Liquidity risk management

by the Banking Policy Department

Recently the HKMA has issued a new statutory guideline on Liquidity Risk Management as a replacement for the one issued in 1994. The guideline sets out the key elements of effective liquidity risk management, taking into account latest international standards and the practices currently adopted by some international banks, and explains the enhanced approach that the HKMA will adopt towards authorized institutions' (AIs) liquidity risk management. On-line access to the module is available under the "Supervisory Policy Manual" in the HKMA's public website (www.hkma.gov.hk).

This memo aims to summarise the key requirements of the new supervisory regime and to provide guidance to AIs for their preparations for compliance with the regime.

Q1 Why does the HKMA consider it necessary to revise its guideline on liquidity risk management?

A1. There have been various developments in international standards and best practices relating to the liquidity risk management of banks since 1994 when our old liquidity regime was introduced. Technological and financial innovations have provided banks with new ways of funding their activities and managing their liquidity. Increased reliance on wholesale funds and the turmoil in financial markets in 1997 have changed the way banks view liquidity. Corresponding to these developments and consistent with the guidance of the Basel Committee on the sound practices for managing liquidity in banking organisations issued in 2000, the HKMA has updated its guideline on liquidity risk management by issuing a new SPM module.

Q2. What are the new features of the revised guideline?

A2. In addition to restating the need for AIs to comply with the statutory liquidity ratio requirements, the revised liquidity regime provides more guidance on the development of an effective liquidity risk management framework; cash flow management and reporting for liquidity management under normal and stressed situations; and contingency planning for dealing with a liquidity crisis.

Q3 What should AIs now be doing in preparing for compliance with the revised regime?

A3. The Boards of Directors and senior management of AIs should be aware of the requirements set out in the revised regime and ensure that the policies and procedures adopted by the AIs to manage liquidity risk are effective and in compliance with the HKMA's guideline. For example, they should ensure that the AIs' policy statements on liquidity risk management are prepared in sufficient detail to the effect that they cover the various factors and requirements set out in the HKMA's guideline.

In particular, they should be aware that under the revised liquidity regime, increased supervisory focus will be placed on AIs' liquidity risk management systems and controls, as well as their ability to maintain adequate liquidity under stressed situations. AIs will be expected to adopt a cash flow approach to manage their liquidity. They should ensure that they have in place appropriate systems and procedures to monitor net funding requirements under normal business conditions, and to conduct regular cash flow analyses (including separate analysis for significant foreign currency positions) based on stress scenarios. Reasonable assumptions would need to be developed for the above cash flow projections.

Regarding regulatory reporting, AIs should be prepared to submit to the HKMA their internal management reports on cash flow and scenario analysis on a quarterly basis, based on the scenarios and behavioural assumptions agreed with the HKMA. They should also be prepared to provide a breakdown of their foreign assets and liabilities maturing within three months. Locally incorporated banks need to submit a new return on a few selected asset and liabilities items on a quarterly basis.

Q4. Do the requirements under the revised liquidity regime apply to all AIs?

A4. In general, all AIs are required to put in place all the basic requirements stated in the SPM, such as establishing an appropriate liquidity management framework, monitoring of the liquidity ratio, and conducting cash flow analysis and stress testing. However, the sophistication and complexity of these systems and controls could vary among AIs and should be commensurate with their risk profiles as well as the nature, scale and complexity of their business.

To cater for the differences in risk profiles as well as the nature, scale and complexity of AIs, the HKMA is adopting a flexible approach under the new liquidity regime. For example, rather than follow an across-the-board limit, AIs are allowed to set their own maturity mismatch limits so long as such limits are realistic and commensurate with the AIs' normal capacity to fund in the interbank market.

In assessing the adequacy of liquidity of branch or subsidiary of banks incorporated outside Hong Kong, the HKMA will take account of the global liquidity risk management policies of the head office or parent bank and the extent to which liquidity is supervised by the home supervisory authority. A more flexible approach (other than the statutory liquidity ratio requirement) will be adopted for the supervision of these AIs, provided that their liquidity is managed, and supervised, on an integrated global basis.

In addition, the HKMA is not imposing a hard and fast implementation deadline for the overall revised regime. While AIs are required to submit the statutory returns within one year of the issue date of the SPM (i.e. starting from the position of 30 June 2005), they can individually agree with the HKMA on their plans and timetables to comply with the remaining requirements of the revised regime. The flexible implementation timetable is in response to some comments of the industry that additional resources and preparation work would be required to upgrade individual banks' liquidity risk management, especially in the area of cash flow management and stress testing, to comply with the new regime. Nevertheless, most AIs are expected to be able to complete the enhancement within 12 months.

Q5. What measures will the HKMA take to ensure that AIs comply with the revised regime according to the expected timetable?

A5. The HKMA has started discussions with individual AIs on what steps they are taking to ensure that their liquidity risk management framework can comply with the new requirements. In particular, AIs will be required to review their liquidity risk management policy, including the various liquidity control limits, in light of the HKMA's revised guideline and submit their revised policy to the HKMA for approval. They will also be required to set out their plans and timetables to enhance their liquidity risk management framework and reporting capability for HKMA's monitoring.