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Level 2B assets under LCR and derivative liabilities under NSFR



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I. Purpose

1. This consultation paper (CP) consists of two parts:
 - Part 1 sets out the HKMA's proposals for expanding the scope of level 2B assets under the Liquidity Coverage Ratio (LCR) and that of liquefiable assets under the Liquidity Maintenance Ratio (LMR).
 - Part 2 presents the HKMA's proposal of implementing a required stable funding (RSF) charge of 5% on total derivative liabilities under the Net Stable Funding Ratio (NSFR) and Core Funding Ratio (CFR).
2. Authorized institutions (AIs) are invited to provide comments via the two industry associations by 6 August 2018.

Part 1: Level 2B assets under LCR

II. Background for Part 1

3. Under the Basel LCR standard¹, the scope of high quality liquid assets (HQLA) includes, in addition to level 1 assets and level 2A assets, a class of level 2B assets that can be accepted by national supervisors on a discretionary basis. The Basel definition of level 2B assets includes –
 - (a) residential mortgage backed securities (RMBS) with a credit rating of AA or above;
 - (b) marketable debt securities issued by corporates with an issue-specific credit rating between BBB- and A+; subsequent Basel FAQ also

¹ The Basel LCR standard was prescribed in the document “*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*” issued by the Basel Committee in January 2013. (<https://www.bis.org/publ/bcbs238.pdf>)

clarifies that marketable debt securities issued by sovereign, central banks and public sector entities with a credit rating of BBB+ to BBB- may also be recognised;² and

- (c) listed common equity shares issued by corporates.
4. Level 2B assets must satisfy the applicable conditions set out in paragraph 54 of the Basel LCR standard (which are described in paragraph 8 below in the case of common equity shares). The total weighted amount of level 2B assets should comprise no more than 15% of the total weighted amount of HQLA.
 5. When the HKMA developed the local LCR policy during 2013 and 2014, it was decided to adopt a more conservative policy stance by only including single-A rated debt securities and RMBS (the latter subject to case-by case pre-approval) as level 2B assets.³ In particular, amid unstable financial market environments in the aftermath of the 2007/08 Global Financial Crisis (GFC), the HKMA was minded to preserve its liquidity supervisory standard adopted over the years, where equity shares and most triple-B rated debt securities were not recognised as “liquefiable assets” under the Liquidity Ratio requirements before 2015. Moreover, the HKMA’s initial study on the local share market indicated that only a very limited number of shares in the Hang Seng Index (HSI) could meet the Basel qualifying criteria fully, while the international supervisory practices on the treatment of overseas listed shares were also not clear at that time.
 6. Recently the HKMA has conducted a post-implementation review of its LCR policy taking into account the current market conditions and international supervisory practices. The review indicates that there may be a stronger case to include Basel-compliant equity shares and triple-B rated debt

² As an elaboration on paragraph 54 of the LCR standard, items 3(a) and 5(b) of the document “*Basel III – The Liquidity Coverage Ratio framework: frequently asked questions*” (<https://www.bis.org/bcbs/publ/d406.pdf>) also clarify that marketable debt securities issued by sovereign, central banks and public sector entities with a credit rating of BBB+ to BBB- may also be recognised as Level 2B assets.

³ For the details of the HKMA’s initial policy consultation, please refer to the Consultation Paper “Implementation of Basel III Liquidity Standards in Hong Kong (L3)” issued in July 2013. (http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/basel-3/consultation_on_local_implementation_of_basel-3_liquidity_standards/Consultation_paper.pdf)

securities as level 2B assets. In particular, the global economic recovery and gradual improvement of financial market stability⁴ in recent years have set a ground for us to re-examine our policy on level 2B assets. We also noted that a majority of the Basel member jurisdictions have fully adopted the Basel definition of level 2B assets by including equity shares and triple-B marketable debt securities.⁵ As for the local share market, our updated assessment suggests that, the number of HSI constituent shares potentially qualified for recognition as level 2B assets seem to have increased since our initial assessment.

7. In light of the above developments, the HKMA proposes to amend the local scope of level 2B assets in order to better align with the Basel standard and majority international practices. The proposed amendments are set out in section III.

III. Proposed scope of level 2B assets under LCR

Listed common equity shares

8. The HKMA proposes to accept listed common equity shares as level 2B assets subject to the Basel qualifying criteria. Namely, a qualifying issue of equity shares must be –
 - (a) issued by an entity which is not financial institution or its affiliated entity;
 - (b) exchange-traded and centrally cleared;

⁴ For example, please refer to the World Economic Outlook report issued by the International Monetary Fund in April 2018.
(<https://www.imf.org/en/Publications/WEO/Issues/2018/03/20/world-economic-outlook-april-2018>)

⁵ Please refer to the Basel Committee's reports on its member jurisdictions' implementation of the LCR standard under the Regulatory Consistency Assessment Programme (RCAP). These RCAP reports are available at the Committee's website.
(https://www.bis.org/bcbs/implementation/rcap_jurisdictional.htm)

- (c) a constituent of a major stock index in the home jurisdiction or where the liquidity risk is taken, as decided by the supervisor in the jurisdiction where the index is located;
- (d) denominated in Hong Kong dollar or in the currency of the jurisdiction where a bank's liquidity risk is taken;
- (e) traded in a large, deep and active repo or cash market characterised by a low level of concentration; and
- (f) demonstrated with proven records as a reliable source of liquidity in the markets (whether through direct sale or repo-style transactions) even during stressed market conditions, i.e., the maximum decline of share price not exceeding 40% (or an increase in haircut not exceeding 40 percentage points if used as collateral in a repo-style transaction) within any period of 30 calendar days during a relevant period of significant liquidity stress.

9. The HKMA intends to implement these criteria in the following manner:

- The meaning of “financial institution” in criterion (a) will follow the definition currently provided in Rule 2(1) of the Banking (Liquidity) Rules (BLR). “Affiliated entity” will be equivalent to “associated entity” defined in section 97H(4) of the Banking Ordinance.
- With regard to criteria (b), (c) and (d), the qualifying shares listed in Hong Kong must be HSI constituent shares.⁶ Overseas listed shares may also be qualified as level 2B assets, subject to the liquidity policy applicable in the relevant overseas jurisdiction where an AI has incurred any liquidity risk⁷, and the relevant overseas liquidity policy

⁶ The HKMA's assessment indicates that most equities in other local stock indexes would not be able to meet the Basel qualifying criteria.

⁷ For example, the institution has a certain amount of net cash outflows arising from its operation in that jurisdiction, and that amount of outflows is included in the calculation of the institution's LCR.

should not be less prudent than the Basel standard on the inclusion of equities as level 2B assets.⁸

- To supplement criterion (e), the HKMA may develop guidelines for AIs to assess market liquidity and avoid concentrated holding of individual shares. For example, the HKMA may require AIs to assess individual shares' market liquidity with reference to some quantitative indicators such as the relevant shares' floating market value and transaction volume. The HKMA is undertaking some quantitative studies to inform guideline development.
- For criterion (f), the meaning of a "relevant period of significant liquidity stress" would be defined in line with the existing guidance provided in footnote 39 of module LM-1 of the Supervisory Policy Manual (SPM). In other words, an AI seeking to include a particular issue of equity shares as level 2B asset should assess the price volatility of the shares starting from 1 January 2007, so that the share price performance during the GFC period can be taken into account in the eligibility assessment. For equity shares listed after 1 January 2007, the assessment should be conducted from the first day of listing.

Marketable debt securities

10. In addition to single-A rated corporate debt securities that have been accepted as level 2B assets under the BLR, the HKMA proposes to also accept triple-B rated marketable debt securities issued by corporates, sovereigns, central banks and foreign public sector entities subject to the Basel criteria, which have been set out in section 7(1)(d), (e), (f), (g) and (3) of Part 3 of Schedule 2 to the BLR.

⁸ For example, if a category 1 institution has any total net cash outflows arising from its operation in an overseas jurisdiction where the relevant banking supervisory authority has specified that the qualifying shares for inclusion as level 2B assets must be the constituents of a specified local index, the HKMA will be prepared to accept the institution to treat the qualifying shares as level 2B assets for covering the institution's net cash outflows arising from that operation. However, if the overseas jurisdiction's qualifying criteria is less prudent than the Basel criteria (e.g. the overseas jurisdiction's policy does not exclude shares issued by financial institutions), the Basel criteria (which will be incorporated in the BLR) will prevail.

IV. Proposed scope of liquefiable assets under LMR

11. In line with the proposed amendment to the scope of level 2B assets for the LCR, the HKMA also proposes to amend the scope of liquefiable assets for the LMR accordingly. This may be achieved through appropriate revision of Table A in Schedule 5 to the BLR (Annex).

V. Risk mitigation measures

12. Notwithstanding the proposed amendments to the scope of level 2B assets under the LCR and liquefiable assets under the LMR, AIs seeking to include equity shares and triple-B debt securities as HQLA / liquefiable assets are expected to have effective policies and procedures to manage the associated risks. These include, for example, effective management oversight, appropriate internal limits, effective valuation, sufficient stress-testing, regular compliance review and internal audit. In particular, the HKMA would expect AIs to set appropriate limit on each of these two asset classes to avoid undue concentration of holding. The SPM modules LM-1 and LM-2 will be enhanced to provide more guidance in this aspect.
13. Last but not least, if the HKMA finds it warranted to order AIs (or a particular AI) to reject a specified asset (or a specified type of assets) as HQLA under the LCR, it may do this by exercising the power already provided under rule 29(1) or 30(1). Similar power is also exercisable under rule 51(1) or 52(1) for the LMR.

Part 2: Derivative liabilities under NSFR

VI. Background for Part 2

14. In the Basel NSFR standard published in 2014⁹, there was an RSF factor (initially set at 20%) imposed on a bank's on-balance sheet total derivative liabilities. Subsequently the Basel Committee announced in October 2017 that jurisdictions may exercise discretion to lower the value of this factor but with a floor of 5%.¹⁰
15. When the HKMA developed the Banking (Liquidity) (Amendment) Rules 2017 during last summer to prescribe the NSFR and CFR requirements, the Basel Committee was still considering the treatment of total derivative liabilities without any conclusion. In light of the uncertainty, we decided not to introduce the RSF charge on total derivative liabilities while waiting for the Committee's decision. By the time of the Committee's announcement made in October 2017, the local legislation timeline made us unable to incorporate the Committee's final decision (including the minimum charge of 5%) in the Rules. Having reviewed international implementation practices and AIs' derivatives exposures, the HKMA now proposes to implement an RSF charge of 5% on total derivative liabilities under the NSFR.
16. Likewise, a charge of "required core funding" also at 5% is proposed for the CFR in order to maintain the consistency of treatment on derivatives across the two ratios.

⁹ The Basel NSFR standard was presented in the document "*Basel III: the net stable funding ratio*" published by the Basel Committee in October 2014. (<https://www.bis.org/bcbs/publ/d295.pdf>)

¹⁰ Please refer to the Basel Committee's press release on 6 October 2017: "*Implementation of net stable funding ratio and treatment of derivative liabilities*". (<https://www.bis.org/press/p171006.htm>)

VII. Way forward

17. The HKMA will seek to finalise the proposed amendments after receiving the industry's comments. Meanwhile, we will engage some AIs to conduct quantitative impact studies to inform policy amendments. It is our current target to make a set of liquidity amendment rules and revise the returns and guidelines for industry consultation in the course of 2019, so that the amendments could come into operation starting from 2020 or earlier if possible.

Annex

Possible amendments (highlighted in red) to Item 6 of Table A in Schedule 5 to the BLR

Item	Liquefiable assets	Liquidity conversion factor
6.	<p>Marketable debt securities or prescribed instruments that are—</p> <p>(a) issued or guaranteed by—</p> <p style="padding-left: 20px;">(i) the Government, the Monetary Authority for the account of the Exchange Fund, or a domestic public sector entity, with a remaining term to maturity of—</p> <p style="padding-left: 40px;">(A) not more than one year;</p> <p style="padding-left: 40px;">(B) more than one year;</p> <p style="padding-left: 20px;">(ii) an authorized institution incorporated in Hong Kong or the Hong Kong branch of an authorized institution incorporated outside Hong Kong, with a remaining term to maturity of—</p> <p style="padding-left: 40px;">(A) not more than one month;</p> <p style="padding-left: 40px;">(B) more than one month but not more than one year;</p> <p style="padding-left: 40px;">(C) more than one year;</p> <p>(b) issued or guaranteed by the central bank or central government of a country, a multilateral development bank, or a relevant international organization, where the debt security or instrument, or its issuer or guarantor, has a qualifying ECAI rating, with a remaining term to maturity of—</p> <p style="padding-left: 20px;">(i) not more than one year;</p> <p style="padding-left: 20px;">(ii) more than one year;</p> <p>(c) with a qualifying ECAI issue specific rating, issued or guaranteed by—</p> <p style="padding-left: 20px;">(i) a bank, other than those included in item 6(a)(ii), with a remaining term to maturity of—</p> <p style="padding-left: 40px;">(A) not more than one month;</p> <p style="padding-left: 40px;">(B) more than one month but not more than one year;</p>	<p>100%</p> <p>95%</p> <p>100%</p> <p>95%</p> <p>90%</p> <p>100%</p> <p>95%</p> <p>100%</p> <p>95%</p>

