HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref.: B1/15C
B9/128C

27 January 2015

The Chief Executive
All authorized institutions

Dear Sir / Madam,

<u>Supervisory Policy Manual (SPM) CA-B-1</u>
<u>"Countercyclical Capital Buffer (CCyB) – Approach to its Implementation"</u>

I am enclosing the SPM module "Countercyclical Capital Buffer (CCyB) – Approach to its Implementation", which is being issued today as a non-statutory guideline.

As the Basel Committee has observed, the losses incurred in the banking sector during a downturn, which has been preceded by a period of excess credit growth, can be extremely large, with the potential to destabilise the banking sector and effectively spark a vicious circle. In an endeavour to address these issues, the Basel Committee has developed a series of measures to help ensure that the banking sector serves as a "shock absorber", rather than an amplifier of risk to the financial system and the broader economy.

One of these measures is the Basel III Countercyclical Capital Buffer (CCyB). The enclosed SPM module endeavours to explain the Monetary Authority (MA)'s approach towards implementing the CCyB as part of the capital adequacy framework for Authorized Institutions (AIs) incorporated in Hong Kong. The module is intended to complement AIs' understanding of the relevant parts of the Banking (Capital) Rules (BCR) as amended by the Banking (Capital) (Amendment) Rules 2014 (BCAR 2014) and of the Banking (Disclosure) Rules as amended by the Banking (Disclosure) (Amendment) Rules 2014 (BDAR 2014), but should not be read as in any sense substituting or amending the text of the BCR or BDR. The module principally covers:

(i) **Overview of the CCyB Framework** – in Sections 1 and 2, the module provides an overview of the CCyB's policy objectives and of the rules relating to the CCyB in the BCR and BDR:

- *The primary aim of the CCyB is to provide a measure of protection to the banking sector against the build-up of system-wide risk associated with periods of excessive aggregate credit growth.* The CCyB seeks to achieve this by ensuring that banks, and the banking sector in aggregate, accumulate additional capital during any observed "credit boom", which can be used later ("released") to absorb any losses or meet any increased capital requirements when system-wide risk crystallizes, probabilities of default increase, and the financial system enters a phase of stress and contraction. This should, in turn, help to maintain the flow of credit to corporates and individuals and thereby lessen the impact of the stress on the real economy after a period of exuberant credit growth.

- *As a secondary benefit, the CCyB may also tend to lean against the build-up of excessive exuberance in the credit cycle* in the first place, potentially containing credit growth to some degree and perhaps thereby helping to moderate swings in asset prices and/or the economy. However, this potential moderating effect is not the primary objective envisaged for the CCyB.
- Section 2 summarizes the rules for the operation of the CCyB as an extension of the Capital Conservation Buffer (CCB); the calculation of the AI-specific CCyB rate as the weighted average of the applicable jurisdictional CCyB rates in respect of the jurisdictions in which an AI has private sector credit exposure (the industry has been consulted on a separate SPM module setting out the details for the geographic allocation of private sector credit exposures in order to determine the weights in this calculation); the time provided for AIs to adjust their capital between the announcement of a jurisdictional CCyB rate and its becoming effective (advance announcement period); and the relevant reporting and disclosure requirements.

(ii) **The MA's approach to determining and announcing the Hong Kong jurisdictional CCyB rate** – in Section 3, the module explains the MA's "guided discretion" approach to determining and announcing the Hong Kong jurisdictional CCyB rate:

- The approach takes as its starting point the CCyB rate resulting from an "Initial Reference Calculator" (capped at 2.5% of RWA and subject to the phase-in schedule provided by the Basel Committee for the period 2016-2019) that is transparently calculated and made public. The Initial Reference Calculator's CCyB rate guide is the lower of two guides: (i) a Composite CCyB Guide based on a credit/GDP gap and a property price/rent gap, which reflect increasing or decreasing signs of excessive credit growth and/or property prices; and (ii) an Indicative CCyB Ceiling based on an interbank market spread and a loan quality indicator, which can provide an early signal of significant stress in the banking system that could lead to excessive credit constraint if the CCyB is not released in a timely manner.
- The decision process then builds upon the Initial Reference Calculator by incorporating the analysis of information from a broader set of "Comprehensive Reference Indicators" and other appropriate sources. The final policy decision is then taken on the basis of informed judgement and will be publicly communicated, with a reasoned justification if and when the decision departs from the indicative guide

provided by the Initial Reference Calculator in either a "tightening" or "loosening" direction. As provided under the BCAR 2014, any decision to accelerate the phase-in of the Hong Kong CCyB rate or to set it above 2.5% will be subject to specific consultation with the industry.

(iii) **The MA's approach to recognizing overseas CCyB rates** – in Section 4, the module explains the MA's approach to implementing the Basel Committee's standards on jurisdictional reciprocity, as incorporated into the BCAR 2014. This approach can be summarized as follows:

- Absent any notification by the MA indicating otherwise, AIs should adopt, for the purposes of determining the applicable jurisdictional CCyB rate in respect of a jurisdiction outside Hong Kong, the level of the jurisdictional CCyB rate and the date for its becoming effective as announced by the relevant authority of the respective jurisdiction, except that: (i) AIs are not required to adopt an applicable jurisdictional CCyB rate of more than 2.5%; (ii) if the pre-announcement period is less than 6 months, AIs may adopt an effective date falling 6 months after the date of the announcement by the relevant authority concerned; and (iii) if the pre-announcement period is more than 12 months, AIs must instead adopt an effective date falling not more than 12 months after the date of the announcement by the relevant authority concerned.
- Notwithstanding the above, the MA may (i) where a jurisdiction sets a jurisdictional CCyB rate below 2.5%, require AIs to adopt a higher rate (but not higher than 2.5%) or (ii) where a jurisdiction sets a jurisdictional CCyB rate above 2.5%, require AIs to adopt the rate set by the jurisdiction concerned, in each case in the circumstances set out in the BCAR 2014. The MA may also specify a different effective date from that set by the relevant jurisdiction, in the circumstances set out in the BCAR 2014, but if the applicable jurisdictional CCyB rate is increasing, the effective date must not be less than 6 months nor more than 12 months from the date of announcement of the CCyB rate. Section 4 describes the criteria to which the MA proposes to have regard when exercising the discretion provided above.

On-line access to the SPM module CA-B-1 is available to AIs under the icon for "Supervisory Policy Manual" on the HKMA's public (http://www.hkma.gov.hk) and private (http://www.stet.iclnet.hk) websites.

Should you have any questions regarding the enclosed module, please feel free to contact Mr Noel Sacasa (njsacasa@hkma.gov.hk) or Mr Rocco Huang (rrhuang@hkma.gov.hk).

Yours sincerely,

Karen Kemp
Executive Director (Banking Policy)

Encl.

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