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Implementation of Basel IV Leverage Ratio ("LR") in Hong Kong

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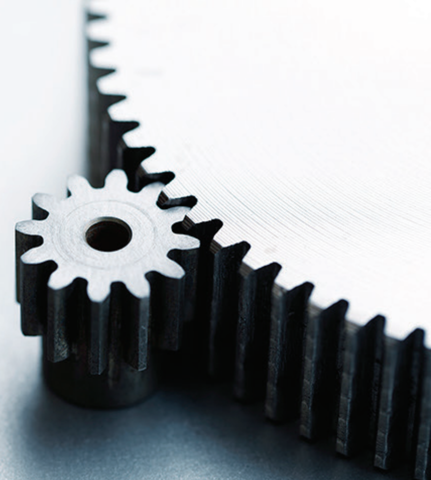

Overview of the Leverage Ratio

The Leverage Ratio Framework of Basel Committee on Banking Supervision (BCBS) intends to restrict the build-up of leverage in the banking system, enhance bank stability and reinforce the risk-based requirements with a simple, non-risk-based "backstop" measure. In line with the revised timeline announced by BCBS, HKMA subsequently announced that the target implementation of the revised framework on leverage ratio and the associated disclosure requirements will be deferred by one year to 1 January 2023.

The HKMA released their consultation paper on adoption of the new leverage ratio requirements in November 2020; the contents are largely consistent with the Basel framework.

Definition of the Leverage Ratio

The leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), with this ratio expressed as a percentage:

$$Leverage\ Ratio = \frac{Capital\ Measure}{Exposure\ Measure}$$

Banks must meet a 3% leverage ratio minimum requirements at all times. Both the capital measure and the exposure measure are to be calculated on a quarter-end basis. However, banks may, subject to supervisory approval, use more frequent calculations (e.g. daily or monthly averaging) as long as they do so consistently.

Capital Measure

The capital measure for the leverage ratio is the Tier 1 capital. In other words, the capital measure used for the leverage ratio at any particular point in time is the Tier 1 capital measure applicable at that time under the risk-based framework.

Exposure Measure

A bank's total leverage ratio exposure measure is the sum of items summarized in below table. In general, no offset is allowed for physical or financial collateral held, guarantees in favour of the bank or other credit risk mitigation techniques.

Items	Scope	Amount
On-balance sheet exposures	Banks must inclzude all balance sheet assets in their exposure measure, including on-balance sheet derivatives collateral and collateral for securities financing transactions (SFTs), with the exception of on-balance sheet derivative and SFT assets that are covered in derivative exposures and SFT exposures.	Gross accounting values.
Derivative exposures	Banks must calculate their exposures associated with all derivative transactions, including where a bank sells protection using a credit derivative.	Consistent with default exposures under SA-CCR framework.

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Exposure Measure (Cont'd)

Items	Scope	Amount
Securities financing transaction (SFT) exposures	SFTs are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements.	The sum of the adjusted gross SFT assets recognised for accounting purposes and a measure of CCR calculated as the current exposure without an add-on for PFE.
Off-balance sheet items	Off-balance sheet items include commitments (including liquidity facilities), whether or not unconditionally cancellable, direct credit substitutes, acceptances, standby letters of credit and trade letters of credit.	Committed but undrawn amount multiplied by a credit conversion factor (CCF). Consistent with the new standardized approach for credit risk.

It is natural to consider the relations between LR exposures and Banking (Exposure Limits) Rules ("BELR") exposures given their similarities in their exposure types and credit risk nature. However, banks will not be able to leverage much from the BELR implementation. BELR exposures are calculated for counterparties / groups which also factor in credit risk mitigation, offsetting, exemptions etc. which are not applicable for LR.

Exemption of Central Bank Reserves

In order to keep the LR framework simple, the HKMA does not intend to exercise the national discretion on excluding central bank reserves from the LR exposure measure. This is based on the consideration that the issue should not have a material impact in Hong Kong, and to avoid the potential speculation on "exceptional macro-economic circumstances" as well as the operational complexities otherwise required to accommodate the temporary calibration mechanism.

Additional Requirements for G-SIBs

The Basel framework introduced a LR buffer requirement for G-SIBs, which is consistent with the risk-weighted G-SIB buffer (i.e. higher loss-absorbency ("HLA") requirement) and aims at mitigating the externalities created by G-SIBs. The HKMA does not propose to implement the LR buffer requirement on any locally incorporated banks, including those that are domestic systemically important banks (on which the HLA requirement is already imposed to address their systemic risks) or other local subsidiary operations of overseas incorporated G-SIBs. This is based on the consideration that these banks are already required to be subject to the LR buffer requirement at the parent bank group level.

How KPMG can help?

- KPMG specialists can assist you on performing a gap analysis to understand a detailed breakdown of the new requirements and help you come up with an implementation plan. Banks will need to pay special attention to the new exposure calculation requirements and alignment with the broader Basel IV requirements such as those for credit risk and counterparty credit risk;
- KPMG experts can help you analyze the business and strategic implications of implementing the new leverage ratio requirements; and
- KPMG team can assist you on system enhancements to fulfill the new calculation requirements and help you fulfill new banking return and disclosure requirements.

Contact us

Tom Jenkins
Partner,
Head of Financial Risk Management
KPMG China
T: +852 2143 8570
E: tom.jenkins@kpmg.com

Michael Monteforte
Partner,
Financial Risk Management
KPMG China
T: +852 2847 5012
E: michael.monteforte@kpmg.com

Gemini Yang
Partner,
Financial Risk Management
KPMG China
T: +852 3927 5731
E: gemini.yang@kpmg.com

Yi-Hsin Wang
Director,
Financial Risk Management
KPMG China
T: +852 2685 7422
E: yihsin.wang@kpmg.com

kpmg.com/cn

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