G.N. 3887

BANKING ORDINANCE (Chapter 155)

CODE OF PRACTICE

The Monetary Authority, pursuant to section 97M(1) of the Banking Ordinance (Chapter 155), approves and issues a code of practice after consultation with the persons specified in section 97M(2) of that Ordinance. The Monetary Authority hereby, as required pursuant to section 97M(3) of that Ordinance:—

(a) identify the following code (with English and Chinese versions) as being that code entitled:—

(i) in English — 'Code of Practice for the Purposes of Providing Guidance in Respect of the Provisions of Rules 20(4)(b), 29(2), 31, 41 and 59 of the Banking (Exposure Limits) Rules (Chapter 155S)'; and

(ii) in Chinese —「就《銀行業(風險承擔限度)規則》(第155S章)第20(4)(b), 29(2), 31, 41及59條的條文提供指引的實務守則」;

(b) specify 1 July 2019 as the date on which the Monetary Authority's approval of the code is to take effect; and

(c) specify the following provisions of the Banking (Exposure Limits) Rules (Chapter 155S) as the relevant provisions for which the code is approved:—

(i) Rule 20(4)(b);

(ii) Rule 29(2);

(iii) Rule 31;

(iv) Rule 41; and

(v) Rule 59.

14 June 2019 Norman T. L. CHAN *Monetary Authority*

Code of Practice

for the Purposes of Providing Guidance in Respect of the Provisions of Rules 20(4)(b), 29(2), 31, 41 and 59 of the Banking (Exposure Limits) Rules (Chapter 155S)

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Code of Practice for the Purposes of Providing Guidance in Respect of the Provisions of Rules 20(4)(b), 29(2), 31, 41 and 59 of the Banking (Exposure Limits) Rules (Chapter 155S)

(Approved and issued by the Monetary Authority pursuant to section 97M(1) of the Banking Ordinance (Chapter 155))

I. Preliminary

1. Citation

This code of practice may be cited as the Banking (Exposure Limits) Code.

2. Interpretation

(1) In this code of practice, BELR means the Banking (Exposure Limits) Rules (Chapter 155S).

(2) All words and expressions used in this code of practice that are defined in the BELR have the same meaning as in the BELR.

(3) Unless the context otherwise requires, a reference to a rule in this code of practice means a rule of the BELR.

II. Guidance

3. Guidance on rule 20(4)(b) of the BELR in respect of "a competent and reliable third party market data provider"

(1) Rule 20(4) provides as follows:

"For subrule (1)(c), Formula 2 may be used if—

(a) the 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 lower 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."

(2) In determining, for the purposes of rule 20(4)(b), whether a third party market data provider is competent and reliable, an authorized institution should take into account the following in respect of the third party market data provider:

(a) market position and reputation;

(b) financial strength and service capability;

(c) track records;

(d) contingency service arrangements;

(e) any other factors that the authorized institution considers appropriate or relevant.

4. Guidance on rule 29(2) of the BELR in respect of "acceptable to a prudent banker"

(1) Rule 29(2) provides as follows:

"For the definitions of ***secured financial facility*** and ***unsecured financial facility*** in subrule (1), a security is an acceptable security if, in the opinion of the Monetary Authority, it would be acceptable to a prudent banker."

(2) The Monetary Authority considers that, for the purposes of rule 29(2), a security would be acceptable to a prudent banker if the security falls under section 79(1)(a) to (o) of the Capital Rules or is real property with an available secondary market.

5. Guidance on rule 31 of the BELR in respect of "a method to calculate an employee's annual salary that the Monetary Authority considers reasonable"

(1) Rule 31 provides as follows:

"An authorized institution must not, except with a consent given under rule 32, for any of its employees, at any time maintain an

aggregate financial facility amount exceeding the employee's annual salary calculated by a method that the Monetary Authority considers reasonable."

(2) The Monetary Authority considers, for the purposes of rule 31, a method to calculate the annual salary of an authorized institution's employee reasonable if the method reflects the sum of (i) the basic salary (including overtime payment as applicable) payable to the employee for the year concerned; (ii) any other fixed monetary payments and benefits (e.g. fixed annual bonuses and housing allowances) payable to the employee for the year concerned; and (iii) estimated performance-based commissions and incentives payable to the employee for the year concerned. Other variable payments and non-monetary benefits such as variable bonuses and medical insurance should be excluded from the calculation of the employee's annual salary for the purposes of rule 31.

(3) For the purpose of subparagraph (2), an authorized institution should regard "the year concerned" as a period of 12 months starting on the first day of the current month or as the current calendar year. Regarding item (i) in subparagraph (2), an authorized institution should include it in the calculation of an employee's annual salary by either using the employee's historical basic salary received for the 12-month period immediately preceding the year concerned or the annualised basic salary based on the employee's current basic salary. Regarding item (ii) in subparagraph (2), if an authorized institution decides to include it in the calculation of an employee's annual salary, it should calculate the amount by a method which is consistent with that used for item (i) (e.g. if an authorized institution uses the employee's historical basic salary received for the 12-month period immediately preceding the year concerned for calculating the amount of item (i), in calculating the amount of item (ii), the institution should use the employee's historical fixed monetary payments and benefits received for the 12-month period immediately preceding the year concerned). Regarding item (iii) in subparagraph (2), if an

authorized institution decides to include it in the calculation of an employee's annual salary, it should estimate the performance-based commissions and incentives payable to the employee for the year concerned by using the average amount of the performance-based commissions and incentives paid to the employee over the last three 12-month periods (to the extent applicable) immediately preceding the year concerned.

(4) An authorized institution should take into account the following factors in developing a specific method to calculate an employee's annual salary which is consistent with the guidance set out in subparagraphs (2) and (3) and document its rationale for developing such specific method:

(i) the institution's risk management policies (such as its risk appetite and tolerance) in respect of providing financial facilities to its employees;

(ii) the institution's remuneration policies and practice;

(iii) potential impact on an employee's annual salary calculated by the specific method from economic cycles or other factors that may fluctuate over time; and

(iv) versatility of a method to accommodate different scenarios (e.g. a steady or fluctuating basic salary, length of service of an employee and the dominating component of a remuneration package).

(5) An authorized institution is expected to apply the specific method developed by it consistently to all of its employees and continuously over the years unless the institution could demonstrate that there are particular circumstances of a case which would justify a different method (for which the institution should document its rationale behind).

6. Guidance on rule 41 of the BELR in respect of "economically dependent"

(1) Rule 41 provides as follows:

"(1) For this Part, subject to subrules (3), (4) and (5)—

(a) for a counterparty of an authorized institution (***reference counterparty***), another counterparty of the institution is a linked counterparty of the reference counterparty if the other counterparty is an entity specified in subrule (2); and

(b) the reference counterparty and all of its linked counterparties are collectively treated as an LC group of the institution.

(2) The other counterparty is one that is—

(a) an entity that controls the reference counterparty;

(b) an entity that is controlled by the entity that controls the reference counterparty;

(c) an entity that is controlled by the reference counterparty;

(d) an entity that is not an entity specified in paragraph (a), (b) or (c), but is economically dependent on the reference counterparty or an entity specified in paragraph (a), (b) or (c);

(e) an entity that is controlled by an entity specified in paragraph (d); or

(f) any other entity that—

(i) controls; and

(ii) is economically dependent on,

an entity specified in paragraph (d).

(3) For subrule (1), if the reference counterparty is a counterparty in relation to which the institution's ASCE ratio does not exceed 5% or is an exempted sovereign entity, the institution, in determining its ASC exposure to the LC group (by reference to the reference counterparty), may treat any of the following entities as not being in the LC group—

(a) an entity specified in subrule (2)(d) that is economically dependent on the reference counterparty;

(b) an entity specified in subrule (2)(e) that is controlled by an entity specified in paragraph (a);

(c) an entity specified in subrule (2)(f) that controls and is economically dependent on an entity specified in paragraph (a).

(4) For subrule (1), if a counterparty of an authorized institution (***counterparty A***) is a linked counterparty of the reference counterparty by virtue of subrule (2)(a), (b) or (c) and the institution's ASCE ratio in relation to the counterparty A does not exceed 5%, the institution, in determining its ASC exposure to the LC group (by reference to the reference counterparty), may treat any of the following entities as not being in the LC group—

(a) an entity specified in subrule (2)(d) that is economically dependent on the counterparty A;

(b) an entity specified in subrule (2)(e) that is controlled by an entity specified in paragraph (a);

(c) an entity specified in subrule (2)(f) that controls and is economically dependent on the entity specified in paragraph (a).

(5) For subrule (1), if 2 or more counterparties of an authorized institution—

(a) are controlled by, or economically dependent on, an exempted sovereign entity, a specified sovereign-owned entity or The Financial Secretary Incorporated established under the Financial Secretary Incorporation Ordinance (Cap. 1015); and

(b) are otherwise not in an LC group under subrule (1),

regardless of whether the exempted sovereign entity, the specified sovereign-owned entity or The Financial Secretary Incorporated is a counterparty of the institution, the counterparties are treated as not being in an LC group of the institution.

(6) For this rule, subject to subrule (7), an entity (***subordinate entity***) is treated as being controlled by another entity (***parent entity***) if—

(a) the parent entity owns more than 50% of the voting rights in the subordinate entity;

(b) the parent entity has control of a majority of the voting rights in the subordinate entity under an agreement with other shareholders (or similar holders of voting rights);

(c) the parent entity has the right to appoint or remove a majority of the members of the subordinate entity's board of directors (or a similar governing body);

(d) a majority of the members of the subordinate entity's board of directors (or a similar governing body) have been appointed solely as a result of the parent entity exercising its voting rights; or

(e) the parent entity has the power, under a contract or otherwise, to exercise a controlling influence over the management or policies of the subordinate entity.

(7) For subrule (6), in so far as a parent entity falls within subrule (6)(a), (b), (c), (d) or (e), by virtue of its fiduciary capacity on behalf of a non-anonymous beneficiary—

(a) the subordinate entity is not to be treated as being controlled by the parent entity; and

(b) to avoid doubt, the subordinate entity is treated as being controlled by the beneficiary if, by virtue of the beneficiary's beneficial interest—

(i) the beneficiary owns more than 50% of the voting rights in the subordinate entity;

(ii) the beneficiary has control of a majority of the voting rights in the subordinate entity under an agreement with other shareholders (or similar holders of voting rights);

(iii) the beneficiary has the right to appoint or remove a majority of the members of the subordinate entity's board of directors (or a similar governing body);

(iv) a majority of the members of the subordinate entity's board of directors (or a similar governing body) have been appointed solely as a result of the beneficiary exercising its voting rights; or

(v) the beneficiary has the power, under a contract or otherwise, to exercise a controlling influence over the management or policies of the subordinate entity.

(8) For this rule, an entity (***Entity A***) is economically dependent on another entity (***Entity B***) if they are connected in a way that if Entity B were to encounter financial problems (in particular funding or repayment difficulties), Entity A would also be likely to encounter financial problems (in particular funding or repayment difficulties).

(9) In this rule—

specified sovereign-owned entity (指明官方擁有實體) means an entity that is specified in Schedule 2."

(2) When an authorized institution assesses, for the purposes of rules 41(2)(d), 41(2)(f)(ii), 41(3)(a) , 41(3)(c), 41(4)(a) , 41(4)(c), 41(5)(a) and 41(8), whether a counterparty is economically dependent on another entity, the authorized institution may rely on information provided in good faith by the counterparty that is potentially economically dependent on another entity provided that such information is not in conflict with any information otherwise available to or in possession of the authorized institution. An authorized institution is expected to request a counterparty to provide the relevant information which could facilitate the authorized institution's assessment of the counterparty's economic dependence during regular credit reviews, at the time of the authorized institution granting new credit facilities to the counterparty, and immediately when the authorized institution is aware of any indications that the counterparty is economically dependent on another counterparty.

(3) An authorized institution should calculate, for the purposes of rules 41(3) and 41(4), its ASCE ratio in relation to a reference counterparty or counterparty A by determining its ASC exposure to the reference counterparty or counterparty A in accordance with rule 46. In other words, the calculation should take into account the provisions on exposures disregarded under rule 48, credit risk mitigation under Subdivision 2 of Division 3 of Part 7, specific circumstances

(including in relation to credit protection provider) under Subdivision 3 of Division 3 of Part 7 and offsetting and deduction under Subdivision 4 of Division 3 of Part 7.

(4) An authorized institution should regard, for the purposes of rule 41(8), that if Entity B were to encounter financial problems (in particular funding or repayment difficulties), Entity A would also be likely to encounter financial problems (in particular funding or repayment difficulties) and hence Entity A is economically dependent on Entity B when any of the following applies:

(i) 50% or more of the gross receipts or gross expenditures (on an annual basis) of Entity A are derived from transactions with Entity B;

(ii) Entity A has fully or partly guaranteed the exposure of Entity B, or is liable in respect of that exposure in any other manner (e.g. by the giving of an indemnity), and the exposure is so significant that Entity A is likely to default if a claim occurs;

(iii) 50% or more of Entity A's product/output or services is sold to Entity B, and Entity B cannot easily be replaced by other customers;

(iv) the expected source of funds to repay the loans of both Entity A and Entity B is the same and neither Entity A nor Entity B has another independent source of income from which the loans may be fully repaid;

(v) it is likely that the financial problems of Entity B would cause difficulties for Entity A in terms of full and timely repayment of liabilities;

(vi) the insolvency or default of Entity A is likely to be associated with the insolvency or default of Entity B;

(vii) both Entity A and Entity B rely on the same source for 50% or more of their funding and neither Entity A nor Entity B has another independent source of funding.

(5) To avoid doubt, when Entity A is economically dependent on Entity B, an authorized institution should include Entity A in the LC group of

Entity B. However, if Entity B is not economically dependent on Entity A, an authorized institution should not include Entity B in the LC group of Entity A unless Entity B meets other criteria for inclusion in the LC group of Entity A.

(6) In relation to subparagraph (4)(iv) and (vii) above, Entity A and Entity B are regarded as economically dependent on each other; however, it is not necessary to regard Entity A and Entity B as economically dependent on each other merely on the grounds that they are employees of the same employer.

(7) In relation to subparagraph (4)(v) and (vi) above, it is not necessary to regard Entity A as economically dependent on Entity B merely on the grounds that Entity B is the employer of Entity A.

7. Guidance on rule 59 of the BELR in respect of valuation of CCR exposure of derivative contracts

(1) Rule 59 provides as follows:

"A CCR exposure arising from a derivative contract entered into by an authorized institution is valued by using the following methods—

(a) if the institution does not adopt an internal modelling approach to calculate the amount of the default risk exposure of its derivative contracts for calculating its capital adequacy ratio under the Capital Rules—the method that the institution currently adopts (being a method prescribed under the Capital Rules) for that calculation, but without converting the exposure into a risk-weighted amount as in the case of determining regulatory capital under the Capital Rules;

(b) if the institution adopts an internal modelling approach to calculate the amount of the default risk exposure of its derivative contracts for calculating its capital adequacy ratio under the Capital Rules—a method prescribed under the Capital Rules, as notified by the Monetary Authority in writing after consultation with the institution."

(2) In valuing CCR exposure of derivative contracts, pursuant to rule 59(a) or (b), by a method prescribed under the Capital Rules, the following general principle of the Capital Rules applies - exposures

arising from posted collateral to a counterparty will be subject to a capital requirement only if the collateral is held by the counterparty in a manner that is not bankruptcy remote from the counterparty. Accordingly, for the purposes of valuing CCR exposure of derivative contracts under rule 59, an authorized institution may exclude its collateral posted as initial margin to the counterparty if the collateral is held by the counterparty in a manner that is bankruptcy remote from the counterparty.

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14 June 2019