HONG KONG MONETARY AUTHORITY
香港金融管理局

Banking Policy Department *銀行政策部*

Our Ref.: B1/15C
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S5/1C

17 January 2013

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Basel III: Revisions to Liquidity Coverage Ratio (LCR)[1]

I am writing in relation to the revisions to the LCR recently published by the Basel Committee on Banking Supervision (BCBS) and to update you on some aspects of our current thinking for implementing the LCR in Hong Kong.

Revisions to the LCR

Last week, the BCBS issued the full text of the LCR in a document entitled *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*[2]. As you are no doubt aware, this text incorporates a number of changes to the LCR from the version originally published in December 2010[3].

The revised LCR is the outcome of work undertaken by the BCBS to address a variety of issues identified by supervisors and the international banking community over the past two years since the LCR was originally published. In devising the revisions, the BCBS has been mindful not only of the potential impact of the standard on the financial markets, the extension of credit and economic growth, but also of the timing of its introduction as significant financial strains persist in some banking systems.

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1 The LCR, expressed as a ratio of "Stock of high-quality liquid assets" to "Total net cash outflows over the next 30 calendar days", is one of the two global liquidity standards which form an essential component of the Basel III reform package. It has been designed with the objective of promoting the short-term resilience of banks by ensuring that they have an adequate stock of unencumbered high-quality liquid assets to meet contingent liquidity needs for 30 calendar days under an acute liquidity stress scenario.

2 http://www.bis.org/publ/bcbs238.pdf

3 *Basel III: International framework for liquidity risk measurement, standards and monitoring* www.bis.org/publ/bcbs188.pdf

55th Floor, Two International Finance Centre,
8 Finance Street, Central, Hong Kong
Tel: (852) 2878 1661 Fax: (852) 2878 1670
E-mail: KDKemp@hkma.gov.hk
Website: www.hkma.gov.hk

香港中環金融街8號國際金融中心2期55樓
電話: (852) 2878 1661 傳真: (852) 2878 1670
電郵: KDKemp@hkma.gov.hk
網址: www.hkma.gov.hk

There are four major areas of change:

- *Expansion of the range of assets eligible for inclusion in the stock of high-quality liquid assets (HQLA)*, through the addition of a new category of Level 2B assets[4] which national supervisors may choose to recognise as HQLA in their local LCR regulations. Supervisors exercising such discretion are expected to ensure that the Level 2B assets included as HQLA meet all relevant qualifying criteria and that the banks holding these assets have appropriate systems to monitor and control the associated risks;

- *Recalibration of the stress assumptions for some cash-flow items* (including in respect of retail and non-financial corporate deposits and undrawn committed facilities), taking into account industry feedback and actual experience in times of stress. Such assumptions will affect the calculation of the "Total net cash outflows" denominator of the LCR;

- *Affirmation of the usability of the stock of HQLA by banks in times of stress*, notwithstanding that this may cause the LCR to fall below the minimum requirement. Supervisors are expected to establish guidance to specify the circumstances for usage of the HQLA, and to ensure appropriate supervisory action in response to such circumstances; and

- *Adoption of a phase-in arrangement* that introduces the LCR as planned on 1 January 2015, but with the minimum requirement set at 60%. This will then rise by 10 percentage points per annum to reach 100% on 1 January 2019. This graduated approach is to ensure that the standard can be implemented without material disruption to the ongoing strengthening of banking systems and financing of economic activity.

A summary of the revisions to the LCR is provided for ease of reference at Annex 1.

Review of Net Stable Funding Ratio (NSFR)[5] / Other areas of further analysis

Following the issue of the revised LCR package, the review of the NSFR will now become a priority for the BCBS over the next two years. It remains the intention of the BCBS that the NSFR (with any revisions arising from the review) will become a minimum standard by 1 January 2018.

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4 Level 2B assets consist of (i) A+ to BBB- rated non-financial corporate debt securities (with 50% haircut); (ii) listed common equities issued by non-financial corporates (with 50% haircut); and (iii) residential mortgage-backed securities (RMBS) rated AA or higher (with 25% haircut). Level 2B assets in aggregate (after application of haircuts) cannot exceed 15% of the total HQLA. These assets also need to satisfy all other relevant criteria set out in the January 2013 Basel III LCR document.

5 The NSFR, expressed as a ratio of the "Available amount of stable funding" to the "Required amount of stable funding", supplements the LCR with the objective of promoting banks' longer term resilience by ensuring that they fund their assets and activities with more stable sources of funding on an ongoing basis.

The BCBS will also be continuing work on:

- Developing disclosure requirements for bank liquidity and funding profiles;

- Exploring the use of market-based indicators of liquidity, to supplement the existing asset class and credit rating measures, for defining HQLA under the LCR; and

- Studying the interaction between the LCR and the provision of central bank facilities under different circumstances.

The HKMA will continue its active participation in the BCBS discussions on these issues reflecting the Hong Kong perspective.

Implementation of the revised LCR in Hong Kong

Finalisation of the LCR demonstrates the continuing global commitment to ensuring that banks hold sufficient liquid assets to withstand liquidity shocks. Following the issue of the revised standard, we propose to restart our consultation process with the industry associations with a view to implementing the LCR in Hong Kong from 1 January 2015.

During 2012, we conducted two rounds of consultation to gather opinions from the industry on the scope of application of the Basel III liquidity standards. We are now assessing the implications of the changes to the LCR for our local liquidity regime, and intend to resume industry consultation on the liquidity proposals in the first quarter of this year (please see the next section on "Updated work schedule" and Annex 2 for more information). Our intention is to develop, in consultation with the industry, a framework for the local implementation of the revised LCR that creates a robust liquidity regime in Hong Kong, which takes into account local circumstances (including the nature and characteristics of local financial and debt markets) and which is commensurate with the liquidity risks faced by the Hong Kong banking sector.

Our general intention is to follow the LCR standard closely. If, however, we consider that there are substantive prudential grounds prompted by local circumstances for going beyond the LCR standard in specific areas, the industry's views on the proposals will be specifically sought. We will, of course, also be observing the implementation approaches being adopted in other key jurisdictions from a level playing field perspective.

In order to maintain a close dialogue with the industry during the development of our policy proposals vis-à-vis the LCR, we will be arranging meetings with various industry groups in the coming weeks to discuss the revised LCR package and our preliminary thinking in some specific areas.

Major issues

- *Two-tiered approach for application of the LCR*: We remain of the view that the adoption of a two-tiered approach is appropriate for Hong Kong having regard to the diversity of AIs in terms of their scale and complexity of operation. Under this approach, only AIs (the majority of which will likely be licensed banks) that are considered at the core of the local banking system (Category 1) will be subject to the LCR. Other AIs (Category 2) will be subject to a suitably modified version of the existing minimum 25% Liquidity Ratio (LR).

  Our present intention is to finalise the criteria for classifying AIs into Category 1 or Category 2 in the first half of this year, taking into account the comments received from the previous consultations. Preliminary classification of AIs will then follow, with the results being communicated to AIs before the end of the year.

- *Phase-in of the LCR*: We are now considering whether, and if so to what extent, the BCBS phase-in arrangement should be adopted in Hong Kong. We will assess the impact of the LCR on banks' liquidity positions based on the latest calibration. We will also have regard to the approaches likely to be adopted by other jurisdictions and any associated level playing field implications for the Hong Kong banking sector. If, ultimately, we decide to adopt a phase-in of the LCR, we would nevertheless expect banks not to materially weaken their liquidity positions during the phase-in period in order to take advantage of phased implementation. Even if Hong Kong were to adhere to the original timetable, we would not expect major problems for banks in Hong Kong to comply with a 100% LCR requirement by 2015 (although some may need to adjust their liquidity profiles or the composition of their liquid assets).

- *Level 2B assets*: The addition of Level 2B assets to the range of assets eligible as HQLA offers additional flexibility for national supervisors to set an appropriate scope of HQLA for their jurisdictions based on specific local circumstances. However, bearing in mind that the fundamental purpose of the LCR is to ensure that banks have a stock of highly liquid assets, which can be readily exchanged for cash even in stressed markets, it is crucial that if Level 2B assets are to be recognised they must meet all of the relevant qualifying criteria designed to assess their "liquefiability". To this end, we will be critically examining the attributes of the Level 2B asset types from a local perspective. Specific focus will be placed on assessing the price volatility and market liquidity of these assets based on their historical performance in local markets (especially in times of stress) as well as the potential for incentivising banks to assume more proprietary risk through increased holdings of particular asset classes.

- *Usability of HQLA in times of stress*: We will incorporate into our LCR rules the flexibility for banks to use their HQLA, even to the extent of causing their LCR to fall below the minimum requirement, should this be warranted during a period of financial stress. In this regard, we will develop supervisory guidance to set out the circumstances under which such usage may be allowed, and the considerations underlying our supervisory response in such circumstances.

- *Use of alternative liquidity approaches (ALA)*: Given the limited supply of HQLA denominated in Hong Kong dollars, Hong Kong will likely be a jurisdiction that needs to adopt the BCBS ALA treatment for LCR purposes. Now that the three ALA options and the associated eligibility criteria have been finalised, we will conduct a self-assessment of Hong Kong's eligibility for such treatment and, subject to that, will develop supervisory guidance setting out the ALA framework to be implemented in Hong Kong. Based on the specific circumstances in Hong Kong, it is likely that we will only make available the second ALA option (i.e. use of foreign currency HQLA to cover local currency liquidity needs) to banks subject to the LCR.

- *Implications for the MLR regime*: Under the proposed two-tiered approach, AIs in Category 2 will be subject to a modified LR (MLR). The latest LCR revisions will have implications for implementation of the MLR. In particular, we need to address the implementation timetable for the MLR (and how this would be affected if, ultimately, a decision is taken to phase-in the LCR) and those areas where the LR adopts a more stringent approach than the revised LCR (e.g. certain Level 2B assets such as listed common equities and BBB-rated non-financial corporate debt securities do not qualify as liquefiable assets under the LR). These issues require further deliberation. Our inclination is to avoid any move that may weaken the overall liquidity position of the banking sector in Hong Kong. Consideration will also be given to ensuring a level playing field between Category 1 and Category 2 AIs.

- *Update of LM-2*: It should be stressed that the LCR prescribes a *minimum* level of funding liquidity for banks, and is not the only measure for ensuring the liquidity adequacy of banks. In addition to meeting the LCR, banks are expected to adhere to the enhanced liquidity risk management standards set out in the *Principles for Sound Liquidity Risk Management and Supervision*) [6] published by the BCBS in September 2008. These principles have been incorporated into the HKMA's Supervisory Policy Manual (LM-2) "Sound Systems and Controls for Liquidity Risk Management"[7]. We will continue to place strong emphasis on AIs' implementation of LM-2, and we plan to update LM-2 in the latter part of this year taking into account implementation experience and the latest LCR revisions.

Updated work schedule

We regard the establishment of the local liquidity framework for implementation of the revised LCR as a priority for 2013. This will include (i) the finalisation of the

6 www.bis.org/publ/bcbs144.htm

7 http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy manual/LM-2.pdf)

classification framework under the two-tiered approach; (ii) the delineation of methodologies for calculation of the LCR; (iii) the development of an appropriate ALA framework in Hong Kong, taking into account the relevant requirements set out in the January 2013 LCR document; and (iv) any necessary modifications to the LR / MLR regime.

We intend to roll out the policy proposals for consultation in phases with a view to reaching a conclusion on the major policy issues within the year, so that the rule-making and legislative processes can be completed in good time for the implementation of a set of Banking (Liquidity) Rules on 1 January 2015. Meanwhile, we will continue to collect liquidity data from selected AIs to facilitate implementation monitoring and impact analysis.

An updated work schedule (with indicative timelines) based on the latest developments is attached at Annex 2 for reference.

Should you have any question regarding the contents of this letter, please feel free to contact Rita Yeung on 2878-1388 or Thomas Wong on 2878-1219.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

Encl.

c.c. Hong Kong Association of Banks
Deposit-taking Companies Association
FSTB (Attn: Mr Jackie Liu)