Consultation Paper

Implementation of Basel III Liquidity Standards in Hong Kong (L1)

Purpose

1. This paper outlines the HKMA's proposals for giving effect to certain aspects of the Basel III liquidity standards in Hong Kong, and invites the industry's feedback on the proposals.

Overview

2. In December 2010, the Basel Committee on Banking Supervision issued a package of reforms to strengthen global capital and liquidity rules for banks with the goal of promoting a more resilient banking sector.

3. The Basel Committee's liquidity standards were set out in the document entitled *Basel III: International framework for liquidity risk measurement, standards and monitoring* and include:-

   - the introduction of two global liquidity standards to achieve two separate but complementary objectives:

     (i) Liquidity Coverage Ratio (LCR) – This standard seeks to promote the short-term liquidity resilience of banks by ensuring that they have sufficient high-quality liquid assets (HQLA) to survive for at least 30 days under an acute stress scenario combining an idiosyncratic and market-wide shock.

     (ii) Net Stable Funding Ratio (NSFR) – This standard seeks to promote the longer term resilience of banks by requiring them to hold minimum amounts of funding expected to be "stable" over a one-year time horizon under an extended stress scenario.

   - a set of liquidity monitoring tools for supervisors' ongoing monitoring of banks' liquidity risk exposures to further strengthen and promote global consistency in liquidity risk supervision.

4. In a letter of 26 January 2011, the HKMA informed authorized institutions (AIs) of its support for the Basel III reform package and of its intention to consult the industry on its proposals for implementing the package in Hong Kong in due course.

5. This document is the first in a series of consultation papers which the HKMA intends to issue for the purpose of seeking the banking industry's feedback on proposals to implement the Basel III liquidity standards in Hong Kong. It focuses primarily on:

   - the scope of application of the Basel III liquidity standards (Section 1);
   - the relationship of the Basel III standards with the existing liquidity ratio in the Banking Ordinance (Section 2); and
   - the approach to implementation and the transitional timeline (Section 3).

6. Other aspects of the Basel III liquidity package, including the proposed approach to the calibration of certain LCR items which are subject to national discretion, definitional issues, etc., will be the subject of future consultations.

7. In developing its implementation proposals, the HKMA has taken into account the results of a series of liquidity quantitative impact studies (QIS) and other surveys conducted in 2010 and 2011, as well as issues raised during bilateral discussions with a number of selected AIs.

Section 1

Scope of application

8. The HKMA proposes to adopt a two-tiered approach to the application of quantitative liquidity standards in Hong Kong. Under this approach:

- the LCR and the NSFR will apply to a group of AIs (regardless of their place of incorporation) that are at the core of the Hong Kong banking system on the basis of their systemic importance and the nature of their operations (Category 1 AIs);

- a modified version of the existing liquidity ratio (LR) in the Banking Ordinance (an MLR)[1] will apply to other AIs with simpler operations, and/or relatively less systemic implications for the banking system should they get into financial difficulty (Category 2 AIs). Category 2 AIs may, however, seek supervisory approval to adopt the LCR and the NSFR voluntarily; and

- a set of criteria will be developed for determining which AIs should be classified as Category 1 AIs and made subject to the LCR and the NSFR. The HKMA's initial thinking is to apply the LCR and the NSFR to AIs with significant maturity transformation in their operations (and which hence potentially pose a higher level of liquidity risk), and/or which play a significant role in the local banking sector (for example in terms of market share, payment system involvement and retail banking activities). If these criteria are adopted, it is likely that most of the local banks and some branches of foreign banks that are significant to the Hong Kong markets will be classified as Category 1 AIs. The HKMA would be interested in hearing suggestions from the industry on other criteria which may be used to classify AIs for this purpose.

9. The conceptual framework underlying the LCR (and the NSFR) is fundamentally different from that upon which the LR (and hence any new MLR) is based. The LCR cannot be regarded as a complete substitute for the MLR in all circumstances (please see paragraph 15 for further discussion on this point). This raises the issue of whether Category 1 AIs should be subject to both the

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[1] See Section 2 of this paper for the rationale for retaining the LR, albeit in a modified form, as a liquidity standard and a description of the proposed approach to modification.

LCR and the MLR. Mindful of the need not to over-complicate the framework, the HKMA would propose to require a Category 1 AI, in complying with the LCR, to observe a floor amount for HQLA, which is equal to 25% of the AI's 1-month qualifying liabilities (net of deductions) as calculated under the MLR. In other words, if the amount of HQLA included in the LCR of a Category 1 AI is lower than the floor amount, the AI will need to top up its HQLA to the floor amount.

10. Although Category 2 AIs will not be required to comply with the stress-based LCR, they will remain subject to the liquidity stress-testing requirements under the HKMA's liquidity guideline LM-2 *Sound Systems and Controls for Liquidity Risk Management* (which implements the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee in September 2008) as part of the required liquidity risk management standards.

Section 2

Treatment of the existing 25% minimum liquidity ratio in the Banking Ordinance (LR)

Should the LR be retained, modified or phased out?

11. The HKMA proposes to retain the LR, and to modify the LR to enhance the ratio's effectiveness. The HKMA's proposal reflects the different focus of the LR vis-à-vis the LCR.

12. In comparison to the LCR, the LR is a somewhat simpler liquidity measure requiring an AI to hold an amount of "liquefiable assets" that is sufficient to cover at least 25% of its 1-month "qualifying liabilities". This ratio, not being attached to any specific stress scenario, is essentially a broad-brush liquidity buffer requirement more directed towards providing for unexpected withdrawals or other day-to-day liquidity contingencies. For example, in the case of demand deposits, an AI will need to ensure that there are liquefiable assets sufficient to meet withdrawals of up to 25% of such deposits without differentiating between the type and stability of deposits.

13. The LCR, on the other hand, is a liquidity measure that seeks to strengthen banking stability by improving individual banks' capacity to absorb liquidity shocks arising from a prescribed financial and economic stress scenario, and so minimise the risk of spill-over from the financial sector to the real economy. To achieve this, the HQLA under the LCR are confined to a narrow set of highly liquid asset types and subject to other stringent qualifying criteria. Moreover, the stress parameters (i.e. run-off / drawdown rates) for different types of liabilities, commitments or obligations are set based on their individual liquidity risk characteristics under the prescribed stress scenario.

14. The HKMA has considered the different attributes and policy focus of the ratios and concluded that there remains a role for both the LR (or at least the MLR) and the LCR, taking into account the characteristics of the local banking sector. The HKMA is inclined to the view that an across-the-board application of the LCR (and similarly of the NSFR) to all AIs may not be the optimum choice for Hong Kong given the diversity of its AIs in terms of their level of systemic significance and the nature and relative sophistication of their operations. Generally speaking, the LCR and NSFR are more suited for application to AIs

with a significant role in the financial system, or whose safety and soundness are crucial for the stability of the banking sector. For AIs whose business is simple, small and localised, and/or whose failure is not likely to have systemic implications, the LR will provide an adequate liquidity buffer requirement, provided that the ratio is suitably modified and enhanced to improve its operation.

Interplay between the LCR and the LR

15. In addition to analysing the respective policy objectives of the LCR and the LR, it is also important, in any consideration of whether to retain and modify the LR, to understand the interplay between the two ratios. This involves an assessment of how the results of applying the LCR will compare with the results of the application of the LR for AIs with different business or liquidity risk profiles. The HKMA's analysis of how AIs perform under the ratios, based on available QIS data, indicates that AIs with significant retail portfolios tend to perform better than those with significant wholesale portfolios under the LCR, but there are cases where the LR levels of some AIs with significant retail portfolios are relatively low. The reason is that under the LCR, retail and corporate customers are treated differently with different run-off rates applied to their respective deposits (i.e. 5% / 10% for retail deposits and 25% / 75% for wholesale deposits), whereas under the LR, the deposits of all these customers are treated the same (that is subject to a uniform 25% liquid asset requirement). All things being equal, an AI is likely to perform better under the LCR than under the LR if the amount of its retail deposits is larger than the amount of its wholesale deposits. This suggests that the LCR cannot be regarded as a complete substitute for the LR in all circumstances. It is this line of thinking that has, for example, prompted the proposal in paragraph 9.

How should the LR be modified?

16. The LR has been in place for many years and the HKMA considers that, if the LR is to be retained as a liquidity standard, some of its components will need to be updated to reflect market developments over the years as well as some of the lessons of the recent financial crisis. The HKMA is therefore contemplating changes to certain aspects of the LR, while still seeking to preserve the simple structure of the ratio and its minimum level of 25%. Some initial proposals include -

(i) adjusting the definition of "liquefiable assets" to exclude all "cash inflow" items (e.g. eligible loan repayments and net bank placements), in order to restrict the numerator to assets that are genuinely liquid and available;

(ii) including some assets which qualify as HQLA under the LCR but are not otherwise included under the LR (e.g. central bank reserves or amounts due from the Exchange Fund), while considering the extent to which other liquefiable assets that do not qualify as liquid assets under the LCR (e.g. gold, export bills, and marketable securities of investment grade issued by financial institutions) can be included. There is a case for including a broader range of liquid assets as long as these assets serve the purpose of the ratio (which is not necessarily tied to a period of severe stress);

(iii) applying the concept of "net cash outflows" under the LCR to the denominator of the LR by allowing AIs to deduct cash inflows due within one month from 1-month qualifying liabilities if the cash inflows can meet prescribed criteria for liquefiable assets such as those under the Fourth Schedule to the Banking Ordinance (e.g. not overdue, unencumbered, freely remittable and convertible into Hong Kong dollars). This means that items such as "eligible loan repayments" and "net bank balances" can still be regarded as a source of liquidity to AIs (insofar as they can be deducted from 1-month qualifying liabilities) albeit not in the form of liquid assets in the numerator. As a result of this adjustment, the denominator of the LR would be in terms of net cash outflows (but without applying any specific stress parameters as in the case of the LCR); and

(iv) applying a cap to total cash inflows (at a level to be determined), similar to the 75% cap under the LCR, to ensure that an AI with "net cash inflows" must still maintain a minimum stock of liquefiable assets to cater for contingencies.

17. The HKMA considers that modifications such as these would have the merits of encouraging AIs to maintain an adequate amount of liquid assets as back-up liquidity rather than relying too heavily on "cash inflow" items, and incorporating some elements of the LCR to make the two ratios more comparable.

18. In addition, the HKMA will review its approach to the treatment of RMB liquefiable assets and qualifying liabilities under the LR and consider other necessary refinements to the ratio, such as the continued appropriateness of the existing liquidity conversion factors in the Fourth Schedule to the Banking Ordinance. A comprehensive review of the LR will be conducted to identify all necessary or desirable modifications, and the industry will consulted on the proposals in due course.

Section 3

Implementation approach and transitional timeline

19. According to the Basel Committee's transitional timeline, the LCR and NSFR should be formally implemented on 1 January 2015 and 1 January 2018 respectively. In the interim, there is an "observation period" (which started from 1 January 2011) to allow banks sufficient time to transition to the new standards. During this period, the Basel Committee will monitor the potential impact of the standards on financial markets, credit extension and economic growth, and seek to address any observed unintended consequences by adjusting the design and calibration of the standards as appropriate.

20. <u>The HKMA proposes to follow the Basel Committee's transitional timeline and to implement the LCR on 1 January 2015 and the NSFR on 1 January 2018.</u> Some AIs will be required to report their positions vis-à-vis the two standards from 2012 (in a similar manner to that adopted in the previous liquidity QIS) to facilitate the monitoring by the HKMA of any behavioural changes or other consequences of the standards during the Basel Committee's observation period (see paragraph 24). <u>The HKMA also proposes to adopt the Basel Committee's proposed liquidity monitoring tools in its ongoing liquidity risk supervision by 2015.</u>

21. In order to implement the LCR and NSFR in Hong Kong, the HKMA is seeking a power to make rules to prescribe liquidity requirements for AIs. A Banking (Amendment) Bill was introduced into the Legislative Council in December 2011 for this purpose. The use of a rule-making power for liquidity standards takes into account the need to cater for the technical complexity of the standards (where subsidiary legislation is generally preferred to primary legislation) and provides flexibility to make changes as the standards evolve over time. Subject to the passage of the Bill, the new liquidity standards will be issued by the HKMA in a set of Banking (Liquidity) Rules which will take the form of subsidiary legislation. Where necessary, the rules will be supplemented by codes of practice and guidelines. Supervisory guidance will also be issued to support the operation of the liquidity monitoring tools.

22. Subject to passage of the Banking (Amendment) Bill, the intention would be for all three liquidity standards (LCR, NSFR and MLR) to be incorporated into the Banking (Liquidity) Rules referred to in paragraph 21. When the LCR and the

MLR are implemented on 1 January 2015, Part XVIII of the Banking Ordinance and the Fourth Schedule to the Ordinance will be repealed.

23. Indicative timelines for implementing the liquidity standards and monitoring tools in Hong Kong are set out below for information. The timelines may be subject to change in the light of international developments affecting the Basel III standards and progress locally as regards consultation and legislative processes.

Key Tasks	**Indicative Timelines**		
	LCR & MLR	**Monitoring tools**	**NSFR**
• Development of, and consultation on, implementation proposals in phases[2]	H1 2012	N/A	2014-2015
• Development of, and consultation on, Banking (Liquidity) Rules	H2 2012 – H1 2013[3]	N/A	2015-2016
• Development of, and consultation on, reporting requirements for liquidity standards and monitoring tools (including reporting templates)	H2 2013 – Q1 2014	H2 2013 – Q1 2014	2016-2017
• Development of, and consultation on, any relevant codes of practice and guidelines	H2 2013 – Q1 2014	H2 2013 – Q1 2014	2016-2017
• Legislative process for Banking (Liquidity) Rules[4]	2014	N/A	2017

24. During the past two years, the HKMA has conducted a series of local QIS exercises on selected AIs to help monitor states of readiness for the implementation of the LCR and the NSFR and assess the implications of the standards for the banking sector. <u>The HKMA proposes to formalise these local</u>

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[2] The implementation proposals, after taking into account the industry's comments, will form the basis for drafting the Banking (Liquidity) Rules.

[3] The need for further consultation on changes to the Banking (Liquidity) Rules for the LCR will be contingent upon any fine-tuning of the liquidity standard by the Basel Committee during the observation period.

[4] The intention would be to table the Banking (Liquidity) Rules in respect of the LCR and the MLR for negative vetting by the Legislative Council in the course of 2014. This is to cater for any final changes to the LCR.

QIS reporting arrangements for regulatory reporting purposes in 2012.[5] Regulatory reporting is likely to commence as a semi-annual reporting exercise covering a target number of AIs, with a first reporting position as of end-December 2011. The frequency of reporting and the coverage of AIs will then be progressively increased as 2015 approaches. For example, in the case of the LCR, the reporting frequency may be increased to quarterly in 2013 and to monthly in 2014, and the coverage will be extended to all AIs to which the LCR will be applicable, as soon as practicable.

25. The regulatory reporting exercise is for supervisory monitoring purposes. It is not intended to, de facto, bring forward the implementation dates for the standards and it is therefore not intended to require AIs' compliance with the liquidity standards as if they were already in force.

26. The HKMA believes that continued dialogue with the industry is crucial for the smooth and effective implementation of the new liquidity standards. In this regard, the HKMA will continue to seek industry input on market practices and specific issues affecting implementation. This will include discussions with individual AIs and representatives of the two industry Associations.

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[5] Paragraph 197 of *Basel III: International framework for liquidity risk measurement, standards and monitoring* (December 2010) notes that there will be reporting to supervisors throughout the observation period starting from 1 January 2012. The information reported to supervisors would include the overall percentages of the LCR and the NSFR, as well as information on all the components, similar to the information gathered for the QIS.