HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref: B9/127C
B4/1C

24 March 2014

By email and by hand

Mr He Guangbei
Chairman
The Hong Kong Association of Banks
Room 525, 5/F
Prince's Building
Central
Hong Kong

Dear Mr He,

Consultation on a framework for systemically important banks in Hong Kong

I am writing to seek comments from the Association with regard to the enclosed consultation paper on a framework for systemically important banks in Hong Kong.

BACKGROUND

The failure of a number of very large, globally active, financial institutions during the recent financial crisis left some authorities in the jurisdictions worst hit with little choice but to effectively bail out these "too big to fail" entities using public funds, in order to prevent severe disruption to banking and financial systems and to their economies more broadly. In the wake of the costs of (and the moral hazard associated with) these interventions, the G20 Leaders charged the Financial Stability Board ("FSB") with the task of developing a policy framework to address the "negative externalities" (i.e. spillover systemic risks) posed by these systemically important financial institutions ("SIFIs"). The SIFI framework extends not only to global systemically important banks ("G-SIBs") but also to banks that are systemically important at domestic level ("D-SIBs").

The Basel Committee on Banking Supervision ("BCBS") issued in October 2012 a principles-based framework for D-SIBs ("the D-SIB principles"), which allows for appropriate national discretion to accommodate the structural characteristics of a jurisdiction's domestic financial system. The principles include guidelines for authorities to assess the systemic importance of banks in a domestic context, with the option for countries to go beyond the minimum D-SIB framework and impose additional requirements based on the specific features of their jurisdictions and their domestic banking sectors.

PROPOSALS IN THE CONSULTATION PAPER

The enclosed paper covers proposals on:

Assessment methodology for identifying D-SIBs – Drawing from the BCBS G-SIB framework and D-SIB principles, the HKMA proposes a quantitative indicator-based approach, overlaid with qualitative indicators to be incorporated by supervisory judgement, for the purpose of identifying D-SIBs in Hong Kong.

Quantitative indicators for assessing bank-specific factors – The key bank-specific factors identified by the BCBS in assessing D-SIBs are: size, interconnectedness, substitutability and complexity. "Total assets" is proposed to be used as the quantitative indicator for size in Hong Kong; "placement with banks", "deposits and balances from banks", and "loans to financial concerns" are proposed as indicators for interconnectedness; and "deposits from customers" as well as "loans and advances to customers" are proposed to assess substitutability. Complexity (the remaining bank-specific assessment factor specified in the BCBS D-SIB principles) is not proposed to be incorporated under the quantitative approach as the HKMA has so far not identified any suitable and readily available quantitative indicator for measuring complexity locally. Instead, complexity is proposed to be assessed in a qualitative manner.

Qualitative indicators for assessing bank-specific factors – The HKMA has identified a number of qualitative indicators relating to specific aspects of the systemic importance of authorized institutions ("AIs") that may not otherwise be captured by the quantitative indicator-based measurement approach, for instance qualitative factors for complexity and for the conduct of functions that are difficult-to-substitute and critical to the Hong Kong banking sector among other things. These will be considered as an overlay to the quantitative scores to support the exercise of supervisory judgement in assessing which AIs should be designated as D-SIBs.

Scope of D-SIB assessment – The HKMA proposes to include all licensed banks within the scope of assessment, to consider whether they should be designated as D-SIBs. The HKMA does not propose to routinely include restricted licence banks ("RLBs") and deposit taking companies ("DTCs") within the scope of the D-SIB assessment exercise, although individual RLBs and DTCs may be added to the assessment sample on a case-by-case basis in instances where the externalities potentially associated with them may be of systemic concern.

Collation of data for the purpose of D-SIB assessment – Whilst data relating to the proposed indicators is largely available publicly pursuant to existing disclosure requirements, in order to streamline the data source and to facilitate the D-SIB assessment process, the HKMA proposes to request all AIs within the scope of the D-SIB assessment to submit selected quantitative data relating to the relevant indicators on a consolidated basis, as relevant, through the creation of a new regulatory return. The HKMA does not envisage that completion of the new regulatory return will be unduly burdensome for AIs, as the return will only seek to collate selected data items that AIs already disclose under the BDR, in a designated return format for the purpose of facilitating the D-SIB assessment process.

Range and effect of the higher loss absorbency requirement – The BCBS D-SIB principles envisage that D-SIBs be subject to a higher loss absorbency ("HLA") requirement to provide an additional pool of capital to absorb losses and hence reduce the probability of their failure. The HLA is essentially a layer of core equity tier 1 capital, which takes effect as an extension of the Basel III capital conservation buffer. Consequently, the HLA capital is intended to be available for "use" by AIs, i.e., it is not a "hard" minimum, but restrictions on discretionary distributions will apply whilst an AI is below the upper limit of its extended capital conservation buffer requirement.

Regarding the level of HLA to be imposed on D-SIBs, the HKMA is contemplating an HLA requirement ranging from 1% to 3.5%, with D-SIBs grouped into a number of "buckets" of increasing systemic importance that correspond to increasing levels of required additional loss absorbency within this range. The top bucket corresponding to 3.5% of HLA will initially be empty to provide an incentive for the most systemically important D-SIBs to refrain from becoming yet more systemic. This reflects the construction of the "bucketing" approach in the G-SIB framework, where the bucket thresholds are set such that the top bucket, corresponding to 3.5% of HLA, is currently empty.

Scope of application of the HLA – The HKMA proposes to follow its usual approach to the implementation of the Basel regulatory capital framework and apply the HLA to all D-SIBs that are locally incorporated AIs on both a solo and consolidated basis.

Since foreign bank branches ("FBBs") are not presently subject to local capital adequacy requirements in Hong Kong, the HKMA does not propose to introduce any HLA (effectively branch capital requirements) on FBBs. In the event that a FBB is considered a D-SIB, suitable measures will be determined on a case-by-case basis.

Additional considerations for the application of the HLA to subsidiaries of foreign G-SIBs and/or D-SIBs – For any D-SIB that is a subsidiary of a foreign G-SIB, and/or of a foreign bank that is a D-SIB in its home jurisdiction, the HKMA proposes to assess whether some degree of reliance may be placed on the "group" HLA requirement, and may consider allowing such subsidiary to be subject to a lower HLA requirement locally if certain conditions are met, such as a demonstrable ability in the parent group to provide capital support to the subsidiary, with no apparent restrictions and with no objections from the home authority.

More intensive supervision of D-SIBs – In line with international developments in this area, notably the on-going work of the FSB, the HKMA proposes to apply a proportionately more intensive supervisory approach to D-SIBs. This will entail more intensive supervisory interaction and engagement between the HKMA and the D-SIB, including more frequent meetings between the HKMA and the D-SIB's board and risk committee members. In addition, the standards expected of D-SIBs in terms of risk culture and risk management, corporate governance, internal controls, MIS and data aggregation capability, among other things, will be higher.

Recovery and resolution planning for D-SIBs – As the Association is aware, the HKMA is developing a local recovery and resolution planning ("RRP") framework for AIs in Hong Kong. The initial focus of RRP locally will be on those AIs that are more systemically important or critical to financial stability in Hong Kong. AIs designated as D-SIBs will accordingly be prioritised for the implementation of RRP.

Proposed quarterly disclosure requirements for D-SIBs – To promote market discipline, the BCBS regulatory capital Pillar 3 minimum standard stipulates that, "large internationally active banks and other significant banks (and their significant bank subsidiaries)" must disclose key quantitative regulatory measures on a quarterly basis. The HKMA is accordingly contemplating requiring D-SIBs to disclose key quantitative regulatory measures, including regulatory risk-weighted capital ratios and leverage ratios, on a quarterly basis.

Operationalising the G-SIB framework in Hong Kong – Although there are currently no G-SIBs for which the HKMA is the home supervisory authority, a mechanism is needed to enable the HKMA to identify and designate an AI as a G-SIB in accordance with the BCBS G-SIB framework, in order to cater for the future eventuality of any local banking group becoming a G-SIB. In this regard, the HKMA proposes to issue supplementary guidance to explain its approach to applying the BCBS G-SIB methodology for the purpose of assessing the global systemic importance of an AI.

Implementation and phase-in arrangements – The HKMA plans to conduct its first formal D-SIB identification exercise as soon as the methodology has been finalised, and expects to communicate the results to those AIs designated as D-SIBs no later than end-2014. The regular identification exercise will be conducted annually thereafter. In implementing the D-SIB policy measures, the HKMA is proposing to adopt the Basel III phase-in timeframe for the HLA requirement. This means that HLA requirements will be phased-in incrementally, in parallel with the capital conservation buffer, from 1 January 2016, with the HLA requirement being implemented in full by 1 January 2019. The necessary amendments to the Banking (Capital) Rules ("BCR") and Banking (Disclosure) Rules ("BDR") to cater for a HLA requirement for G-SIBs and D-SIBs locally will be introduced later in the year. The industry will be consulted in respect of these proposed amendments before they go into effect.

In terms of the other regulatory and supervisory requirements applicable to an AI designated as a D-SIB, the HKMA will follow up with relevant AIs bi-laterally to confirm a timetable for implementing RRP, and to communicate and discuss the supervisory interaction which they can expect from the HKMA.

Following this consultation, the HKMA will further refine its proposals, taking into account the comments received, for the purposes of producing a Supervisory Policy Manual ("SPM") module on the operation of the framework and amending the BCR and the BDR to recognise both D-SIB and G-SIB designation and provide for the consequent application of HLA requirements. In accordance with the HKMA's usual practice, the industry will be consulted on the draft SPM module and the proposed amendments to the rules in due course.

I would appreciate it if you would circulate this letter and the enclosed consultation paper to all members of the Association, and provide written comments by 26 May 2014.

If you should have any questions on the enclosed Consultation Paper, please feel free to contact Martin Sprenger (msprenger@hkma.gov.hk) or Olivia Cheng (oyycheng@hkma.gov.hk).

I am writing in similar terms to the DTC Association.

Yours sincerely,

Karen Kemp
Executive Director (Banking Policy)

Encl

cc: FSTB (Attn: Mr Jackie Liu)