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Implementation of Basel III Leverage Ratio Framework

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Contents

I INTRODUCTION

1 Overview

1 Basel III introduced a non-risk based Leverage Ratio ("LR") requirement alongside the risk-based capital ratios as a "back-stop" to restrict the build-up of excessive leverage in the banking sector, which was identified as one of the key factors contributing to the global financial crisis.

2 The Basel Committee of Banking Supervision ("BCBS") issued the LR framework together with the associated disclosure requirements in January 2014 ("2014 framework")[1]. Under the BCBS transitional arrangement for Basel III implementation, banks are required to report their LR to regulators for supervisory monitoring based on a 3% "testing minimum" from 2013 until 1 January 2018 (when the LR is finalized for implementation as a minimum Pillar 1 requirement) and to comply with the associated disclosure requirements from 2015. To promote consistent global implementation of the framework, the BCBS subsequently issued supplementary interpretative guidance in the form of frequently asked questions ("FAQs")[2].

3 In view of market comments, further revisions to the framework were proposed in the BCBS consultative document *Revisions to the Basel III leverage ratio framework* published in April 2016 ("2016 proposed revisions")[3]. The BCBS is currently finalizing the LR framework for publication as part of the final package for the outstanding post-crisis reforms.

4 This consultation paper outlines the Hong Kong Monetary Authority's ("HKMA") proposals for implementing the LR framework. The consultation will close on 15 May 2017.

2 Structure of this Consultation Paper

5 This consultation paper is organised as follows:

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[1] http://www.bis.org/publ/bcbs270.pdf

[2] The latest version of *"Frequently asked questions on the Basel III leverage ratio framework"* is at http://www.bis.org/bcbs/publ/d364.pdf

[3] http://www.bis.org/bcbs/publ/d365.pdf

- Section II outlines the general approach to implementing the LR framework in Hong Kong, having regard to the implementation date (i.e. 1 January 2018) under the Basel III transitional arrangement, while the 2016 proposed revisions are still being finalised for the final LR framework to be published by the BCBS.
- Section III sets out proposals in respect of the legislative approach to implementing the LR as a statutory minimum requirement; two specific implementation issues relating to (i) the interaction of the minimum LR requirement and the existing distribution constraint mechanism for capital buffer operation and (ii) the measurement of counterparty credit risk exposures; as well as the consequential changes necessitated by the LR implementation in respect of on-going supervisory monitoring, regulatory reporting and disclosure.
- Section IV summarizes the proposed implementation timeline for bringing the LR framework into effect from 1 January 2018.

II GENERAL APPROACH TO IMPLEMENTATION

6 Under the BCBS transitional arrangement (referred to in paragraph 2 above), locally incorporated authorized institutions ("AIs") in Hong Kong have been required to report to the HKMA their LR based on a *Quarterly Template on Leverage Ratio* ("Quarterly Template") since December 2013. The completion instructions and guidance for reporting the Quarterly Template issued by the HKMA in May 2014[4] incorporates a methodology for calculating the LR based on the 2014 framework. The HKMA also requires AIs to follow the interpretative guidance issued by the BCBS in the form of FAQs in calculating their LR.

7 While the 2016 proposed revisions are still to be finalised for the final LR framework to be published by the BCBS, there is no indication that the BCBS will change the originally decided implementation timeline (i.e. 1 January 2018) of making LR a Pillar 1 minimum standard. In this regard, the HKMA's current thinking is to adopt a "two-phase approach" for implementation:

- <u>First phase</u> (from 1 January 2018) – the minimum LR requirement will be set at 3% (i.e. same as the current testing minimum)[5] calculated on the same basis as the calculation methodology used for reporting the Quarterly Template (which was designed in accordance with the 2014 framework), together with the latest FAQs finalised and published by the BCBS (some of which has already been reflected in the 2016 revisions); and
- <u>Second phase</u> – the minimum LR requirement and its calculation methodology will be revised as necessary in accordance with the final LR framework to be published by the BCBS, taking effect based on the implementation date specified in the final framework.

8 The HKMA considers that the above approach should present little practical difficulty to AIs as the first phase implementation represents in effect a formalisation of what they are already required to calculate and report in the Quarterly Template. For the second phase implementation, the HKMA will consult the industry again when

[4] http://www.hkma.gov.hk/eng/key-functions/banking-stability/basel-3/basel-3_implementation_leverage_ratio_20140509.shtml

[5] The HKMA will however keep in view practices of other jurisdictions in setting the minimum LR requirement for the purpose of reassessing whether any adjustment to the 3% minimum is merited going forward.

the final LR framework is published and ensure that sufficient time is available for AIs to prepare for adopting the framework.

Q1. Do you agree with the general approach described above for implementing the LR framework?

III SPECIFIC IMPLEMENTATION PROPOSALS

1 Legislative approach

9 Existing section 97C of Banking Ordinance ("BO") empowers the Monetary Authority ("MA") to make rules to prescribe "minimum capital requirements for AIs in Hong Kong, taking into account risks associated with the institutions". The HKMA therefore intends to implement LR through incorporating relevant new provisions in the Banking (Capital) Rules ("BCR"), the LR being essentially a requirement on the minimum Tier 1 capital an AI must maintain to cover risks brought about by excessive leverage. Section 97F of the BO further provides the MA with the discretion to vary any capital requirement rules made under section 97C, meaning that the MA may vary the minimum LR for individual AIs (similar to Pillar 2 add-on should the MA consider this necessary in future).

10 In terms of the legislative approach to implementing the LR framework, the HKMA's current thinking is to adopt an approach similar to that previously used for implementing the Liquidity Coverage Ratio. That is, new provisions will be incorporated in the BCR to set out the basic formula for LR calculation and a brief description of the key constituent elements, while the technical calculation mechanics for key constituents will be set out in the standard calculation methodology in the completion instructions for a banking return (see para. 15) to be submitted by an AI to the MA under section 63(2) of the BO. Inter alia, this approach will have the benefit of flexibility to accommodate further changes to the technical calculation mechanics, for instance, to cater for the second phase implementation (referred to in para. 7) and the implementation of the standardized approach to counterparty credit risk ("SA-CCR") (see para. 13), potentially within the next few years.

11 The structure of the required new provisions to be incorporated in the BCR is expected to cover:

- the <u>minimum 3% LR</u> applicable to all locally incorporated AIs;
- the <u>requirement to notify MA</u> by an AI in case it fails to maintain the minimum LR or an LR varied pursuant to section 97F of the BO;
- the <u>calculation basis</u> (solo, solo-consolidated and consolidated) of LR which is the same as the basis for calculation of capital adequacy ratios ("CAR");
- the <u>calculation formula for LR</u> as "Tier 1 capital" divided by "exposure measure", with "Tier 1 capital" cross-referred to existing BCR definition; and

"exposure measure" calculated as sum of an AI's exposure to each of the following 4 components (subject to refinements):

(a) on-balance sheet items (other than derivative contracts and securities financing transactions ("SFTs"));

(b) derivative contracts;

(c) SFTs; and

(d) Off-balance sheet items (other than derivative contracts and SFTs);

- a brief <u>definitional description</u> of each of the above 4 components; and
- a requirement for AIs to calculate their exposure to each of the 4 components by using <u>standard calculation methodology set out in the standard LR template</u> to be submitted by an AI to MA under section 63(2) of the BO.

Q2. Do you agree with the proposed legislative approach for implementing the leverage ratio framework in Hong Kong?

2 Interaction with distribution constraint mechanism for capital buffer operation

12 Where the regulatory (Tier 1) capital required to meet the minimum LR is more than that required to meet the (risk-based) minimum (Tier 1) capital ratio (i.e. when the former is "more binding" than the latter), there is a possibility that some "surplus CET1 capital" (i.e. in excess of the amount of CET1 capital required to meet the risk-based minimum capital ratios) otherwise available to meet capital buffers may need to be retained (for meeting the minimum LR), hence not available for distribution. The HKMA therefore considers it necessary to build in clarification in the BCR (potentially under Division 2 of Part 1B on "Constraint on Distribution Payment") to subject the maximum distribution amount to the minimum LR requirement. The intended effect will be for the LR to be implemented as a completely separate "parallel measure", with calculation of the distribution constraint continuing to be based on the risk based framework only, but capable of being overridden in case distribution based on the calculation would cause an AI to fall below the minimum LR.

Q3. Do you agree with the above interpretation regarding how the minimum LR requirement should interact with the existing distribution contraint mechanism for capital buffer operation?

3 Methodology for measuring counterparty credit risk exposures

13 Another relevant implementation issue relates to the methodology for determining the exposure measure for counterparty credit risk ("CCR") exposures under the LR, where the SA-CCR is incorporated in the risk-based capital framework sooner than in the LR framework as a replacement for the existing current exposure method ("CEM"). In this regard the industry has expressed concerns about AIs having to maintain two systems for measuring CCR exposures based on two different methodologies (viz., the SA-CCR for risk-based capital framework, and the CEM for the LR framework). To address this, the HKMA's proposal is that, pending implementation of the SA-CCR in Hong Kong[6], the first phase implementation of the LR framework (i.e. from 1 January 2018) will be based on the CEM until the final LR framework is implemented, when CEM in the LR calculation methodology are expected to be replaced by (an adjusted version of) the SA-CCR (which is expected to form part of the final LR framework). Where the SA-CCR is implemented in Hong Kong under the risk-based capital framework earlier than the implementation of the final LR framework, the HKMA will endeavor to incorporate swiftly in the calculation methodology (in the completion instructions of the banking return) the option for AIs to use an SA-CCR-based methodology for determining exposure measure.

Q4. Do you have any comments on the proposed arrangement regarding the methodology to be used by AIs before and after the implementation of the SA-CCR in Hong Kong?

4 Ongoing monitoring of minimum Leverage Ratio

14 Given that compliance with the LR minimum beginning from 2018 is a statutory requirement similar to the CAR requirement, the HKMA considers that there is a practical need to incorporate under the Supervisory Review Process an on-going monitoring mechanism based on an AI-specific internal target LR to be agreed with individual AIs.

[6] The SA-CCR was originally scheduled for implementation from 2017 but was postponed primarily for level-playing field reasons due to the delay of US and EU in implementing the standard.

Q5. Do you have any particular views on the proposed monitoring mechanism, particularly in relation to the key attributes (in terms of an AI's risk profile and specific circumstances) that should be considered for the purposes of determining a potential Pillar 2 add-on to the statutory minimum (i.e. 3%) and the AI-specific internal target LR?

5 Regulatory reporting

15 As mentioned in paragraph 6, AIs are currently reporting to the HKMA their LR based on a Quarterly Template. To support implementation of LR as a statutory minimum under the BCR, the HKMA intends to:

(a) formalise the Quarterly Template into a banking return by reformatting the completion instructions as appropriate and updating them to reflect the FAQs published by the BCBS so far on the LR framework. The HKMA is minded to retain in the banking return the same level of granularity as the existing template (at least for first phase implementation); and

(b) amend the Return of Certificate of Compliance to cater for the minimum LR requirement, with the incorporation of a new item under Part II of the Return for an AI to state whether or not its LR complies with the LR specified by the MA.

16 Pursuant to section 63(3) of the BO, the MA may require an AI to submit a report prepared by an auditor appointed by the institution as to whether or not a return submitted or information submitted by the institution is correctly compiled from the books and records of the institution and, if not correctly compiled, the nature and extent of the incorrectness. Section 63(3A) of the BO allows the MA to require AIs to appoint auditors to report on the adequacy of their systems of control over the compilation of banking returns or other information. With the introduction of the new banking return on LR, the scope of section 63(3) and section 63(3A) audits under the BO should accordingly be broadened to cover the return.

6 Disclosure template

17 The implementation of LR will necessitate consequential changes to the existing LR disclosure template specified by the MA under section 6(1)(ab) of the Banking (Disclosure) Rule regarding the explanatory notes of the disclosure template where

references are made to the existing Quarterly Template, as the latter is superseded and revised by the new banking return.

IV IMPLEMENTATION TIMELINE

18 The HKMA proposes to bring into force the relevant requirements described in this consultation paper on 1 January 2018, in line with the internationally agreed timetable. The proposed implementation timeline is as follows:

	Legislative changes	Implementation guidance
Q2 2017	Consult industry on implementation proposals	
Q2/Q3 2017	Prepare draft amendment rules (to the BCR) taking into account comments received from industry consultation	Consult industry on the new banking return of LR (designed based on existing Quarterly Template and completion instructions, having regard to FAQs published by the BCBS) and the revised Certificate of Compliance return
Q3 2017	Conduct statutory consultation of draft amendment rules	
By mid-Oct 2017	Finalize amendment rules taking into account industry comments Gazette amendment rules and submit them to the Legislative Council for negative vetting	
1 Jan 2018	Amendment rules come into effect	AIs to comply with the LR minimum with effect from 1 January 2018
By 31 Mar 2018	-	Launch the new banking return and the revised Certificate of Compliance return