Announcement by the Monetary Authority
of Applicable Jurisdictional Countercyclical Capital Buffer Ratio for Hong Kong
27 January 2017

The Monetary Authority hereby announces, pursuant to section 3Q(3) of the Banking (Capital) Rules (Cap. 155L) (BCR), that the applicable jurisdictional countercyclical capital buffer (CCyB) ratio for Hong Kong will increase to 1.875% with effect from 1 January 2018.

The considerations underlying this decision are set out in the Annex to this announcement.

Monetary Authority
27 January 2017

Annex

Decision

In reaching his decision to announce a Hong Kong jurisdictional CCyB rate of 1.875% effective from 1 January 2018, the Monetary Authority reviewed a range of quantitative indicators and qualitative information. This included the "indicative buffer guide" produced by the Monetary Authority's Initial Reference Calculator (IRC) which is a metric that takes into account conditions in local credit and property markets. By mapping (i) deviations ("gaps") of the ratios of credit to GDP and of residential property prices to rentals from their respective long term trends to (ii) the Basel III CCyB range of 0% to 2.5%, the IRC produces a consistent starting point for further analysis.

Despite recent volatility in domestic credit growth and uncertainties facing the local housing market, both the credit to GDP gap and property price to rental gap remain at significantly elevated levels above their respective long-term trends. A gap has to be greater than 2% to be regarded as significant for the purposes of the IRC, and has to reach 10% to signal a 2.5% CCyB. The credit/GDP gap stood at over 11% and the property price/rent gap at over 8% on the latest 2016 figures used for the IRC. As a result, the IRC, calibrated to the Basel III 0% to 2.5% CCyB range, signals a CCyB of 2.25%.

The setting of a CCyB is not however a mechanical exercise and in considering whether there is above-trend excessive credit growth in Hong Kong leading to a build-up of systemic risk, the Monetary Authority will consider a broad range of information in addition to the indicative buffer guide produced by the IRC. In particular, the Monetary Authority also reviewed a series of "Comprehensive Reference Indicators" designed to provide an aggregate view of local conditions including the build-up of systemic risk (such as measures of bank, household and corporate leverage; profitability and funding conditions within the banking sector; borrowers' debt servicing ability; and macroeconomic indicators). This information, on this occasion, broadly confirmed the signal from the IRC. Housing affordability remains highly stretched, and corporate leverage trended upwards while interest coverage ratio deteriorated. Additionally, the local financial system is facing growing economic and political uncertainties externally. Given such risks, the Monetary Authority considered that a CCyB of 2.25% would be appropriate absent the Basel III phase-in mechanism.

The Basel III phase-in mechanism (which is reflected in BCR section 3Q(4)) provides for the maximum countercyclical buffer requirement to "begin at 0.625% of RWAs on 1 January 2016 and increase each subsequent year by an additional 0.625 percentage points, to reach its final maximum of 2.5% of RWAs on 1 January 2019". (Basel III: *A global regulatory framework for more resilient banks and banking systems*, issued by the Basel Committee in December 2010 and revised in June 2011, para. 150). This means that the maximum CCyB rate for 2018 under the Basel III phase-in mechanism is 1.875%. The Monetary Authority has decided, on this occasion, to continue to follow the Basel III phase-in mechanism.

The Monetary Authority will continue to monitor local credit conditions and potential systemic risk build-up in Hong Kong closely and the CCyB rate will be reviewed on a quarterly basis.

The Monetary Authority is also mindful that the Basel III Capital Conservation Buffer will increase to 1.875% from January 2018. Furthermore, those authorized institutions (AIs) which are designated as domestic systemically important authorized institutions under the BCR will be subject to a higher loss absorbency capital requirement (ranging from 0.75% to 1.875%) from January 2018. Hence there will be a cumulative effect from these several measures on AIs' common equity tier 1 (CET1) capital requirements.

<u>Background</u>

The CCyB is part of the Basel III regulatory capital framework and is being implemented in parallel by Basel Committee member jurisdictions worldwide. The CCyB has been designed by the Basel Committee to increase the resilience of the banking sector in periods of excess credit growth. The banking sector can then act as a "shock absorber" in times of stress, rather than as an amplifier of risk to the broader economy.

The specific CCyB requirement applicable to a given AI is expressed as a percentage of its CET1 capital to its total risk-weighted assets (RWA). Each AI's CCyB requirement may vary depending on the geographic mix of its private sector credit exposures and the CCyB rate applicable in each jurisdiction where it has such exposures.

The CCyB, once implemented and triggered, “extends” an AI’s Capital Conservation Buffer (also introduced by Basel III) which is, like the CCyB, being phased-in from 2016 to 2018, beginning with a rate of 0.625% of RWA in 2016 and increasing by equal instalments to reach 2.5% of RWA from 1 January 2019.

The power to implement the CCyB in Hong Kong is provided by the Banking (Capital) Rules, which give the Monetary Authority the power to announce CCyB rates applicable to Hong Kong if the Monetary Authority considers that a period of excessive credit growth in Hong Kong is leading to a build-up of system-wide risks in the financial system of Hong Kong.

As an initial reference for the Monetary Authority to assess the extent of system-wide risks resulting from excessive credit growth and determine the corresponding level of the CCyB requirement, the Monetary Authority uses a methodology that synthesizes information from two main indicators, namely the size of the deviation of the credit/GDP ratio and the residential property price/rent ratios from their respective long-term trends, where the trends are estimated using historical data with a method (recommended by the Basel Committee and commonly used in macroeconomics to detect cyclical fluctuations) that gives a higher weight to more recent observations. A high credit/GDP gap signals significant leverage in the non-bank private sector (as the accumulated effect of above-trend credit growth over a period of time) and therefore vulnerability to such negative shocks as an increase in interest rates or a fall in income. A high residential property price/rent gap signals potentially unsustainably high property valuations (as a result of above-trend price increases over a period of time) and therefore vulnerability to a major market correction. However, the Monetary Authority also assesses a broader set of indicators and other relevant information before reaching a decision on the appropriate level of the CCyB.