HONG KONG MONETARY AUTHORITY 香港金融管理局		
Supervisory Policy Manual		
CA-B-2	**Systemically Important Banks**	V2~~1~~ – consultation~~18.02.2015~~

This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To set out the MA's assessment methodology for identifying systemically important AIs in Hong Kong and for calibrating the level of any higher loss absorbency ("HLA") capital requirements to which such AIs incorporated in Hong Kong will be subject; to set out other policy and supervisory measures to be applied to AIs identified as being systemically important in order to address the risks they pose.

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §7(3).

Previous guidelines superseded

~~This is a new guideline~~CA-B-2 "Systemically Important Banks" (V1) dated 18.02.2015~~.~~

Application

To all AIs.

Structure

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1. Introduction

1.1 Terminology

1.1.1 Unless otherwise specified, abbreviations and terms used in this module follow those used in the Banking (Capital) Rules ("BCR") and Banking (Disclosure) Rules ("BDR").[1]

1.2 Background

1.2.1 To address the negative externalities posed by systemically important institutions, the Basel Committee on Banking Supervision ("Basel Committee") established a framework in November 2011 (subsequently updated in July 2013 and July 2018) to identify global systemically important banks[2] ("G-SIBs"), and calibrate a capital surcharge or HLA capital requirement (expressed in terms of Common Equity Tier 1, or "CET1", capital) that would apply to each identified G-SIB according to its perceived degree of systemic importance. Subsequently the Basel Committee moved from the global to the domestic domain and issued *A framework for dealing with domestic systemically important banks*[3] ("D-SIBs") in October 2012. The D-SIB framework provides a complementary perspective to the G-SIB framework, focussing on the impact that the distress of banks (including international banks) may have on a jurisdiction's domestic economy. Similar G-SIB and D-SIB frameworks are also set out in chapters SCO40 and

[1] It should be noted however that the terms D-SIB and G-SIB and their derivations are not confined to those locally incorporated AIs designated under the BCR for the purposes of applying HLA capital requirements.

[2] See *Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement*~~*Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*~~, issued in July ~~2013~~2018: https://www.bis.org/bcbs/publ/d445.pdf

~~http://www.bis.org/publ/bcbs255.pdf~~

[3] http://www.bis.org/publ/bcbs233.pdf

SCO50, respectively, of the consolidated Basel Framework launched in December 2019.[4]

1.2.2 Under the Basel Committee's D-SIB framework, national authorities are responsible for establishing a methodology for assessing the degree to which banks are systemically important locally, and calibrating the level of an appropriate corresponding HLA requirement, as well as for applying other policy/supervisory measures appropriate to address the risks posed by a D-SIB.

1.2.3 This module sets out the MA's framework for assessing the systemic importance of AIs, and for determining the HLA capital requirements to which any locally incorporated AI designated as a D-SIB or G-SIB under the BCR should be subject.

1.2.4 The ~~HLA requirement will be phased-in between 1 January 2016 and the end of 2018, with the~~ full HLA requirement ~~becoming~~ became effective from 1 January 2019 ~~(see paragraph 4.1.5)~~.

1.3 Legal basis

1.3.1 The BCR [5], issued pursuant to §97C of the Banking Ordinance, empower the MA to designate locally incorporated AIs as D-SIBs or G-SIBs and to apply an HLA requirements to the AIs so designated. An AI would be considered a D-SIB if in the opinion of the MA the risks associated with the AI are such as to render the AI capable of having a significant impact on the effective working and stability of the banking or financial system of Hong Kong were the AI to become non-viable. An AI would be considered a G-SIB if in the opinion of the MA the risks associated with the AI are such as to render

[4] https://www.bis.org/basel_framework/index.htm

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

the AI capable of having a significant impact on the effective working and stability of the global financial system were the AI to become non-viable.

1.3.2 The BDR[6], issued pursuant to §60A of the Banking Ordinance, will empower the MA to require designated AIs to make additional disclosures as a result of their designation.

2. Overview of the D-SIB framework in Hong Kong

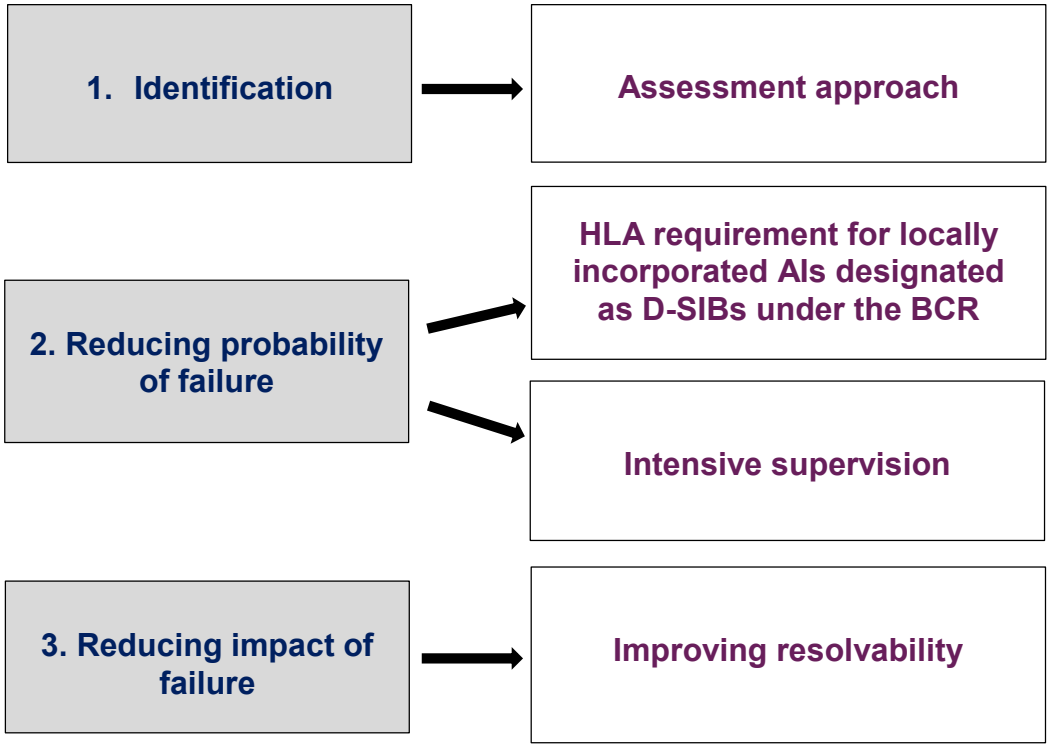
2.1 Objective

2.1.1 The overarching objective of the D-SIB framework is to identify AIs whose impact, in the event of distress or failure, could cause significant disruption to the financial system and economic activity locally. To address the negative externalities posed by such AIs, regulatory and supervisory measures will be taken with the aim of:

- reducing their probability of failure, by increasing their going-concern loss absorbency in the case of locally incorporated AIs designated as D-SIBs under the BCR, requiring early recovery planning, and increasing the intensity of their supervision; and
- reducing the extent or impact of any failure, by improving the resolvability of these AIs.

[6] As amended by the Banking (Disclosure) (Amendment) Rules 2014 which will commence operation on 31 March 2015.

Chart 1: Key components of the D-SIB framework in Hong Kong



2.1.2 As noted in paragraph 2.1.1, the D-SIB framework focuses on the impact that the distress or failure of an AI may have on the domestic economy. Given that the size of the Hong Kong banking sector is large in comparison to the local economy and that the local banking sector is diversified with extensive links to both the domestic and global economies, there is potential for shocks affecting AIs and the banking sector to pose significant risks to financial stability more broadly and to spill-over into the "real economy". These risks have not been fully addressed in the Basel III framework, which focuses primarily on addressing the risks faced by individual AIs rather than the risks such AIs pose to the system as a whole. The D-

SIB framework is specifically intended to address the system-wide perspective, and hence complement Basel III.

2.2 Scope of application

2.2.1 All licensed banks ("LBs") will automatically be within the scope of the MA's regular assessment for the purpose of identifying D-SIBs. In contrast, restricted licence banks ("RLBs") and deposit-taking companies ("DTCs") will generally not automatically be within scope, because the individual failure of these types of AI would generally be expected to create limited systemic externalities for the domestic economy. Nevertheless, in those instances where the externalities potentially associated with an individual RLB or DTC may be of systemic concern, such institutions can be brought within the D-SIB assessment process on a case-by-case basis.

2.2.2 AIs incorporated in Hong Kong will be assessed on a consolidated basis to the extent possible.[7] Overseas incorporated AIs will be assessed on the position of their Hong Kong offices.

2.3 Application to foreign bank branches

2.3.1 Since the primary responsibility for supervising capital adequacy in respect of foreign bank branches rests with the home supervisory authority, such branches are not subject to local branch capital adequacy requirements in Hong Kong and hence will not be formally designated as D-SIBs under the BCR for the purposes of applying HLA requirements to them. However, where a foreign bank branch is considered to be so systemically important in Hong Kong as to be identified

[7] If consolidated position is not applicable, then it will be based on the combined position (if the AI has overseas branches). Otherwise, the Hong Kong office position will be used.

as a D-SIB, the MA will examine whether there is a need to adopt a more intensive regulatory and supervisory approach in relation to it.

2.3.2 In determining the most appropriate supervisory and regulatory approach for foreign bank branches that are identified as D-SIBs, the MA will take into account a number of factors, including the extent and character of the local operations of the branch and the home authority's supervision and regulation of the group (and therefore the extent to which the MA can rely on the home authority), in order to assess the risks posed by the branch to financial stability in Hong Kong. As with foreign bank subsidiaries, the MA will seek to coordinate and cooperate with the home authority in making such assessments focussing, among other things, on the adequacy of capital and liquidity levels at the parent group, and the parent group's relationship with the foreign bank branch in Hong Kong.

2.3.3 In cases where, notwithstanding more intensive supervisory measures, the MA still considers it needs greater ability to regulate and supervise the branch more closely in order to promote the general stability and effective working of the banking system in Hong Kong, the MA may consider whether there is a case for the AI to be required to operate locally through a subsidiary rather than a branch (e.g. whether the AI has such extensive retail operations in Hong Kong that its potential failure would significantly impair the normal functioning of the domestic economy).

3. Assessment methodology to identify D-SIBs

3.1 General

3.1.1 According to paragraph 14 of the Basel Committee's D-SIB framework, D-SIBs should be assessed in terms of the potential impact of their failure on the reference system. This

can be interpreted as a "loss given default" concept rather than a "probability of default" concept. On this basis, the indicators to be used in the D-SIB identification process are focussed primarily on measures of the "impact of failure", as opposed to measures of "risk of failure".

3.1.2 The D-SIB framework in Hong Kong aims to assess the degree to which AIs are systemically important in a domestic context by reference to the financial system and domestic economy in Hong Kong. This means that the assessment focuses on addressing the externalities that the distress or failure of an AI could generate at a local level.

3.1.3 The D-SIB assessment is based on the following four factors drawn from the Basel Committee's D-SIB framework:

(i) size (subsection 3.2);

(ii) interconnectedness (subsection 3.3);

(iii) substitutability (subsection 3.4); and

(iv) complexity (subsection 3.5).

3.1.4 D-SIBs are identified using a two-step approach. The first step is to draw up a preliminary indicative list of D-SIBs based on the quantitative scores calculated using a set of factors/indicators. The second step involves the exercise of supervisory judgement that may serve as a complement to the quantitative assessment process, i.e. to refine the preliminary indicative list by either (i) removing AIs from the list; or (ii) including other AIs onto the list. Please see subsection 3.7 for details of the two-step assessment approach.

3.1.5 The MA's approach to using each of the four factors drawn from the Basel Committee's framework is discussed below.

3.2 Size

3.2.1 Size is a key measure of systemic importance. The larger the AI, the more widespread the effect of a sudden withdrawal of its services and therefore the greater the chance that its distress or failure would cause disruption to the financial markets and systems in which it operates, and to the broader functioning of the economy. The size factor broadly measures the volume of a D-SIB's banking activities within Hong Kong's banking system and economy and therefore provides a good measure of the potential systemic impact in case the AI should fail.

3.2.2 The quantitative indicator used in the D-SIB framework to measure an AI's size is the AI's "total assets", as disclosed in the balance sheet. This proved to be the most suitable indicator based on analysis undertaken by the MA.

3.3 Interconnectedness

3.3.1 This measure captures the extent of an AI's interconnections with other financial institutions that could give rise to externalities affecting the financial system and domestic economy in Hong Kong.

3.3.2 The quantitative indicators used to capture interconnectedness are:

- interbank activities (represented by balances and placement with banks[8] and deposits and balances from banks[9]); and
- loans to financial concerns[10].

[8] Represent amounts placed with other banks in the form of cash and deposits, and loans and advances. Balances with central banks will be excluded.

[9] Represent amounts owed by the AI to other banks which arise out of banking transactions. Balances from central banks will be excluded.

[10] The definition is the same as specified in BDR §47(1)(a)(i)(C).

"Balances and placement with banks" and "deposits and balances from banks" provide a broad sense of the extent of each AI's interconnectedness within the banking sector at an aggregate level, whereas "loans to financial concerns" is intended to provide some indication of an AI's exposure to (and interconnectedness with) the wider financial system.

3.4 Substitutability

3.4.1 The concept underlying substitutability as a factor for assessing systemic importance is the recognition that the greater the role of an AI in a particular business line or in acting as a service provider in relation to market infrastructure, the more difficult it will be to swiftly replace that AI and the extent of the products and services it offers, and therefore the more significant the risk of disruption in the event that the AI becomes distressed.

3.4.2 Obviously assessments of substitutability will need to recognise local conditions within the banking industry including the intensity of domestic competition and the homogeneity of product offerings. In identifying the indicators to capture this factor, the MA has sought to identify aspects/elements which are susceptible to some degree of "measurement" or "assessment" (in the sense, for example, that information and data is relatively readily available) for incorporation into the assessment process.

3.4.3 There are certain functions performed by certain AIs in Hong Kong that would obviously be difficult, if not impossible, to substitute at short notice. These critical and specialised functions include acting as the settlement institutions for local payment and settlement systems and Hong Kong Dollar banknote issuance. The MA will review the functions deemed critical from time to time and will incorporate them into the assessment as appropriate. AIs that perform these critical and difficult-to-substitute functions are likely to qualify as D-SIBs.

3.4.4 Whilst the provision of more common services and functions, such as deposit taking and lending to customers, may be seen as more readily substitutable given that virtually all AIs perform these roles and the products may be considered largely homogenous, it may nevertheless be the case that a certain "critical mass" in terms of market share may in reality make it difficult to substitute a significant market player.

3.4.5 In identifying a "critical mass" in the more common but yet essential services offered by AIs, "deposits from customers"[11] and "loans and advances to customers"[12] are used as the quantitative indicators for substitutability. This is based on the logic that the higher the market share of an AI, the more difficult it will be to substitute the extent and level of service it provides.

3.5 Complexity

3.5.1 The degree of complexity of an AI is generally expected to be proportionately related to the systemic impact of the AI's distress, since the less complex an AI is, the more "resolvable" it will likely be, and in turn the more likely the impact of its failure could be contained.

~~3.5.2 It has not proved possible as yet to identify any suitable and readily available quantitative indicator for measuring complexity in Hong Kong. To accommodate the multifaceted nature of complexity, a qualitative approach will therefore be used to assess complexity. This will allow the MA to better take into account the various sources of complexity, such as:~~

~~(i) business complexity arising from a significant degree of involvement in complex financial products (e.g. scale of non-plain vanilla products/portfolios and special purpose~~

[11] The definition is the same as specified in BDR §36(1)(b)(ii) and §94(b)(ii). "Deposit" is defined under §2 of the Banking Ordinance.

[12] The definition is the same as specified in BDR §36(1)(a)(v)(A) and §94(a)(vii)(A).

~~vehicles, extent of the use of off-balance sheet exposures) or the scale of provision of specialised non-banking services such as brokerage and insurance;~~

~~(ii) structural complexity arising from the composition of an AI's group (e.g. the number of hierarchical "layers", subsidiaries and associates within the group);~~

~~(iii) operational complexity in internal systems (e.g. existence of booking centres outside Hong Kong, and locational mismatch between the place where a trade is originated and booked); and~~

~~(iv) resolvability – in that the more complex an AI, the more difficult it will be to resolve and hence the more difficult it will be to contain the impact of its distress.~~

~~3.5.3~~3.5.2 ~~The considerations referred in paragraph 3.5.2 for determining complexity will not be exhaustive as each AI may have a unique business model and structure. The qualitative input in assessing complexity would primarily be based on the information gathered through regular supervisory interaction.~~The quantitative indicator used in the D-SIB framework to measure an AI's complexity is the AI's total notional amount of outstanding over-the-counter (OTC) derivatives reported to the trade repository of the Hong Kong Monetary Authority (HKTR). Other sources of complexity may be assessed qualitatively in the second step of the D-SIB assessment as described in subsection 3.6.

3.6 Qualitative indicators

3.6.1 To prevent the identification process from becoming overly mechanistic, the MA will apply a supervisory judgemental overlay to the quantitative assessment process recognising that some of the most effective indicators for assessing systemic importance tend not to be of a quantitative nature,

and hence not captured by a quantitative indicator-based measurement approach.

3.6.2 To support the exercise of such supervisory judgement, the MA has identified an indicative list of qualitative indicators that will typically be considered in the assessment process and these are set out in Annex 1. Because the exercise of judgement inevitably requires flexibility to take into account the individual characteristics of AIs and specific market developments, the list in Annex 1 should not be regarded as exhaustive and will be updated periodically in light of implementation experience and market developments.

3.6.3 To ensure that the qualitative indicators will be considered in a consistent manner, the process should focus on factors and indicators pertaining to an AI's domestic systemic impact, i.e. the *impact* given the AI's distress/failure and not the *probability* of distress/failure of the AI.

3.7 Assessment approach

3.7.1 As mentioned in paragraph 3.1.4, the D-SIB identification process is a two-step approach. First, a score will be calculated for an AI based on the quantitative indicators of "size", "interconnectedness", ~~and~~ "substitutability" and "complexity".

3.7.2 For this purpose, a weight is assigned to each of the "size", "interconnectedness", ~~and~~ "substitutability" and "complexity" factors. The MA applies a ~~50~~40% weight to "size", ~~and~~ a 25% weight to each of "interconnectedness" and "substitutability", and 10% weight to "complexity" ~~while the quantitative indicators within each factor, as discussed in subsections 3.2, 3.3 and 3.4, are weighted equally~~. Table 1 provides a summary of the quantitative indicators used for the assessment and their respective weights. ~~As noted in paragraph 3.5.2, no quantitative indicators have been assigned for the "complexity" factor. Complexity will be assessed purely by reference to qualitative factors.~~

Table 1: Factor / Indicator weighting

Factor (and weighting)	Quantitative Indicator	Indicator weighting
Size (~~50~~40%)	Total assets	~~50~~40%
Interconnected-ness (25%)	Interconnectedness within the banking system: Balances with and from banks (both components weighted 6.25% each)	12.5%
	Interconnectedness with the financial system: Loans to financial concerns	12.5%
Substitutability (25%)	Deposits from customers	12.5%
	Loans and advances to customers	12.5%
Complexity (10%)	Total notional amount of outstanding OTC derivatives	10%

3.7.3 The~~A higher~~ highest weighting is assigned to "size" because, in addition to being the single most dependable quantitative indicator in terms of data reliability and objectivity, size is genuinely a more important overall measure of systemic importance than other factors and indicators. Generally speaking, the larger the size of an AI, the greater its market share of critical financial services and the more interconnected it is to the banking sector and the domestic economy, and therefore the more difficult to substitute. In addition, in the event of any impairment or failure of an AI, the larger the AI, the more likely that it will have a damaging effect

on the confidence in, and the stability of, the banking system as a whole.

3.7.4 The systemic score for each AI is calculated in a manner similar to that in the Basel Committee's G-SIB assessment methodology. Thus the score for a particular quantitative indicator is calculated by dividing the individual AI's amount for that quantitative indicator by the aggregate amount for the quantitative indicator summed across all AIs in the assessment pool. The AI's score for each quantitative indicator will then be weighted (based on the weights shown under the "Indicator weighting" column of Table 1). The overall systemic score for the AI equals the sum of its weighted scores for all the quantitative indicators.

3.7.5 Once the overall systemic scores have been calculated, the MA will first determine a cut-off threshold above which AIs are putatively considered systemically important. The establishment of the cut-off threshold will take into consideration the overall distribution of scores and cluster analysis.

3.7.6 The MA will then overlay supervisory judgement, as a complement to the quantitative scores of potential D-SIBs, based on qualitative indicators. This is because, as noted above, a robust assessment approach cannot rely solely or mechanically on quantitative indicators, as some of the most effective factors for assessing systemic importance tend not to be of a quantitative nature.

3.7.7 As one of the policy objectives of the D-SIB framework is to give appropriate incentives for D-SIBs to become less systemic, the MA will assess the list of D-SIBs at least annually to ensure that there are continued incentives for AIs to reduce the systemic risks they pose to the system. In exceptional cases an AI may be identified as a D-SIB (and in the case of a locally incorporated AI designated as a D-SIB under the BCR) by the MA outside of the annual assessment

exercise (e.g. due to an intervening merger or acquisition which substantially increases the size of the AI).

3.7.8 The MA intends to conduct a review of the methodology, including the indicators used; the approach for incorporating these indicators into the assessment and identification process; the calibration of scores and the cut-off threshold for D-SIBs at least every three years. This should enable the MA to capture developments within the banking sector, and to reflect evolving international practices in the methods and approaches for measuring systemic importance.

3.8 Data reporting

3.8.1 To facilitate the data collection for the purpose of the D-SIB assessment~~ in the future~~, a specifically tailored regulatory return ~~will be~~MA(BS)24 "Return of Information for Assessment of Systemically Important Authorized Institutions" has been issued for AIs within the scope of D-SIB assessment to submit the selected data items for the calculation of the relevant indicators. The ~~indicators used in the D-SIB assessment exercise are~~ required data are mostly based on items that form part of the disclosure requirements in the BDR or that are included in existing banking returns. Thus most of the data items in return MA(BS)24 are not "new".~~[13]~~

3.8.2 Once AIs are identified by the MA as D-SIBs, they should inform the MA as soon as possible of any identification or designation by any overseas authorities of their parent companies, their overseas branches and their downstream subsidiaries as a D-SIB and of any HLA requirement applied to any such entity.

~~[13] For the first assessment exercise, in order to reduce AIs' reporting burden, the MA will base its D-SIB assessment on data obtained through existing banking returns and, where applicable, will adjust certain significant data items manually in order to conduct its assessment from a consolidated perspective.~~

4. HLA requirement for locally incorporated AIs designated as D-SIBs under the BCR

4.1 General

4.1.1 The rationale for imposing an HLA requirement on designated D-SIBs is to reduce the probability of their failure, which is considered both prudent and justified in view of the greater impact that such failure would likely have on the domestic financial system and the local economy more broadly.

4.1.2 The MA may require the HLA requirement to be applied on an unconsolidated basis and/or consolidated basis.

4.1.3 The HLA requirement applied to a designated D-SIB should be determined based on its degree of systemic importance and forms part of the D-SIB's buffer level (see BCR §§3V and 3G respectively). The HLA requirement applied to D-SIBs is expressed as CET1 capital as a percentage of total risk-weighted amount ("RWA") as calculated under the BCR. If and when a designated D-SIB's CET1 capital ratio (see the following paragraph on the priority of how CET1 capital should be applied) is equal to or below its buffer level (being its capital conservation buffer as extended by the HLA requirement and, where applicable, any countercyclical capital buffer to which a given AI may be subject from time to time), the D-SIB will be subject to restrictions on the discretionary distributions it may make (including by way of dividend, share buyback, discretionary coupon payments on capital instruments and discretionary bonus payments to staff) according to a specified scale (see BCR §3H(1)). The effect of this is that, for so long as D-SIBs' CET1 capital ratios are equal to or below their buffer levels, designated D-SIBs will be required to retain earnings in order to bolster their regulatory capital.

4.1.4 In calculating its regulatory capital requirements, including the CET1 capital it has available to meet the (extended) buffer, an

AI's CET1 capital must first be applied to meeting all of the three minimum capital ratios (i.e. the CET1 capital ratio, Tier 1 capital ratio and Total capital ratio — including any Pillar 2 add-on applicable to the AI pursuant to a notice issued by the MA under §97F of the Banking Ordinance), before the remainder can contribute to the (extended) buffer requirements. Table 2 depicts the "capital stack" (assuming fully phased-in buffers and that no additional CET1 capital is used to comply with Tier 1 and Total capital ratios over and above the CET1 ratio).

Table 2: CET1 capital stack of a typical D-SIB

Buffers: • Countercyclical Capital Buffer (usually 0%–2.5% of RWA) • HLA requirement (usually 1%–2.5% of RWA) • Capital Conservation Buffer (usually 2.5% of RWA)
Minimum CET1 capital • 4.5% of RWA and applicable Pillar 2 CET1 capital add-on

~~4.1.5 In parallel with the phase-in of the Basel III capital conservation and countercyclical buffers, the phase-in period for the HLA requirement applicable to designated D-SIBs will be between 1 January 2016 and the end of 2018, so it becomes fully implemented on 1 January 2019. The year-by-year transitional timetable is summarised in Table 3 below. This arrangement is also reflected in §3V(2) of the BCR.~~

~~Table 3: Transitional arrangement for the phasing-in of the HLA requirement~~

~~Year~~	~~HLA requirement~~
~~2016~~	~~25% of the full HLA requirement~~
~~2017~~	~~50% of the full HLA requirement~~
~~2018~~	~~75% of the full HLA requirement~~
~~2019 and later~~	~~100% of the full HLA requirement~~

4.2 Allocation to HLA buckets

4.2.1 Given the diversified nature and the varying degrees of systemic importance of AIs in Hong Kong, the MA considers a differentiated approach to the local HLA requirement for designated D-SIBs justified. The MA will therefore use a "bucketing approach" to achieve such differentiation. The approach is broadly consistent with the Basel Committee's G-SIB framework [14], to ensure compatibility within the frameworks and provide appropriate incentives to designated D-SIBs to refrain from increasing their systemic importance over time.

4.2.2 Upon locally incorporated AIs being identified as D-SIBs through the two-step approach (see subsection 3.7), they will be allocated to different buckets of HLA requirements based on the relative distribution of their systemic scores. Table 4 sets out the buckets to which locally incorporated D-SIBs will be allocated together with the corresponding HLA requirement. The minimum HLA requirement is 1%. Each locally incorporated D-SIB identified using the methodology described in subsection 3.7 will be allocated to a bucket corresponding to a required level of HLA ranging from 1% to 2.5% of total RWA. An empty top bucket of 3.5% is maintained

[14] The Basel Committee's G-SIB framework takes a differentiated approach to the HLA requirement for G-SIBs whereby the G-SIBs are allocated to "buckets" corresponding to a required level of HLA ranging from CET1 equivalent to 1% to 2.5% of risk-weighted assets, with an empty top bucket of 3.5%, to provide incentives for G-SIBs to refrain from becoming yet more systemically important.

to provide an incentive for the most systemically important locally incorporated D-SIBs to refrain from becoming even more systemically important in the future. If the empty top bucket should become populated, the MA will consider the addition of new buckets so as to maintain the appropriate incentives as part of its regular review of the assessment methodology.

Table 334: Bucketing approach

Bucket	HLA requirement (CET1 as % of RWA)
5	3.5%
4	2.5%
3	2%
2	1.5%
1	1%

~~The application of HLA requirements to locally incorporated D-SIBs will however be subject, during the period 2016 to 2018, to the phase-in arrangements referred to in paragraph 4.1.5 above.~~

4.2.3 For the purposes of determining the thresholds for each bucket, the MA will assess and draw reference from the different "clusters" of systemic scores in the D-SIB identification assessment as set out in section 3.

4.2.4 The systemic importance of AIs may evolve over time; AIs may migrate in and out of D-SIB status, or move between "buckets" or categories of systemic importance. Where a

locally incorporated AI is first designated or re-designated as a D-SIB, it will be required to build up its CET1 capital for HLA purposes within 12 months from the MA's formal notification of its designation (or re-designation). Similarly, if an increased HLA requirement is applied to a designated D-SIB due to the D-SIB moving up one or more buckets as a result of an increase in its degree of domestic systemic importance, the D-SIB will also be subject to the increased HLA requirement within 12 months. However, if a lower HLA requirement is applied to a designated D-SIB due to a decrease in its degree of systemic importance and it moving down one or more buckets or it ceasing to be designated as a D-SIB at all, the D-SIB/AI concerned may recognise the lower (or nil) HLA requirement immediately following the MA's formal notification. For example, a designated D-SIB is notified by the MA in January 2020 that its HLA will be increased from 1% to 1.5%. Then the D-SIB will be required to apply the new HLA within 12 months. However, if the MA notifies the D-SIB subsequently that its HLA requirement will be lowered to 1% from 1.5%, then the D-SIB may recognise the 1% HLA as from that notification date.

4.3 Regulatory capital instruments used to meet HLA requirement

4.3.1 The HLA requirement must be fully met with CET1 capital as defined in §38 of the BCR. This is to ensure that the capital held for HLA purposes will be available to absorb losses on a going concern basis and hence enhance the resilience of the relevant D-SIB by reducing its probability of default.

4.4 Interaction with Pillar 2

4.4.1 As explained above, the HLA requirement is in effect an additional buffer of the highest quality capital designed to absorb potential losses, enhance resilience and thereby lessen the likelihood of the realisation of the "negative

externalities" associated with a D-SIB. Hence the HLA requirement addresses the risks posed by the D-SIB to the local financial system and domestic economy. Pillar 2 capital requirements, in contrast, capture various specific risks taken on by an AI which are not covered or adequately covered under Pillar 1 (see SPM module on Supervisory Review Process CA-G-5 for further details of the Pillar 2 framework). Therefore, the HLA requirement and the Pillar 2 capital add-on are not duplicative, but rather address the external and internal risks associated with an AI from different but complementary perspectives.

4.4.2 Nevertheless, to the extent that under the methodology set out in SPM module CA-G-5 (subsection 3.4) an AI which is designated as a D-SIB is assessed to have a degree of overlap between its Pillar 2 capital requirement and its capital buffers, the AI's HLA requirement will be considered together with the AI's capital conservation buffer and countercyclical capital buffer for the purposes of calculating the extent to which the P2B portion of the Pillar 2 capital requirement (as described in SPM module CA-G-5 Paragraph 3.4.11) can be absorbed by the AI's extended capital buffer.

4.5 Application to locally incorporated AIs

4.5.1 The MA may impose the HLA requirement on locally incorporated D-SIBs (for which the MA is the home regulatory authority) at both the solo and consolidated level, and at the subsidiary and sub-consolidated level on those locally incorporated D-SIBs that are subsidiaries of foreign banking groups (see BCR §3I(1)). This reflects Principle 10 of the Basel Committee's D-SIB framework which intends to draw a

distinction between the level of application of D-SIB HLA requirements for home and host authorities.[15]

4.5.2 If an AI is the subsidiary of a D-SIB designated by the MA, and the MA also designates that AI as a D-SIB, a different HLA requirement may be applied to the subsidiary and parent by reference to their respective degrees of systemic importance (see BCR §3X).

4.5.3 The HLA requirements under the D-SIB framework in Hong Kong apply to a locally incorporated AI assessed as systemically important locally, regardless of whether the AI is a subsidiary of a foreign banking group, or a subsidiary of a G-SIB. From the perspective of the MA as a host supervisor, it is of significant importance that the capital of systemically important locally incorporated AIs should be bolstered by HLA requirements, irrespective of whether the AIs are subsidiaries of other entities or not, in order to enhance their resilience and mitigate any potential heightened impact of their failure on the domestic economy.

4.5.4 Principle 11 of the Basel Committee's D-SIB framework specifies that home and host authorities should make arrangements to coordinate and cooperate on the appropriate HLA requirements, within the constraints imposed by relevant local laws and regulations. For any locally incorporated D-SIB which is a subsidiary of a foreign G-SIB or D-SIB in its home jurisdiction, the MA will communicate with the home supervisory authority in arriving at any decision on the local D-SIB's HLA requirement. The MA, in discussion with the home supervisory authority, will assess whether some degree of reliance may be placed on the "group" HLA requirement, taking into account a range of factors including:

[15] Principle 10 of the Basel Committee's D-SIB framework specifies that "home authorities should impose HLA requirements that they calibrate at the parent and/or consolidated level, and host authorities should impose HLA requirements that they calibrate at the sub-consolidated/subsidiary level."

(i) the way in which the "group" HLA requirement is calibrated, and whether the calibration may have taken into account the associated systemic impact at a local domestic level;

(ii) whether there are clear and credible assurances from the parent in terms of forthcoming capital support should the subsidiary in Hong Kong come under stress (with demonstrable ability to execute such support);

(iii) the level of cooperation with, and the degree of reliance the MA is able to place on, the home authority regarding the supervision (and, if and when the time comes, orderly resolution) of the D-SIB; and

(iv) the planned resolution strategy for the banking group to which the D-SIB belongs.

4.5.5 To further strengthen the basis of home-host coordination, the MA will consider whether any actions need to be taken, such as amending existing, or entering into further, Memoranda of Understanding, to facilitate the operation of the D-SIB framework. The MA as host will also enter into discussions with the relevant home authority in respect of: (i) the resolution regimes (including recovery and resolution plans) in both jurisdictions, (ii) possible resolution strategies and any specific resolution plan in place for the D-SIB, and (iii) the extent to which such arrangements should influence the respective HLA requirements.

5. Supervisory approach for D-SIBs

5.1 The Financial Stability Board ("FSB") has made a number of recommendations to enhance the intensity and effectiveness of supervision of systemically important financial institutions ("SIFIs").[16]

[16] See *Intensity and Effectiveness of SIFI Supervision, Recommendations for enhanced supervision*, issued in November 2010: http://www.financialstabilityboard.org/publications/r_101101.pdf

One of the recommendations was that all national supervisory authorities should have the powers to apply differentiated supervisory requirements and intensity of supervision to SIFIs based on the risks they pose to the financial system. It follows that supervisors should focus more resources on systemically important banks (SIBs), applying a higher degree of supervisory intensity according to the risk a given SIB poses.

5.2 The MA has long adopted a risk-based supervisory approach to monitor and assess the safety and soundness of AIs on a continuing basis (see SPM module on Risk-based Supervisory Approach SA-1 for details of the supervisory framework). Under this approach, AIs have historically experienced, and will continue to be subject to, more intensive supervision proportionate to their nature, size and complexity. In this regard, the MA's D-SIB assessment exercise should serve to consolidate and enhance, rather than fundamentally change, the existing risk-based approach. Based on the D-SIB assessment results, the MA will fine-tune the intensity of, and tailor the strategy for, supervising individual D-SIBs in Hong Kong. This will include, among other things~~,~~:

(i) more in-depth assessment of D-SIBs (such as more frequent examinations);

(ii) reference to macro-prudential analysis to identify potential risks and threats to the domestic financial system that might adversely affect the risk profile of individual D-SIBs;

(iii) review and consideration of D-SIBs' risk appetite and risk tolerance statements on a regular basis and, as appropriate, review of supplementary information such as associated metrics or management information (e.g. risk or audit reports), to support assessment of whether the risk appetite and risk limits are adhered to at an operational level; and

(iv) in the case of locally incorporated D-SIBs, more intensive supervisory interaction and engagement, including between the MA and the D-SIB's board~~,~~ and its risk committee members.

5.3 The MA expects D-SIBs to adhere to higher standards in general, in terms of risk culture and risk management; corporate governance; and internal controls. AIs are expected generally, and D-SIBs in particular, to be proactive in cultivating a sound risk culture, and ensuring that an effective risk governance framework is in place. D-SIBs should undertake more regular assessments and evaluations of, and generate regular internal reports on, the effectiveness of their risk governance structure and their risk profiles; and use these assessments, evaluations and reports as a basis for discussion with the board and risk committee for the purpose of identifying any actions required to be taken towards enhancing risk governance practices.

5.4 In line with the on-going international work on supervisory intensity and effectiveness, D-SIBs are also expected to adopt higher standards in strengthening their data processing capabilities and risk reporting practices in order to support better risk identification and measurement (also see subsection 5.2 of SPM module on Risk Management Framework IC-1 for general guidance on risk management information system). ~~The MA intends to issue a new SPM module to explain the MA's expectations in this regard. In the meantime,~~ In particular, D-SIBs should ~~make reference to~~be able to demonstrate that they are in full compliance with Principles 1 to 11 of the *Principles for effective risk data aggregation and risk reporting*[17] (issued by the Basel Committee in January 2013). ~~As indicated in the Basel paper, AIs identified as D-SIBs should work towards being in a position to apply these principles~~ within three years of~~after~~ their designation~~identification~~ as D-SIBs.

6. Recovery and Resolution Planning

6.1 Improving the prospects for recovery and the resolvability of a D-SIB are key pillars of the D-SIB framework. The statutory requirements on recovery planning are prescribed in Part XIIA of the BO, and further guidance is provided in the~~MA has issued an~~ SPM module on

[17] http://www.bis.org/publ/bcbs239.pdf

Recovery Planning (RE-1). Part XIIA of the BO defines the recovery plan, specifies the scope of application, and describes the manner in which the MA's powers relating to recovery planning requirements in the BO are to be executed. The SPM module RE-1 further ~~which~~ sets out the key elements of effective recovery planning for AIs, as well as the MA's approach and expectations in reviewing AI's recovery plans and exercising the related powers under the BO~~this area~~. The relevant guidance applies to all AIs in a proportionate manner, having regard to their size, structure and business mix and the systemic risks associated with their activities. Thus, recovery plans for~~In the context of recovery planning, AIs, in particular~~ larger or more complex AIs, ~~which will~~ including~~e~~ D-SIBs, tend to be more complicated in terms of the stress scenarios, recovery options, recovery triggers and communication plan~~are encouraged to adopt more than the minimum scenarios as prescribed in the SPM RE-1 to ensure the adequacy of their recovery plans~~.

6.2 As the resolution authority for banking sector entities, which include all AIs, the MA has issued a Code of Practice chapter under the Financial Institutions (Resolution) Ordinance on the HKMA's approach to resolution planning (RA-2), which provides guidance on the HKMA's approach to resolution planning for AIs including assessment of resolvability. Resolution planning is generally expected to be prioritised for all D-SIBs and any other locally incorporated AIs with total consolidated assets of more than 150 billion Hong Kong dollars as their non-viability would be likely to pose a risk to the stability and effective working of the financial system of Hong Kong, including to the continued provision of critical financial functions~~With respect to resolution planning, the MA is in the process of developing a framework and intends to set out the details in a new SPM module in 2015. Both recovery and resolution planning will be implemented in a proportionate manner in phases, with an initial focus on those AIs (which will include D-SIBs) that are more systemically significant or critical to financial stability in Hong Kong~~.

6.3 ~~Whilst at this stage work on recovery and resolution planning and resolvability assessments is not yet sufficiently advanced to warrant a significant reduction in the systemic score of any AIs, once t~~The ~~local~~

recovery ~~and resolution~~ plans and resolvability ~~are more developed, the MA will review how aspects of recovery and resolution planning might be more closely incorporated into the~~of AIs will be taken into consideration in the D-SIB ~~framework~~assessment qualitatively as described in subsection 3.7.6 as appropriate.

7. Announcement of D-SIBs

7.1 As mentioned in paragraph 3.7.7, the MA will conduct an annual D-SIB identification exercise. In exceptional cases, the MA may also update the D-SIB list outside of the annual cycle if there are important structural changes within the banking system, e.g. a merger or a substantial take-over.

7.2 Relevant AIs which the MA proposes to identify as D-SIBs, and in the case of locally incorporated AIs to designate as D-SIBs under the BCR, will be informed of the MA's intention and may discuss the proposed identification/designation and the reason for it with the MA. Thereafter the MA will finalise its decision and the relevant AIs identified/designated as D-SIBs will be formally advised. Subsequently a public announcement will be made of the identification/designation of D-SIBs and, where applicable, their corresponding HLA requirement to promote transparency. Public disclosure of the list should facilitate international co-ordination and implementation of the SIFI framework.

8. Disclosure requirement for D-SIBs

8.1 Any locally incorporated AI designated as a D-SIB will be required to disclose its specific D-SIB HLA requirement (or G-SIB HLA requirement if higher) in the MA's standard capital disclosure template for the purpose of making disclosures on the composition of the AI's capital base under the BDR.

~~8.2 Currently there are no additional disclosure requirements for AIs identified/designated as D-SIBs on top of those specified in the BDR.~~

~~To enhance regulatory disclosure, the Basel Committee issued *Revised Pillar 3 disclosure requirements* in January 2015.[18] The MA will consider making corresponding amendments to the BDR as appropriate in the local context, and take the opportunity to also consider whether D-SIBs should be required to make certain additional disclosures.~~

9. Approach to designating G-SIBs

9.1 General

9.1.1 As mentioned in paragraph 1.3.1, the BCR include a power for the MA to designate a locally incorporated AI as a G-SIB, and to impose an HLA requirement on a G-SIB so designated, if the risks associated with the AI are such that, upon its failure the AI would be capable of having a significant impact on the effective working and stability of the global financial system.

9.1.2 A public announcement will be made of any G-SIB so designated and its corresponding HLA requirement.

9.2 Assessment methodology

9.2.1 The assessment methodology to identify G-SIBs adopts the Basel Committee's G-SIB framework as mentioned in paragraph 1.2.1. In parallel with the Basel Committee's annual assessment, the MA will conduct its own annual G-SIB assessment applying the Basel Committee's assessment process to any relevant reporting AIs (see paragraph 9.2.2 below) for which the MA is the home regulatory authority.

9.2.2 AIs meeting the following criteria will be required under §63(2) of the Banking Ordinance to report data on the ~~twelve~~ thirteen G-SIB indicators used in the Basel Committee's G-SIB

~~[18] http://www.bis.org/bcbs/publ/d309.pdf~~

methodology to the MA, using the template and reporting instructions devised by the Basel Committee[19]:

(i) AIs of a size (as measured by the leverage ratio measure of exposure) exceeding the Hong Kong Dollar equivalent of 200 billion Euro, based on the exchange rate at the relevant cut-off date;

(ii) any AIs which (although below the threshold in (i)) the MA, in the exercise of supervisory judgement, considers should be added to the reporting group; and

(iii) any AIs which were classified as G-SIBs in the previous year.

9.2.3 Given that the Basel Committee and MA assessments use identical data, methodology and parameters, the outcomes should be consistent. In the unlikely event that the results of the local MA process and global Basel Committee process should differ, the MA will liaise with the Basel Committee with a view to identifying the source of the difference and rectifying the matter.

9.2.4 The Basel Committee's G-SIB framework also allows for the designation of banks as G-SIBs on the basis of supervisory judgement. If the MA were to consider that a locally incorporated AI (for which the MA is the home authority), which would not otherwise be assessed to be a G-SIB by the application of the Basel Committee's methodology, should in fact be designated as a G-SIB, the MA may propose the addition to the Basel Committee and provide the MA's supporting justification for consideration by the Basel Committee and the FSB. However, this would be expected to be a very rare event. The MA envisages that, in general, any designation by the MA of a locally incorporated AI as a G-SIB

[19] The template and reporting instructions can be found at: https://www.bis.org/bcbs/gsib/reporting_instructions.htm ~~www.bis.org/bcbs/gsib/~~, and may be updated by the Basel Committee from time to time.

will be in line with the inclusion of that AI on the list of G-SIBs published annually by the FSB.

9.3 HLA requirement

9.3.1 The MA will apply HLA requirements to any locally incorporated AIs that are designated as G-SIBs in a manner commensurate with their degree of systemic importance. §3T(2) of the BCR prescribes a G-SIB HLA range of 1–3.5% of total RWA in line with the Basel Committee's G-SIB framework. The G-SIB will be notified in writing of its HLA requirement.

9.3.2 If a locally incorporated AI is designated as both a G-SIB and D-SIB, the HLA requirement to be applied to the AI will be the higher of the D-SIB or G-SIB HLA requirement (BCR §3W). This is in line with Principle 10 of the Basel Committee's D-SIB framework.

9.4 Disclosure requirement

9.4.1 A locally incorporated AI must disclose information (and will thus be subject to disclosure requirements under the BDR) regarding its group's systemic importance if it falls into any of the following categories:

(i) it is designated as a G-SIB by the MA in the annual reporting period or was designated as a G-SIB by the MA in the immediately preceding annual reporting period; or

(ii) the AI's consolidation group had, at the immediately preceding 31 December, a leverage ratio exposure measure in respect of its group exceeding the Hong Kong Dollar equivalent of 200 billion Euro, and the MA directs the AI to make the requisite disclosure.

9.4.2 Information to be disclosed includes the AI's group figures in relation to the twelve indicators used in the Basel Committee's

G-SIB assessment methodology. However, it should be noted that this disclosure requirement may be updated from time to time following any review by the Basel Committee.

9.4.3 The disclosure requirements should be included in the AI's published financial statements, or the AI should provide a direct link or reference in its annual financial statements to the relevant sections of its public website where the disclosures can be found. The disclosure should be made no later than four months after the financial year-end.

9.4.4 Any locally incorporated G-SIB will be required to disclose its specific G-SIB HLA requirement (or D-SIB HLA requirement if higher) in the MA's standard capital disclosure template for the purpose of making disclosures on the composition of the AI's capital base under the BDR.

Annex 1

QUALITATIVE INDICATORS

1. Anticipated business expansion/contraction
2. Anticipated merger and acquisition
3. Analysis of exposures to a particular banking group across AIs
4. Settlement institution for any payment or clearing system (e.g. RTGS)
5. Banknote issuing banks
6. Extent of retail banking network in Hong Kong
7. Number of overseas branches of the AI
8. Activities in the FX market in Hong Kong in terms of market share
9. Activities in Hong Kong dollar-denominated bond market in terms of market share
10. Structure of the group
    a. Number of subsidiaries
    b. Number of associates
    c. Number of special purpose vehicles
    d. Number of joint ventures
    e. Number of local and overseas subsidiaries being designated as D-SIBs
11. Involvement in, and scale of, the following types of services provided by the group:
    a. Securities brokerage

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b. Trustee

c. Insurance

d. Custodial services for debt and equity securities

e. Money lender

f. Money broker

g. Futures trading business

h. Bullion trading business

12. Amount and number of non-plain vanilla products/portfolios held
13. Amount of off-balance sheet exposures
14. Presence of booking centre outside Hong Kong
15. Degree of mismatch in activity and booking centres
16. Recovery plans and resolvability