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25 September 2013

The Chief Executive
All authorized institutions

Dear Sir / Madam,

**Supervisory Policy Manual (“SPM”)
LM-2 “Sound Systems and Controls for Liquidity Risk Management” –
Section 8 – Maintenance of Liquidity Cushion**

I refer to the circular letter issued by the HKMA on 1 April 2011 informing authorized institutions (“AIs”) of the issue of two SPM modules, viz. LM-1 (revised) and LM-2 (new), under section 16(10) of the Banking Ordinance. Pursuant to para. 1.4.6 of LM-2 (see below), I am writing to advise AIs of the approach the HKMA will adopt in implementing the provisions relating to liquidity cushions set out in section 8 of the module.

Background

LM-2 is based on the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee in September 2008. Section 8 of LM-2 sets out the HKMA’s expectations regarding the maintenance by AIs of an adequate cushion of unencumbered “high-quality readily liquefiable assets”¹ as insurance against a range of liquidity stress scenarios of the type described in section 5.4 of the module. At the time of issuing LM-2 the HKMA included a “place-marker” in para. 1.4.6 to further advise AIs of the timing of implementation of section 8. This was in the light of the then ongoing international debate concerning the scope of, and eligibility criteria for, the “High Quality Liquid Assets” (“HQLA”) to be recognised under the Basel III Liquidity Coverage Ratio (“LCR”) which the HKMA considered could potentially have had implications for the section 8 liquidity cushion. As you may recall, at that time the proposed approach for implementing the LCR in Hong

¹ The HKMA is minded henceforth to refer to “high-quality readily liquefiable assets” in the context of the liquidity cushion in LM-2 to distinguish it from, and avoid confusion with, the definition of High Quality Liquid Assets (“HQLA”) adopted under the Basel III Liquidity Coverage Ratio.

Kong was still at a relatively early stage, particularly as regards whether the LCR would be applicable to all AIs. Para. 1.4.6 also provided for AIs to conduct an initial assessment of the extent to which their liquid asset holdings may have to be increased by reference to the provisions in section 8 and to discuss the results of their initial assessments with the HKMA in conjunction with the HKMA's review of their proposed stress scenarios for conducting liquidity stress tests (re para. 5.6.4 of LM-2).

In January 2013, the Basel Committee published a revised LCR standard (including changes related to the constituent elements of HQLA). In response to these revisions, and to industry comments received in previous consultations on local LCR implementation, the HKMA updated its policy proposals and conducted a further round of industry consultation in July 2013.

The HKMA is now of the view that it is an appropriate time for the provisions in section 8 of LM-2 to be implemented locally, as it does not appear from the LCR revisions made by the Basel Committee in January that there will be any need to introduce fundamental changes to the LM-2 provisions relating to the maintenance of cushions of high-quality readily liquefiable assets as a result of the updated proposed approach for LCR implementation in Hong Kong. The HKMA does, however, plan to update LM-2 in other respects in Q1 2014 to incorporate some relevant points from the Basel Committee's revised LCR standard (including for example clarification of the treatment of liquid assets held in the trading book of banks) and to address some key implementation issues identified since the issue of LM-2 in 2011.

Implementation of liquidity cushion

Given the importance for AIs of maintaining adequate liquidity cushions as part of their overall liquidity risk management and the expectation that no material changes will need to be made to the related provisions in LM-2, the HKMA does not consider it prudent or necessary to await further updating of LM-2 before implementing section 8 of LM-2. Accordingly, AIs should regard this letter as the advice referred to in para 1.4.6 of LM-2 and:

- (i) AIs should now take steps to ensure that they have a sufficient liquidity cushion which reflects the considerations and criteria in section 8 of LM-2. AIs that identify gaps in their holdings of high-quality readily liquefiable assets, compared to the liquidity needs indicated by their liquidity stress scenarios (see para. 5.4.17 of LM-2), should take prompt action to fill these gaps, if they have not already done so, by 31 March 2014². In other words, the HKMA will expect all AIs to maintain liquidity cushions, as a source of strategic liquidity reserve, in line with section 8 of LM-2 from 31 March 2014;

² The specified date may be extended at the discretion of the HKMA under exceptional circumstances provided an AI can adequately justify its request for extension (e.g. due to major factors not within its control), and agree with the HKMA a credible plan to fill the gap within a reasonable timeframe. AIs that consider that they may need such an extension should contact their usual supervisory contacts as soon as possible.

- (ii) To facilitate the HKMA's review of AIs' progress in this regard, AIs are required to complete the survey table in the Annex to this letter and return it to the HKMA case team on or before 23 October 2013; and
- (iii) As a general principle, the maintenance by an AI of a liquidity cushion to withstand liquidity stress should be seen as an integral part of the AI's overall liquidity risk management. In assessing the composition and adequacy of an AI's liquidity cushion for the purposes of LM-2, the HKMA will have regard to the AI's liquidity risk profile and position, and to the types of eligible liquid asset, specified by the AI, in its liquidity risk management policies, as eligible for inclusion in the liquidity cushion in accordance with the provisions set out in subsections 8.4 and 8.5 of LM-2³.

Should you have any questions regarding this circular, please feel free to direct them to your usual supervisory contacts at the HKMA.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

Encl.

c.c. FSTB (Attn: Mr Jackie Liu)

³ In other words, high-quality readily liquefiable assets eligible for inclusion in the liquidity cushion of an AI in line with section 8 of LM-2 are not confined to those defined as HQLA that are eligible for LCR purposes.

LM-2 : Progress in building and maintaining liquidity cushion (section 8 of LM-2)

Name of authorized institution (“AI”): _____

Reporting date: _____

Contact person: (Name / rank / department / telephone number)

(Please insert additional sheet(s) if appropriate)

	LM-2 Provisions	Responses
1.	(para. 1.4.6) Has the AI completed the initial assessment of the extent to which its liquid asset holdings may have to be increased based on LM-2 section 8?	<input type="checkbox"/> Yes (please go to item 4) <input type="checkbox"/> In progress <input type="checkbox"/> Not yet started
2.	What are the major reasons for the delay in completing the initial assessment mentioned in item 1?	<u>Reasons:</u>
3.	What is the target date for completing the initial assessment mentioned in item 1? [Go to items 5, 6 then 8]	[Date]
4.	(paragraph 8.2.1) What is the projected size of the required liquidity cushion based on the results of liquidity stress test scenarios (see subsection 5.4 of LM-2)? Please provide supporting documents.	<i>(Please report the highest amount of “liquidity requirement” generated from the most severe liquidity stress test scenarios, HKD million)</i> Institution-specific scenarios: _____ General market crisis scenarios: _____ Combined scenarios: _____

	LM-2 Provisions	Responses
5.	<p>(subsections 8.3 to 8.5) What is the estimated size of unencumbered, high-quality readily liquefiable assets (“HQRLA”) held by the AI as at 31 August 2013 (please indicate the alternative date if the AI chooses to report a more recent position)?</p> <p>Please provide supporting documents.</p>	<p><u>Before haircuts</u> Tier 1 HQRLA: _____ (a/b)* Tier 2 HQRLA: _____ (a/b)* Total HQRLA: _____</p> <p><u>After haircuts</u> Tier 1 HQRLA: _____ (a/b)* Tier 2 HQRLA: _____ (a/b)* Total HQRLA: _____</p> <p>*The above estimates are based on: a. existing LM-2 requirements b. existing LM-2 requirements, taking into account the latest scope of HQLA under LCR proposed by the HKMA in Consultation Paper L3 (July 2013)</p> <p>Please delete as appropriate. If the AI adopts a definition of HQRLA which may not be consistent with existing LM-2 requirements (this will not be regarded as a non-compliant issue until on and after the section 8 compliance date specified in the accompanying circular letter), please provide a best estimate on the basis of either “a” or “b”.</p>
6.	<p>(subsections 8.3 to 8.5) What is the composition of the HQRLA of the AI reported under item 5 above?</p> <p>Please provide supporting documents.</p>	<p><i>(Please provide a breakdown by instrument type (e.g. HKEF bills and notes, US Treasuries, etc) and percentage of total HQRLA; if needed, please insert spreadsheets detailing the composition)</i></p>

	LM-2 Provisions	Responses
		<u>Tier 1 HQRLA</u> <u>Tier 2 HQRLA</u>
7.	<p>(paragraph 8.1.1) Please indicate the derivation of the largest estimated liquidity gap of the AI as at 31 August 2013 (please indicate an alternative date if the AI chooses to report a more recent position). This is expected to be the largest amount of required liquidity cushion, reported under item 4, less the post-haircut total HQRLA held, reported under item 5. Report zero if the difference is ≤ 0.</p> <p>Please provide supporting documents.</p> <p><i>(End of survey if zero liquidity gap is reported)</i></p>	<p>The largest liquidity gap arose from:</p> <p>___ Institution-specific scenarios</p> <p>___ General market crisis scenarios</p> <p>___ Combined scenarios</p> <p><u>Largest liquidity gap#</u></p> <p>Tier 1 HQRLA: _____(a/b)*</p> <p>Tier 2 HQRLA: _____(a/b)*</p> <p>Total HQRLA: _____(a/b)*</p> <p># Report a breakdown if the AI has established internal targets for the level of Tier 1 and Tier 2 assets within the HQRLA portfolio; otherwise report under “Total HQRLA”.</p> <p>* See item 5 for explanations.</p>
8.	<p>(paragraph 8.1.1) What are the AI’s plans and timetable to close the liquidity gaps reported under item 7?</p> <p>Please provide supporting documents.</p>	<p>___ Plan established</p> <p>___ Plan being established, to be completed by <u>(date)</u></p> <p>___ Plan to be established, to be completed by <u>(date)</u></p> <p>Target date for fully closing the liquidity gaps: <u>(date)</u> <i>(Response required even if implementation plan not yet in place)</i></p>