Our Ref: B1/15C
B9/127C

18 February 2015

The Chief Executive
All authorized institutions

Dear Sir / Madam,

New Supervisory Policy Manual (SPM) Module
CA-B-2: Systemically Important Banks

I am writing to inform you that, following consultation with the two industry Associations, the Monetary Authority (MA) is today publishing the above-mentioned SPM module as statutory guidance, by notice in the Gazette, under section 7(3) of the Banking Ordinance.

Responding to lessons learned from the recent global financial crisis, the Basel Committee on Banking Supervision (Basel Committee) has established policy frameworks to address the risks posed by both global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs). The rationale for adopting additional policy measures for systemically important banks is the significant "negative externalities" which these banks could create if they were ever to become non-viable. The work of the Basel Committee in this regard forms part of a broader effort by the Financial Stability Board to make these banks less susceptible to failure and thereby improve the resilience of the financial system and economy as a whole.

The additional policy measures for G-SIBs and D-SIBs include the application of Higher Loss Absorbency (HLA) capital buffer requirements, together with more intensive supervision and prioritised recovery and resolution planning requirements.

The SPM module CA-B-2 complements the Banking (Capital) Rules[1], which empower the MA to determine HLA requirements applicable to locally incorporated AIs designated by the MA as D-SIBs or G-SIBs under the Banking (Capital) Rules. CA-B-2 sets out the MA's approach to assessing the systemic importance of AIs and describes the supervisory measures to be applied to AIs assessed to be G-SIBs or D-SIBs. The key sections of the SPM module cover:

[1] As amended by the Banking (Capital) (Amendment) Rules 2014.

(i) **Overview of the D-SIB framework –** in sections 1 and 2, the module provides an overview of the D-SIB framework in Hong Kong in identifying systemically important AIs locally (including the scope of AIs subject to D-SIB assessment), and the MA's power to designate locally incorporated AIs as D-SIBs and apply HLA requirements to these D-SIBs.

(ii) **MA's approach to D-SIB identification –** in section 3, the module explains the approach underlying the D-SIB assessment process:

- The D-SIB assessment in Hong Kong is based on four factors drawn from the Basel Committee's D-SIB framework, namely size, interconnectedness, substitutability and complexity. Under the D-SIB framework, the MA will take a two-step approach in identifying D-SIBs.

- The first step is to draw up a preliminary indicative list of D-SIBs by reference to a quantitative measure using an indicator-based approach for the "size", "interconnectedness" and "substitutability" factors. A weight will be assigned to each of the factors and quantitative indicators. Based on these weights, an overall systemic score (which is the sum of an AI's weighted scores for all the indicators) will then be calculated for each of the AIs within the D-SIB assessment pool. The "complexity" factor will be assessed using a qualitative approach (in the second step), as no suitable and readily available quantitative indicator has as yet been identified to accommodate the multifaceted nature of complexity.

- The second step in the assessment process is to apply supervisory judgement in order to take into account factors that cannot be appropriately captured by a purely quantitative measure.

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(iii) **Consequences of being identified or designated as a D-SIB –** in sections 4 to 6, the module explains the consequences of being identified or designated as a D-SIB:

- An <u>HLA requirement</u>, which is expressed in terms of Common Equity Tier 1 capital as a percentage of total risk-weighted amount for credit risk, market risk and operational risk (RWA), will be applied to a locally incorporated D-SIB based on its degree of systemic importance. Given the diversified nature and varying degrees of systemic importance of AIs in Hong Kong, the MA will adopt a "bucketing approach" to achieve a degree of differentiation between D-SIBs. Each D-SIB will be allocated to a bucket corresponding to a required HLA ratio ranging from 1% to 2.5% of RWA, with an empty top bucket of 3.5% to provide an incentive for the most systemically important D-SIBs to refrain from becoming even more systemically important in the future.

- The intensity of supervision of D-SIBs in Hong Kong will be higher than for other AIs. D-SIBs will be expected to adhere to higher standards in general, in terms of risk culture and risk management; corporate governance; and internal controls. In order to strengthen their data processing capabilities and risk reporting practices so as to support better risk identification and measurement, D-SIBs will also be expected to be in a position to comply with the *Principles for effective risk data aggregation and risk reporting*[2] issued by the Basel Committee in January 2013 within three years of their designation.

- With respect to the ongoing implementation of recovery and resolution planning requirements in Hong Kong, priority and focus will be given to D-SIBs.

(iv) **Announcement of D-SIBs –** in section 7, the module provides an outline of the process for public announcements regarding the identification and designation of D-SIBs.

(v) **Disclosure requirements applicable to D-SIBs –** in section 8, the module describes the disclosure requirements applicable to AIs identified or designated as D-SIBs. Currently, there are no specific additional disclosure requirements for D-SIBs in addition to those applicable to AIs generally those under the Banking (Disclosure) Rules (BDR). However, the MA will consider whether D-SIBs should be required to make any additional disclosures in the next round of amendments to the BDR to implement the *Revised Pillar 3 disclosure requirements* released by the Basel Committee in January 2015.[3]

(vi) **MA's approach to G-SIB designation –** in section 9, the module describes the MA's approach to applying the Basel Committee's G-SIB framework in Hong Kong. This includes the MA's power to designate locally incorporated AIs as G-SIBs, and to apply an HLA requirement to such G-SIBs. The MA's assessment methodology basically adopts the Basel Committee's G-SIB framework. AIs satisfying the prescribed criteria will be required to report data on the relevant G-SIB indicators and make disclosures under the BDR[4] in line with the Basel Committee's G-SIB requirements. In addition, as with D-SIBs, any local G-SIBs will be expected to adhere to higher standards in terms of recovery and resolution planning, and risk culture as well as data processing and risk reporting capabilities.

Relevant AIs will be informed in advance by the MA that he is minded to identify/designate them as D-SIBs and, in the case of locally incorporated AIs, to apply an HLA requirement to them. The AIs concerned will then be given an opportunity to discuss the proposed identification/designation with the MA and make such representations as they consider appropriate within a given period. Thereafter, the MA will finalise his decision and any AIs ultimately identified/designated as D-SIBs will be so notified by the MA. A full list of the D-SIBs (and, if applicable, the associated HLA requirements applied to locally incorporated D-SIBs) will be published.

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2 http://www.bis.org/publ/bcbs239.pdf
3 http://www.bis.org/bcbs/publ/d309.pdf
4 As amended by the Banking (Disclosure) Rules 2014 which will commence operation on 31 March 2015.

On-line access to the SPM module is available on the HKMA's public website (http://www.hkma.gov.hk/eng/key-functions/banking-stability/supervisory-policy-manual.shtml) and private website (http://www.stet.iclnet.hk/index.htm).

Should you have any questions regarding the SPM module, please feel free to contact Mr Martin Sprenger (msprenger@hkma.gov.hk) or Ms Carita Wan (carita_pm_wan@hkma.gov.hk).

Yours sincerely,

Karen Kemp
Executive Director (Banking Policy)

Encl

cc: The Chairman, Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn: Mr Jackie Liu)