<td>- Requirement to consider eligible collateral, guarantees, credit derivative contracts, and netting</td>
<td></td>
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</tr>
<tr>
<td>- by economic interdependence (new)</td>
<td>- Consideration as ‘indirect exposure’ to the credit protection provider</td>
<td></td>
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<tr>
<td><strong>New and changed exemptions</strong> for certain counterparties</td>
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</tbody>
</table>

### Key Challenges

<table>
<thead>
<tr>
<th>Implementation of new identification and grouping requirements in processes and IT systems for exposures ≥ 5% of Tier 1 Capital</th>
<th>The changed counterparty grouping requirements have to be reflected in the existing exposure calculating engines</th>
<th>Assessment and projection of changes to the Large Exposure portfolio with respect to the lowered limit</th>
<th>Revision of the logic of the reporting engine and the reporting data fields</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Grouping of legally independent clients based on their economic interdependences</strong> which requires an assessment of clients’ business relations</td>
<td>The calculating engine has to take indirect exposure amounts into account while computing the scope of exposures and their value</td>
<td>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</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Consideration of new and changed parameters for the exposure calculation</td>
<td>G-SIBs only: Consideration of the new Inter G-SIB limit for exposures to G-SIBs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>BSC and IRB user will have to implement the STC credit risk mitigation rules</td>
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</tbody>
</table>

### How to identify economically interdependent counterparties (required if exposure ≥ 5% of Tier 1 capital)?

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

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

*Every new and existing exposure exceeding 5% of Tier 1 Capital needs to be assessed for economic interdependence or control relationship. Therefore, processes and IT systems need to be adjusted to incorporate new data needs*
How PwC can support you

To help you assess and understand the impacts of the recently-announced reforms, we have established a team of Basel III experts across our global network. Our experts have a wealth of experience and expertise around the intricate workings of Basel III and are dedicated to assisting banks with assessing and meeting the new Basel III requirements.

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/gx/en/services/advisory/basel-iv.html

• 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/UCosEew32vLFgApuGROq48bBq

• Register for the Basel III channel: https://www.pwc.com/gx/en/services/advisory/basel-iv/register-basel-iv.html


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