Annex 4

IRB Approach: Categorization of Exposures

1. Policies and Procedures for the Categorization of Banking Book Exposures

1.1 A commercial bank shall have in place the policies for the categorization of banking book exposures, the procedures for the classification and adjustment of exposures, the corresponding internal controls, and the related reporting system as a part of its management information system (MIS).

1.2 A commercial bank shall develop the criteria and processes for the categorization of exposures in line with the bank’s governance framework, portfolio status and risk characteristics. Where the categorization criteria adopted by the bank are different from what are prescribed in the Rules, the bank shall file its own criteria with the CBRC.

1.3 A commercial bank shall designate an internal department to lead the categorization of exposures. The determination and verification of exposures categorization shall be performed by two independent functions.

1.4 A commercial bank shall categorize its banking book exposures into the corresponding classes in accordance with the prescribed criteria. Exposures that do not meet the criteria for being categorized as sovereign exposures, financial institution exposures, retail exposures, equity exposures or other exposures but take on credit risk shall be categorized into corporate exposures.
1.5 A commercial bank shall adjust its exposure classes according to the changes in the risk characteristics of exposures. The adjustment of exposure classes shall be completed within half a year after the emergence of the characteristics that marks the need for adjusting exposure classes.

1.6 A commercial bank shall establish an internal reporting system for the categorization and adjustment of banking book exposures, and shall report the categorization and exposure status to the Board of Directors and senior management on a regular basis.

1.7 A commercial bank shall mark the exposure class of each business in the relevant information system.

1.8 A commercial bank shall establish an internal audit system for the categorization of banking book exposures, and audit the categorization practices on a regular basis.

2. Sovereign Exposures

Sovereign exposures refer to a commercial bank’s claims on a sovereign states or economic jurisdictions and their central bank, a non-central government public sector entity, as well as Multilateral Development Banks (MDBs), the Bank for International Settlements, the International Monetary Fund and so on.

The scope of MDBs is defined in Article 56 of the Rules.

3. Financial Institution Exposures

3.1 Financial institution exposures refer to a commercial bank’s claims on financial institutions. The bank shall categorize the financial institution exposures into two sub-classes, i.e. banking institution exposures and non-banking financial institution exposures.
3.2 Banking institutions include commercial banks, rural cooperative banks, rural credit cooperatives and other financial institutions taking public deposits that are established within the territory of the People’s Republic of China, as well as the deposit-taking financial institutions incorporated outside the territory of the People’s Republic of China and approved by the financial regulatory authorities in the host country or jurisdiction.

3.3 Non-banking financial institutions include securities companies, insurance companies, trust companies, finance companies, financial leasing companies, auto financing companies, currency brokerage companies, asset management companies, fund companies and other institutions that are established with the approval and are subject to the supervision of the financial regulatory authorities.

4. Corporate Exposures

4.1 Corporate exposures refer to a commercial bank’s claims on companies, partnerships, proprietorships and other non-natural persons, but do not include claims on sovereigns, financial institutions or corporates included in the retail exposures.

4.2 According to the type of obligor and risk characteristics, corporate exposures are categorized into three sub-classes, i.e. small- and medium-sized entities (SME) exposures, specialised lending exposures and general corporate exposures.

4.3 SME exposures refer to a commercial bank’s claims on corporates with annual sales (arithmetic mean value of sales in recent three years) of no more than RMB 300 million.

4.4 Specialised lending refers to claims within corporate exposures possessing all of the following characteristics:

4.4.1 The borrowing entity is usually a special purpose entity established for physical asset financing or operation;
4.4.2 The borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed; and

4.4.3 The terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates.

4.5 Specialised lending can be sub-categorized into project finance, object finance, commodities finance and income-producing real estate.

4.6 Project finance shall have all of the following features in addition to the characteristics of specialised lending:

4.6.1 The purpose of financing is usually to build a single or a set of large capital installation including construction of plants and infrastructure. Project finance may be also in the form of refinancing of an existing installation, with or without improvements;

4.6.2 The borrowing entity is usually established to develop, operate or finance the installation; and

4.6.3 The repayment depends primarily on the project’s cash flow, including the sales revenue, subsidies or other revenue generated by the project, and generally there are no other sources of repayment.

4.7 Object finance shall have all of the following features in addition to the characteristics of specialised lending:

4.7.1 The purpose of financing is to fund the acquisition of physical assets, e.g. ships, aircraft and rail transportation vehicles; and

4.7.2 Repayment is dependent on the cash flows generated by the specific assets that have been financed and pledged or assigned to the lender. A primary source of these cash flows might be rental or lease contracts with one or several third parties.
4.8 Commodities finance shall have all of the following features in addition to the characteristics of specialised lending:

4.8.1 Commodities finance refers to structured short-term lending to finance reserves, inventories or receivables of exchange-traded commodities (e.g. crude oil, metals or crops);

4.8.2 The borrower has no other material assets, and the repayment mainly relies on the proceeds of the sale of the commodity; and

4.8.3 The exposure’s rating reflects its self-liquidating nature and the lender’s skill in structuring the transaction rather than the credit quality of the borrower.

4.9 Income-producing real estate shall have all of the following features in addition to the characteristics of specialised lending:

4.9.1 The borrower is usually an entity devoted to financing projects, or can be an operating company focused on real estate construction or holdings;

4.9.2 The purpose of financing is to develop, sell or rent out real estate (such as office buildings, retail spaces, multifamily residential buildings, industrial and warehouse spaces and hotels), as well as for land development and reserve; and

4.9.3 Repayment mainly relies on lease or rental payment, sales revenue or land usage fee.

4.10 General corporate exposures refer to corporate exposures other than SME exposures and specialised lending.

5. Retail Exposures

5.1 Retail exposures shall have all of the following characteristics:

5.1.1 The exposure is to one or more natural persons;
5.1.2 The exposure is one of a large pool of exposures and is of small money value; and

5.1.3 The exposure is managed by the bank on a pooled basis.

5.2 Retail exposures are subcategorized as residential mortgage loans, qualifying revolving retail exposures and other retail exposures. A commercial bank could make more detailed sub-categories on the above-mentioned basis according to the bank’s own business conditions and management practices.

5.3 Residential mortgage loans are loans extended to individuals that are owners of the residential properties and secured by the purchased residential properties.

5.4 Qualified revolving retail exposures refer to unsecured revolving loans granted to individuals. In a qualifying revolving retail exposure, the maximum exposure to a single individual shall be no more than RMB 1 million.

5.5 Other retail exposures refer to the claims on natural persons other than the residential mortgage loans and qualifying revolving retail exposures.

5.6 Exposures to micro- and small- corporates specified in Article 64 of the rules can be included in the category of “other retail exposures”.

6. Equity Exposures

6.1 Equity exposures refer to direct and indirect ownership interests held by a commercial bank.

6.2 The financial instrument considered to be an equity exposure shall meet all of the following requirements:

6.2.1 The major source of income by holding the financial instrument is from future capital gains rather than profits to be generated over time;
6.2.2 The financial instrument is irredeemable and does not embody an obligation on the part of the issuer, and

6.2.3 The financial instrument conveys a residual claim on the issuer’s assets or income.

6.3 The financial instrument meeting any of the following criteria shall be categorized as an equity exposure:

6.3.1 Having the same structure as permitted as the bank’s Tier 1 capital;

6.3.2 Embodying an obligation on the part of the issuer and meeting all of the following conditions:

a. The issuer may defer indefinitely the settlement of the obligation;

b. The obligation requires (or permits at the issuer’s discretion) settlement by issuance of a fixed number of the issuer’s equity shares;

c. The obligation requires (or permits at the issuer’s discretion) settlement by issuance of a variable number of the issuer’s equity shares; and the change in the value of the variable number of shares issued has a high co-relation with the change in the value of the obligation;

d. The holder has the option to request the obligation be settled in equity shares unless either: (1) in the case of a traded instrument, the bank could demonstrate, which is also confirmed by CBRC, that the instrument trades more like the debt of the issuer, or (2) in the case of non-traded instruments, the bank could demonstrate, which is also confirmed by CBRC, that the instrument should be deemed as a debt.

7. Other Risk Exposures

7.1 Purchased receivables refer to the assets that emerge when the seller, in accordance with the contracts with the buyer on the sales of
commodities, products or labor, transfers its current receivables or receivables to be generated to a commercial bank with or without recourse. Purchased receivables can be divided into two sub-classes, i.e. eligible purchased corporate receivables and eligible purchased retail receivables.

7.2 Eligible purchased retail receivables shall be categorized as retail exposures, and the eligible purchased corporate receivables be categorized in principle as corporate exposures. A commercial bank can also treat eligible purchased corporate receivables as an independent category of exposures. Eligible purchased corporate receivables shall satisfy all the following requirements:

7.2.1 The sales contract signed between the seller and the buyer is genuine, fair, legal and valid, and the seller is able to offer a complete proof of debt for receivables;

7.2.2 The seller is not a connected party of the commercial bank, and the receivables are not directly or indirectly originated by the commercial bank;

7.2.3 Receivables generated from deals among the group’s subsidiaries or connected parties are not eligible receivables; and

7.2.4 A commercial bank has claims on all proceeds from the pool of receivables or a pro-rata interest in the proceeds.

7.3 Securitization exposures refer to credit exposures that arise when a commercial bank is involved in securitization transactions. Securitization exposures include but not limited to exposures arising from asset-backed securities, mortgage-backed securities, credit enhancements, liquidity facilities, interest rate or currency swap, credit derivatives and tranched products
Reserve accounts, if recorded as an asset by the originating bank, must be treated as securitisation exposures. Reserve accounts include but not limited to cash collateral accounts and interest margin accounts.