

Consultation Paper
Implementation of Basel III Liquidity Standards in
Hong Kong (L3)

Hong Kong Monetary Authority
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Contents

- Section 1** Overview
- Section 2** Classification framework under the two-tiered approach
- Section 3** Implementation timetable for Liquidity Coverage Ratio and Modified Liquidity Ratio
- Section 4** Scope of high quality liquid assets under Liquidity Coverage Ratio
- Section 5** Adoption of Alternative Liquidity Approaches in Hong Kong
- Section 6** Treatment of cash-flow items under Liquidity Coverage Ratio
- Section 7** Modifications to Liquidity Ratio
- Annex 1** Responses to industry comments on proposals consulted upon in June 2012
- Annex 2** Liquidity Coverage Ratio - Illustrative template of key requirements / parameters
- Annex 3** Modified Liquidity Ratio - Illustrative template of key requirements / parameters

Consultation Paper

Implementation of Basel III Liquidity Standards in Hong Kong (L3)

Section 1

Overview

Introduction

1. In the first half of 2012, the HKMA published two consultation papers (L1 and L2)¹ to seek the industry's views on specific issues and proposals in relation to the local implementation of the two global minimum liquidity standards, viz. the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), introduced by the Basel Committee on Banking Supervision (BCBS) in December 2010². As an integral part of the Basel III reform package, the liquidity standards have been developed with the objective of enhancing the resilience of banks and banking systems globally.
2. In January 2013, the BCBS released a revised LCR package³ ("January 2013 LCR Revision") incorporating various refinements to the LCR to address issues identified by national authorities and the international banking community since the LCR was originally published. The major areas of change were -

¹ The two consultation papers published by the HKMA in 2012 are available at the following websites:

L1: http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/basel-3/consultation_on_basel-3_implementation_b/consultation_paper_liquidity.pdf

L2: http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/basel-3/basel3-20120618/consultation_paper_liquidity.pdf

² The two global liquidity standards are set out in the document entitled *Basel III: International framework for liquidity risk measurement, standards and monitoring* (<http://www.bis.org/publ/bcbs188.pdf>) issued by the BCBS in December 2010.

³ The full text of revisions to the LCR is contained in the document entitled *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (<http://www.bis.org/publ/bcbs238.pdf>) issued by the BCBS in January 2013.

- an expansion of the range of assets eligible for inclusion as high quality liquid assets (HQLA) for LCR purposes, through the addition of a new category of Level 2B assets which national supervisors may elect to recognise as HQLA in their local LCR regulations;
 - a recalibration of the stress assumptions for some cash-flow items;
 - an affirmation of the usability of the stock of HQLA by banks in times of stress; and
 - the adoption of a phase-in timetable for implementing the LCR.
3. The HKMA has updated, and further refined, its policy proposals for the local implementation of the LCR (and other proposed corresponding changes to the local liquidity regime), in response to the January 2013 LCR Revision and after taking into account the comments raised by the industry in the previous consultations as appropriate. This Consultation Paper (CP) invites the industry's comments on the HKMA's refined policy proposals as well as its views and suggestions on policy options that the HKMA may consider.
4. It is the HKMA's objective to implement a robust liquidity regime that aligns with international standards and reinforces banking stability, having regard to local circumstances and the liquidity risks faced by the Hong Kong banking sector. Consistent with this objective, the HKMA considers it important to maintain a close dialogue with the industry as it develops and shapes its proposals for the reform of the local regulatory framework. To this end, prior to issuing this CP, the HKMA has held various meetings with different industry groups both to explain the HKMA's current thinking on some specific areas and to understand any potential issues and concerns. The HKMA will continue to engage the industry in such dialogue in the course of finalising its liquidity

proposals, with a view to achieving an optimal approach promoting the stability and the effective working of the Hong Kong banking sector.

Structure

5. In this CP:

- **Section 2** recaps the major aspects of the two-tiered approach proposed by the HKMA in the previous consultations (L1 and L2), and proposes some modifications in the light of industry comment. Further elaboration is provided on the application of quantitative liquidity standards to the Hong Kong branches of foreign banks. Under the two-tiered approach, authorized institutions (AIs) will be classified, by reference to specified criteria, as either Category 1 (to be subject to the LCR / NSFR) or Category 2 (to be subject to the Modified Liquidity Ratio (MLR), an enhanced version of the existing Liquidity Ratio (LR));
- **Section 3** discusses the timetable for implementing the LCR and the MLR in Hong Kong, including the considerations underlying any potential adoption of a phase-in arrangement for the LCR;
- **Section 4** focuses on whether, and to what extent, the HKMA considers that Level 2B assets should be recognised as HQLA in the local LCR regulations, and discusses potential implications for the definition of “liquefiable assets” under the MLR;
- **Section 5** outlines the HKMA’s current thinking on the adoption in Hong Kong of the Alternative Liquidity Approaches (ALA) offered by the BCBS, taking into account the framework stipulated in the January 2013 LCR Revision and local circumstances;

- **Section 6** sets out the HKMA’s proposed treatment for cash-flow items under the LCR, including items specified by the BCBS in the January 2013 LCR Revision as being subject to national discretion. Guidance relating to some definitional issues is also provided; and
 - **Section 7** explains the rationale for the modifications to the LR proposed in the previous consultations, proposes some further refinements to align with similar changes contemplated under the LCR, and discusses the treatment of interbank placements under the MLR.
6. This CP is supplemented by three annexes, which include (i) a summary of major industry comments on L2 and the HKMA’s response (**Annex 1**); and (ii) two illustrative templates providing AIs with a more complete picture of the key requirements and parameters underlying the calculation of the LCR (**Annex 2**) and the MLR (**Annex 3**).
7. This CP does not specifically cover the local implementation of the NSFR. The NSFR is still under review by the BCBS and its local implementation will be the subject of future consultation.

Key policy proposals and options

8. The key policy proposals and options in this CP relate to:
- **Modifications to the two-tiered approach for application of the LCR** – The HKMA remains of the view that the adoption of a two-tiered approach is appropriate in Hong Kong given the diversity of AIs in terms of their scale and complexity of operation as well as their relative significance to the local banking system. Nevertheless, in response to industry comments, the HKMA proposes to (i) increase both of the quantitative benchmarks for assessing an AI’s size of operation and level of international exposure to

HK\$250 billion (from the HK\$200 billion and HK\$100 billion respectively discussed in L2) to accommodate further growth in the banking sector and cater for other adjustments⁴; and (ii) apply the revised benchmarks uniformly to all AIs (local and foreign) for level playing field considerations.

- Approach to applying the LCR to foreign bank branches (FBBs) – Within the two-tiered classification framework, the HKMA proposes to apply a certain degree of flexibility towards the liquidity treatment of potential Category 1 foreign banks and will assess whether some degree of reliance can be placed on the “group” liquidity of these banks having regard to specified criteria (e.g. the adequacy of, and group compliance with, home jurisdiction liquidity requirements, and the extent to which the group’s liquidity risk management framework can provide sufficient assurance in relation to the ability of its Hong Kong branch to comply with the HKMA’s liquidity requirements in normal times and in times of stress). This takes into account the mode of operation of FBBs in Hong Kong and recognises that their operations are typically supported under group liquidity risk management model which operates globally and which may adopt the LCR requirements on a consolidated basis.

Where such “group” reliance can be established, the HKMA is considering, and seeks the industry’s views on, two policy options for recognising such reliance: (i) allowing the Hong Kong branch of such foreign banks to be subject to the simpler and less granular MLR standard; and (ii) adjusting the treatment of such branches under the LCR (e.g. by lowering the LCR minimum requirement or allowing the netting of inter-branch / intra-group transactions in the LCR calculation).

- Implementation timetable for the LCR – The HKMA has considered several policy options for implementing the LCR, including (i) following the BCBS

⁴ For example, the benchmark for “total external claims and liabilities” is proposed to be increased to adjust for the fact that this indicator covers both sides of the balance sheet and includes off-balance-sheet items.

phase-in timetable; and (ii) expediting the implementation either by adopting an accelerated phase-in timetable or by implementing the LCR in full from 2015. As with its implementation of the Basel III capital standards, the HKMA can see merit in not seeking to fast-track the LCR. While the HKMA's general leaning is therefore towards adopting the BCBS phase-in timeline for the LCR, the HKMA considers that the choice of this option must be backed by appropriate supervisory monitoring measures to avoid any material weakening of the overall liquidity of the local banking sector during the phase-in period. The proposed measures are set out in Section 3 of this CP.

- Partial recognition of Level 2B assets as HQLA under the LCR – In determining whether Level 2B assets should be recognised as HQLA for LCR purposes, the HKMA has focused primarily on the “liquifiability” of these assets especially in times of stress, having regard to the characteristics of local financial markets. Based on this assessment, the HKMA proposes to recognise only single-A rated non-financial corporate debt securities and residential mortgage-backed securities (RMBS) rated AA or above as HQLA under the LCR, subject to such assets meeting all relevant qualifying criteria and, in the case of qualifying RMBS, additional approval being obtained from the HKMA on a case-by-case basis.

In relation to RMBS, the HKMA is aware that some of these structured debt securities became extremely illiquid during the last financial crisis and that the global RMBS markets have yet to recover to their pre-crisis levels. Therefore, in order to enable a greater degree of scrutiny to be applied in assessing the liquifiability of any RMBS which AIs propose to include in their stock of HQLA, the HKMA proposes that AIs should seek its case-by-case approval for such inclusion, demonstrating how such debt securities meet all of the relevant qualifying criteria.

- Adoption of ALA in Hong Kong – Given the limited supply of HQLA denominated in Hong Kong dollars, Hong Kong will likely be a jurisdiction that needs to adopt the ALA treatment made available by the BCBS under the LCR. Subject to the results of a self-assessment of Hong Kong’s eligibility for such treatment, the HKMA is minded to adopt ALA Option 2 (which allows banks to use foreign currency HQLA to cover local currency liquidity needs under the LCR), subject to the imposition of haircuts to address currency risk. The relevant proposals are set out in Section 5 of this CP.
- Treatment of cash-flow items – The HKMA intends to follow closely the revised treatment for various cash-flow items set out in the January 2013 LCR Revision. The setting of inflow and outflow rates for certain items will require the HKMA to exercise national discretion. To prepare for this, the HKMA is conducting assessments by reference to empirical experience and, where available, the potential approaches to be adopted by other major jurisdictions. Some preliminary thoughts, together with guidance on definitional issues, are set out in Section 6 of this CP.
- Implementation of the MLR – In L1, the HKMA set out proposals for modifying the LR to enhance its effectiveness, including the exclusion of “interbank placements (net of interbank borrowings)” and “eligible loan repayments” from the definition of “liquefiable assets” and allowing such items to be deducted from “qualifying liabilities” instead. In light of industry comments about the potential impact on the operation of the interbank market, the HKMA is considering, and seeks the industry’s views on, three policy options: (i) maintaining the original proposal; (ii) allowing “interbank placements (net of interbank borrowings)” to be recognised as “liquefiable assets” to the extent that the placements and borrowings can be withdrawn on demand (or mature overnight) and hence can be regarded in some respects as having “cash-like” characteristics; and (iii) retaining

“interbank placements (net of interbank borrowings)” as “liquefiable assets”, subject to the application of a relatively stringent “liquidity conversion factor” (say, 80%) and a cap (say, 40%) expressed as a percentage of total qualifying liabilities (before deduction) to avoid over-reliance on such placements.

As the MLR is a less granular metric than the LCR with components largely similar to the existing LR, the HKMA does not expect implementation of the MLR to pose significant challenges to AIs. The HKMA therefore proposes to fully implement the MLR from 1 January 2015. The industry’s views are, however, sought as to whether any potential issues or problems are likely to arise with this implementation schedule.

Next steps

9. The HKMA plans to finalise its policy proposals for the implementation of the LCR and the MLR, including the classification framework under the two-tiered approach, within this year. Industry comments received from this consultation will be taken into account, and regard will be had to the implementation approaches likely to be adopted in other major jurisdictions (from a level playing field perspective) and any relevant guidance issued by the BCBS. The industry’s views will again be sought on any further policy proposals or major changes to the current proposals which result from this consultation. Thereafter, the HKMA expects to complete the rule-making and legislative processes during the course of 2014 for the implementation of a set of Banking (Liquidity) Rules (BLR) from 1 January 2015. As with the local implementation of the Basel III capital standards, the industry will be consulted on the text of the draft BLR before the rules are introduced into the Legislative Council. Where necessary, codes of practice, supervisory guidance and FAQs will be developed to explain aspects of the BLR and their application.

10. Once the classification framework for the two-tiered approach is finalised, the HKMA will begin to classify each AI, as either Category 1 or Category 2, as soon as practicable. The intention is to notify individual AIs of their classification status before the end of this year. At the same time, the HKMA proposes to agree with each AI -

- the basis of the calculation of the liquidity standard applicable to the AI, and, if the AI is to apply the standard on a consolidated basis, which of its subsidiaries (and associated entities where appropriate) should be included in the consolidation (see [Section 4](#) of L2 for details of the relevant proposals); and
- a plan or roadmap for the AI to implement the liquidity standard applicable to it.

The HKMA will formally reconfirm each AI's classification status following a final review in the middle of next year. This is to ascertain whether there have been any significant changes in the intervening period that may affect the AI's classification.

11. The HKMA proposes to specify the methodology for calculation of the LCR and the MLR by rolling out a set of draft reporting templates and completion instructions for industry consultation later this year. The HKMA will also, to the extent practicable, launch pilot reporting of the LCR and the MLR using the new templates in first half of 2014.

12. In the last quarter of this year, the HKMA intends to update the statutory guideline "Sound Systems and Controls for Liquidity Risk Management" (LM-2) in the Supervisory Policy Manual, having regard to the latest revisions to the LCR and the implementation experience gained to date in respect of LM-2. As the LCR is only intended to prescribe a minimum level of funding liquidity for

AIs, and is not the only measure which AIs should use to ensure their liquidity adequacy, the HKMA will continue to place strong emphasis on the development by AIs of prudent and resilient liquidity risk management systems and their compliance with LM-2.

Section 2

Classification framework under the two-tiered approach

Original proposals

13. This section highlights some major aspects of the proposed classification framework under the two-tiered approach. AIs should refer to the relevant sections in L1 and L2 for the full set of proposals.
14. In L1, the HKMA proposed to adopt a two-tiered approach to the application of quantitative liquidity standards in Hong Kong, under which -
 - the LCR and the NSFR will apply to a group of AIs that are at the core of the Hong Kong banking system (Category 1 AIs); and
 - the MLR will apply to all other AIs (Category 2 AIs).
15. The HKMA considered that this two-tiered approach was appropriate for Hong Kong given the diversity of AIs within the banking sector. The LCR and the NSFR were more suited for application to those 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 for Hong Kong, a suitably modified and enhanced LR should provide an adequate liquidity buffer requirement.
16. L2 further consulted the industry on the approach, criteria and process for classifying Category 1 and Category 2 AIs. Under the proposed framework, an AI could be classified as Category 1 based on one or more of the following factors:

Quantitative factors

- Size of business operation, as measured by the total amount of assets after provisions of an AI;
- Level of international exposure, as measured by the total amount of external claims and liabilities⁵ of an AI;

Other factors

- Complexity of business operation or potential impact on the banking system, as reflected by (i) an AI's role, and level of participation, in local banking / financial markets; (ii) the size and complexity of its derivatives / off-balance-sheet exposures; or (iii) its potential impact on other banks, financial markets and/or other stakeholders (e.g. depositors, retail investors, etc.);
- Connection with a Category 1 AI – this would be assessed on a case-by-case basis⁶. If the HKMA considers that there is potential for regulatory arbitrage between two connected AIs that are not in the same category, the Category 2 AI may be re-classified as Category 1;
- Classification on other grounds – this was to cater for the limited circumstances in which an AI's significance to the banking system may only become apparent or fall to be observed from other exceptional factors; and
- Opt-in as a Category 1 AI with the HKMA's approval.

⁵ For the purposes of this quantitative factor, intra-group exposures should not be excluded as such exposures, conducted across national jurisdictions, still pose a degree of cross-border risk for the intra-group entities concerned.

⁶ The focus is less on subsidiaries of a Category 1 locally incorporated AI which will be included in the calculation of the consolidated LCR of the Category 1 AI, but more on the situations where two connected AIs are not subject to the HKMA's consolidated supervision in respect of their liquidity positions (e.g. two connected AIs being affiliated to the same banking group, one being a Hong Kong branch and the other being a locally incorporated bank).

The HKMA envisaged that Category 1 AIs would primarily be licensed banks. In other words, non-bank AIs (i.e. restricted licence banks and deposit-taking companies) would most likely be Category 2 AIs.

17. The HKMA expected that local banks meeting any of the two quantitative benchmarks specified in L2 (i.e. HK\$200 billion for size of business operation and HK\$100 billion for level of international exposure) would be classified as Category 1. In the case of the Hong Kong branches of foreign banks, more focus would be placed on the other, less quantifiable, factors mentioned above, in addition to assessing their positions against appropriate quantitative benchmarks (yet to be specified). The HKMA would also consider whether there was a sufficient basis for applying the simpler standard, i.e. the MLR, to individual potential Category 1 foreign banks depending on the extent of the reliance that might be placed on their compliance with LCR regulations at the group level and other possible arrangements that could provide further comfort on the adequacy of their liquidity in Hong Kong.

Industry comments

18. According to the feedback received on L2, the industry was generally supportive of the proposals for the two-tiered classification framework⁷, and the comments raised largely related to requests for clarification, or suggestions for refinement, in some specific areas. These comments are summarised in **Annex 1**, along with the HKMA response.

Proposed modifications

19. The industry has made various suggestions about the quantitative indicators that can be used (such as market share, balance sheet composition, sources and uses

⁷ Nevertheless, some opposing views were expressed on the grounds of unlevel playing field and issues of comparability between banks.

of liquidity, etc.) for the purpose of the classification framework. After considering these suggestions, the HKMA remains of the view that the two quantitative indicators proposed in L2 (i.e. “total assets after provisions” and “total external claims and liabilities”) are the more appropriate indicators for use under the classification framework. They are relatively simple to apply, and yet still effective in providing a broad view of individual AIs’ “significance” in terms of their size of operation and level of international exposure, which are two key aspects for assessment under the framework. Moreover, employing other indicators / measures may unnecessarily complicate the quantitative assessment⁸.

20. The HKMA, however, acknowledges the industry’s expectation that the quantitative benchmarks should have regard to the continued development of the banking sector. Further, the industry considers that the same set of quantitative criteria should apply to all AIs (i.e. local and foreign alike) on level playing field grounds. In light of these comments, the HKMA proposes to (i) raise both quantitative benchmarks to HK\$250 billion (from the HK\$200 billion proposed in L2 for “total assets after provisions” and the HK\$100 billion proposed in L2 for “total external claims and liabilities”) to provide scope for further growth in the banking sector⁹; and (ii) apply the revised benchmarks uniformly to all AIs. As mentioned in paragraph 19 of L2, the HKMA will review the level of quantitative benchmarks from time to time to ensure that they remain appropriate for the local banking environment. The industry will be consulted on any proposed adjustment of the benchmarks.

⁸ For example, use of a relative measure like “market share”, or applying an annual increment to the benchmarks to cater for growth in the banking system, will complicate the benchmarking process and pose uncertainty with regard to the exact level of the applicable benchmarks at any point in time.

⁹ In adjusting the level of the two quantitative benchmarks, the HKMA has given due consideration to the market structure of, and business growth trends in, the local banking sector. The revised benchmarks should still be able to capture a group of potential Category 1 AIs constituting a sizable share of the local banking sector. Regarding the trend in business growth, the HKMA notes that the average growth rate of total assets of the local banking sector was around 4% per annum during the past 15 years (1997 to 2012), while the average growth rate of the sector’s total external claims and liabilities was 3% per annum during the same period. The HKMA expects that the proposed adjustment of the benchmarks to HK\$250 billion should be sufficient to cater for the business growth of the banking sector (including potential Category 2 AIs) in the coming few years. The significant increase in the benchmark for external claims and liabilities (to HK\$250 billion from HK\$100 billion) is to reflect the fact that this benchmark covers both sides of the balance sheet (including off-balance-sheet items) and, to cater for the balance sheet structure of FBBs (which may tend to have more international exposures because of their affiliation with overseas banking groups).

21. The HKMA would also like to further clarify some aspects of the classification process in response to industry comments. When assessing the classification status of AIs in the second half of this year, the HKMA proposes to primarily benchmark against AIs' end-2012 position. This refers to (i) the combined position of the Hong Kong offices and overseas branches (if any) of a locally incorporated AI; or (ii) the position of the Hong Kong branch of an overseas incorporated AI. Subsequent assessments are proposed to be conducted at least annually (as part of the HKMA's ongoing risk-based supervision) by referring to individual AIs' reported positions since the last assessment. This is to avoid a point-in-time assessment that may not cater for temporary fluctuations in AIs' positions.
22. As regards the adoption of a forward-looking approach as mentioned in paragraph 16 of L2, the HKMA will take into account any likely effects on the classification status of individual AIs arising from anticipated forthcoming business developments in the next 12 months. Such business developments may include any anticipated business expansion or contraction, merger or acquisition, or other business initiative that will result in the AI concerned meeting, or no longer meeting, the classification criteria for Category 1 AIs in the next 12 months.

Application of liquidity standards to foreign bank branches

23. As reflected in L2, the approach to applying liquidity standards to FBBs is less straightforward (compared to local banks) and necessitates further consideration of their mode of operation in Hong Kong. Among other things, the HKMA expects that the potential Category 1 foreign banks, based on the classification criteria mentioned above, will most likely be international banks that are subject to LCR requirements imposed by their home supervisors on a group basis, once the LCR is implemented from 1 January 2015. This raises the issue of the extent

to which reliance can be placed on the banks' consolidated LCR under home jurisdiction requirements.

24. In addition, it is common for international banks to adopt centralised liquidity risk management models, whereby the head office is responsible for managing the group's liquid asset portfolios and for allocating funds within group entities that operate in multiple jurisdictions. Some foreign banks also operate their branches in Hong Kong as regional "funding hubs" for the group. Applying the local LCR requirements to these banks may have unintended implications for their Hong Kong operations. For example, there will be additional liquidity costs for conducting intra-group funding transactions (by virtue of, say, the 75% cap for recognition of inflows under the LCR)¹⁰, thereby potentially limiting the scope for these banks to operate overseas funding hubs for more efficient funds management or for liquidity risk to be managed centrally within the group.
25. On the other hand, it is clearly within the mandate of the HKMA as a host supervisor to impose quantitative liquidity standards on FBBs to ensure that sufficient "ex ante" liquidity is maintained by them to support their local operations at all times (including in times of stress). This is particularly important in the event of a group liquidity crisis in which the sufficiency, availability and transferability of funds from elsewhere in the group to meet the liquidity needs of the Hong Kong branch in a timely manner may not be fully assured.
26. After weighing the above considerations and in the spirit of home-host supervisory cooperation, the HKMA is minded to adopt a balanced approach that allows some degree of reliance on the "group" liquidity of potential Category 1

¹⁰ Under the LCR, the total amount of cash inflows that can be used to offset cash outflows is limited to 75% of gross cash outflows (i.e. after application of outflow rates). This means that in the case of intra-group inflows and outflows arising from funding operations that are broadly matched, there is effectively a 25% liquidity cost on such operations.

foreign banks that operate within a centralised liquidity risk management model, provided that the following criteria are met to the satisfaction of the HKMA:

- Adequacy of home jurisdiction liquidity requirements – The requirements applicable to the foreign bank should be comparable to the international liquidity risk management standards issued by the BCBS¹¹;
- Group compliance with home jurisdiction liquidity requirements – The foreign bank should demonstrate, through confirmation from the head office and home supervisor, that the bank is able to meet the relevant home jurisdiction liquidity requirements;
- Global liquidity risk management system – The foreign bank should demonstrate that its global liquidity risk management system is able to provide assurance that the Hong Kong branch can meet the HKMA’s liquidity requirements in all major aspects (including both quantitative and qualitative¹² aspects). For example, the stressed liquidity needs of the Hong Kong branch have been duly taken into account in the group’s centralised liquidity pools and that there are credible arrangements to enable the timely transfer of funds to the Hong Kong branch in case of need. Moreover, it should be demonstrated that there are no legal or regulatory impediments (such as exchange and remittance restrictions) in the home jurisdiction that prohibit the foreign bank from transferring liquidity to its Hong Kong branch as and when necessary; and
- Effective home-host information-sharing arrangements – There should be in place effective communication and information-sharing channels between

¹¹ The international liquidity standards are those set out in both: (i) *Principles for Sound Liquidity Risk Management and Supervision* published by the BCBS in September 2008; and (ii) *Basel III: International framework for liquidity risk measurement, standards and monitoring* issued by the BCBS in December 2010 (as updated by *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* in January 2013).

¹² The HKMA’s requirements on liquidity risk management are set out in “Sound Systems and Controls for Liquidity Risk Management” (LM-2), a module of the Supervisory Policy Manual.

the HKMA and the foreign bank's home supervisor such that the HKMA is able to obtain supervisory opinions and relevant information from the home supervisor on the foreign bank's liquidity position on a timely basis.

27. The HKMA is mindful of potential industry concern about the development of an unlevel playing field between Category 1 local banks and Category 1 foreign banks if the above approach is adopted. However, this concern should be somewhat mitigated by the fact that such treatment will be conditional upon all the relevant criteria being met by the foreign banks concerned. It should also be noted that only foreign banks that comply with comparable LCR requirements in their home jurisdiction will be accorded such treatment.
28. Once the HKMA has drawn up a list of potential Category 1 foreign banks, it will assess the position of those banks against the criteria set out in paragraph 26 above. To facilitate its assessment, the HKMA may, where necessary, request an FBB to provide additional information, or seek advice from its home supervisor directly.
29. In giving recognition for the "group" liquidity of potential Category 1 foreign banks that satisfy the criteria under paragraph 26 above, the HKMA is considering two possible options and would welcome the industry's feedback and views upon them:
 - FBB Option 1 : As mentioned in L2, the comfort of sound and prudently managed "group" liquidity could serve to underpin a classification of the local branch of the foreign bank as Category 2, thereby subjecting its Hong Kong branch to the simpler MLR standard rather than the more granular and complex LCR standard; and
 - FBB Option 2 : These approaches recognise that the LCR was developed by the BCBS primarily for application to internationally active banks on a

consolidated basis. The design of the LCR therefore may not be entirely suitable for a “branch” setting, especially with regard to the treatment of an FBB’s transactions with connected branches or entities within the same banking group. There may be ground for adjusting the calculation of the LCR (e.g. in the calculation of “total net cash outflows” allowing the netting of inter-branch / intra-group transactions subject to certain conditions). Alternatively, the HKMA may consider applying a lower minimum LCR requirement (say, not less than 80% versus a 100% minimum requirement) to FBBs to reflect partial recognition of their “group” liquidity.

30. If the HKMA were of the view that a potential Category 1 foreign bank did not meet all of the criteria set out in paragraph 26, its Hong Kong branch would have to comply with the LCR in the same way as other Category 1 local banks.

Section 3

Implementation timetable for Liquidity Coverage Ratio and Modified Liquidity Ratio

BCBS phase-in timeline for LCR

31. In the January 2013 LCR Revision, the BCBS introduced a phase-in arrangement to help ensure the smooth implementation of the LCR and avoid material disruption to banking activity and the global economic recovery. Under the BCBS phase-in arrangement, the LCR will be introduced as planned on 1 January 2015, but the minimum ratio requirement will be set at 60% and will rise by 10 percentage points per annum to reach 100% on 1 January 2019.

| | <u>1.1.2015</u> | <u>1.1.2016</u> | <u>1.1.2017</u> | <u>1.1.2018</u> | <u>1.1.2019</u> |
|----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Minimum LCR : | 60% | 70% | 80% | 90% | 100% |

Local implementation time-table for LCR

32. The HKMA has considered the merits of adopting the BCBS phase-in arrangement in Hong Kong against the signalling benefits of moving to faster implementation of the LCR. Two alternatives present themselves: (i) follow the BCBS phase-in time-table; or (ii) expedite the implementation either by adopting an accelerated phase-in time-table (e.g. starting at, say, a higher minimum requirement of 80% and ending the phase-in period earlier in 2017) or by adopting the BCBS original timetable and implementing the LCR fully from 2015.

33. It seems likely that the timetable for implementing the LCR may vary across jurisdictions due to differing local circumstances. In general, banks in Hong Kong are not expected to encounter significant problems in meeting the LCR even if it were to be fully implemented in 2015 (i.e. subject to a 100% minimum

requirement). Nevertheless, the HKMA acknowledges that a phased implementation of the LCR could provide more time for Category 1 AIs to adjust their liquidity risk profiles more gradually (although market forces may militate against this – if and to the extent that the market “expects” a 100% LCR from January 2015). There is, in the HKMA’s view, also a case for allowing some flexibility or headroom to cater for potential macro-economic uncertainties ahead, as globally, markets and economies have yet to recover fully from the recent financial crisis. The benefits of phased implementation must, however, be weighed carefully against the potential downside of any weakening of AIs’ existing liquidity positions during the phase-in period. This may result from, for example, AIs significantly slowing down their pace of implementing the LCR or reducing their liquidity positions during the phase-in period (especially in the case of those that have already attained LCR levels well above the minimum requirements during, or even before, the phase-in period).

34. Ultimately, as was the case with the Basel III capital standards, the HKMA sees similar merit in not fast-tracking the implementation of the LCR. Therefore, the HKMA’s current leaning is towards adopting the BCBS phase-in approach for local implementation of the LCR, that is option (i) in paragraph 32. However, the choice of this option must be backed by appropriate supervisory monitoring measures to avoid any material weakening of the overall liquidity of the local banking sector during the phase-in period. These measures, most of which reflect existing supervisory practices and which are, to that extent, equally applicable to Category 2 AIs, may include:

- AIs, upon being notified of their classification, developing and agreeing with the HKMA, plans for implementing the liquidity standard applicable to them (i.e. LCR for Category 1 AIs or MLR for Category 2 AIs). Category 1 AIs should establish relevant LCR targets for every year during the phase-in period in order to comply with the minimum requirements applicable at different stages;

- Category 1 AIs, that have already attained an LCR at or above 100%, being required to justify to the HKMA's satisfaction that any decrease in their LCR below 100% is warranted by exceptional circumstances¹³;
- AIs (Category 1 or 2) that envisage a material decline in their liquidity position (or missing any LCR target set in their liquidity plans agreed with the HKMA) being required to alert the HKMA and explain the reasons for any such anticipated decline. The HKMA may, where appropriate, require an AI to take remedial action to restore its liquidity position; and
- including trends in an AI's liquidity position within the HKMA's periodic evaluation of the AI's supervisory rating (i.e. its CAMEL rating), with special attention being paid to any significant weakening of its liquidity position during the review period.

Implementation timetable for MLR

35. The adoption of a phased implementation of the LCR will have implications for the MLR. In contrast to the LCR, the MLR is less granular and has a structure largely similar to the existing LR. The HKMA does not expect that a full implementation of the MLR in 2015 would pose significant challenges to AIs. Moreover, attempting to phase-in specific new components of the MLR appears to the HKMA to be unduly complex in proportion to the benefits to be gained. Therefore, the HKMA proposes to fully implement the MLR from 1 January 2015 with no phase-in arrangements. If, however, contrary to the HKMA's expectation, the industry does envisage significant implementation problems with regard to the MLR and this proposed implementation schedule, the HKMA would welcome its views.

¹³ The pursuit of profit or business growth would not be likely to be regarded as a sufficient ground for a bank to justify a significant weakening of its liquidity position.

Section 4

Scope of high quality liquid assets under Liquidity Coverage Ratio

36. The LCR is expressed as a ratio of the “stock of HQLA” to “total net cash outflows over the next 30 calendar days” under a prescribed stress scenario. The value of this ratio cannot be lower than 100% (once the LCR is fully implemented). This Section addresses the scope of HQLA which may be recognised under the LCR in Hong Kong.

Original scope of HQLA

37. In the December 2010 version of the Basel III liquidity framework, there are two categories of assets, viz. Level 1 assets and Level 2 assets, that can be included in the stock of HQLA under the LCR if the assets meet special characteristics and operational requirements. Level 1 assets can make up an unlimited portion of the stock of HQLA, whereas Level 2 assets are limited to 40% of the stock (after applying a 15% haircut).

38. Level 1 assets comprise: (i) coins and banknotes; (ii) central bank reserves (to the extent that these reserves can be drawn down in times of stress); (iii) marketable securities representing claims on or guaranteed by sovereigns, central banks, public sector entities, or multilateral development banks that satisfy certain conditions (including a 0% risk-weight under the Basel II standardised approach to credit risk); and (iv) debt securities issued in local or foreign currencies by the sovereign or central bank (bearing a non-0% risk-weight under the Basel II framework) in the country in which the liquidity risk is being taken or in the bank's home country¹⁴.

39. Level 2 assets comprise: (i) marketable securities representing claims on or guaranteed by sovereigns, central banks, public sector entities, or multilateral

¹⁴ Debt securities issued in foreign currencies can be included as HQLA up to the amount of the bank's stressed net cash outflows in that specific foreign currency.

development banks that satisfy certain conditions (including a 20% risk-weight under the Basel II standardised approach to credit risk); (ii) corporate debt securities (not issued by a financial institution or any of its affiliated entities) that satisfy certain conditions (including a credit rating from a recognised external credit assessment institution (ECAI) of at least AA-); and (iii) covered bonds (not issued by the bank itself or any of its affiliated entities) that satisfy certain conditions (including a credit rating from a recognised ECAI of at least AA-).

BCBS revisions to HQLA in 2013

40. The January 2013 LCR Revision introduced a new category of assets (Level 2B assets) that may be recognised as HQLA at the discretion of national supervisors. Supervisors exercising such discretion are expected to ensure that (i) the Level 2B assets so recognised meet all relevant qualifying criteria (in addition to the general characteristics and operational requirements applicable to all HQLA); and (ii) banks have appropriate systems and measures to monitor and control the potential risks (e.g. credit and market risks) associated with the holding of these assets.

41. Level 2B assets comprise: (i) corporate debt securities (including commercial paper) with a 50% haircut; (ii) common equities with a 50% haircut; and (iii) residential mortgage-backed securities (RMBS) with a 25% haircut. Level 2B assets should constitute no more than 15% of the stock of HQLA after the application of haircuts. Each type of Level 2B asset is subject to specific qualifying criteria:

| <u>Corporate debt securities</u> | <u>Common equities</u> | <u>RMBS</u> |
|--|---|---|
| <ul style="list-style-type: none"> • Not issued by financial institutions or their affiliated entities • Rated between A+ and BBB- by a recognised ECAI • 30-day price volatility not exceeding 20% | <ul style="list-style-type: none"> • Not issued by financial institutions or their affiliated entities • Constituent of a major stock index in home jurisdiction or in jurisdiction where the liquidity risk is taken • Denominated in home currency or in currency of jurisdiction where the liquidity risk is taken • 30-day price volatility not exceeding 40% | <ul style="list-style-type: none"> • Not issued by, and the underlying assets not originated by, the bank or its affiliated entities • Rated at AA or above by a recognised ECAI • 30-day price volatility not exceeding 20% • Underlying assets restricted to residential mortgages, with full recourse, maximum loan-to-value ratio of 80% on average at issuance • Securitisations subject to “risk retention” regulations, not issued or originated by the bank concerned or its affiliated entities |

42. With the addition of Level 2B assets, the original category of Level 2 assets were redesignated as Level 2A assets. Total Level 2 assets (comprising Level 2A assets and any Level 2B assets recognised by the national supervisor) should not exceed 40% of the stock of HQLA after the application of haircuts.
43. The characteristics of, and the operational requirements relating to, HQLA were further refined in the January 2013 LCR Revision (paragraphs 24 to 43) to enhance clarity and understanding. In particular, there is increased emphasis on the bank having the continuous authority and legal and operational capability to monetise any asset in the stock of HQLA.
44. A new requirement was also included in the January 2013 LCR Revision to (i) stress the importance for a bank to maintain a stock of HQLA that is well diversified within the qualifying HQLA asset classes (except for sovereign debt

of the bank's home jurisdiction or of the jurisdiction in which the bank operates, central bank reserves, central bank debt securities, and cash); and (ii) require banks to have policies and limits in place to avoid concentration with respect to asset types, issue and issuer types, and currency within asset classes.

45. The BCBS further re-affirmed that the stock of HQLA is available for use by banks in times of stress, notwithstanding that this may cause the LCR to fall below the minimum requirement. National supervisors are expected to establish guidance to specify circumstances for the usage of HQLA, and to ensure appropriate supervisory action in response to such circumstances.

Treatment of Level 2B assets in Hong Kong

46. In determining which type of Level 2B asset should be recognised as HQLA for LCR purposes in Hong Kong, there is a primary need for the HKMA to be satisfied that any assets so recognised are demonstrably “liquefiable” having regard to the characteristics of local markets. 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 and recognition of assets which are not demonstrably liquefiable would weaken, and be detrimental to the utility of, the LCR. To this end, the HKMA has reviewed the risk attributes of different types of Level 2B assets, including their price volatility and their market liquidity based on historical performance in local markets (especially in times of stress).
47. With respect to non-financial corporate debt securities, the HKMA has concerns with regard to the potential impact of rating downgrades on the price and market liquidity of triple-B rated debt securities, as well as any potential cliff effects associated with such downgrades. Once downgraded below BBB-, such debt securities would not only fall out of the Level 2B asset category but would also cease to be of investment grade, which could significantly impair their market liquidity especially in stressed markets and make it difficult for AIs to dispose of

such holdings precisely when liquidity is most needed. Hence, the HKMA considers there is a risk that triple-B rated debt securities are likely to perform worse than other investment grade debt securities (including single-A rated debt securities), especially in stressed markets when there is a tendency for a flight to quality on the part of investors.

48. In addition, the existing LR has long recognised single-A rated (but not triple-B rated) corporate debt securities as liquefiable assets. The local market for single-A rated corporate debt securities, though relatively small in itself, is nonetheless significantly larger than that for triple-B rated corporate debt securities¹⁵, indicating that the market liquidity of the triple-B rated debt securities may be lower due to very limited supply. In the light of these considerations, the HKMA proposes to recognise single-A rated non-financial corporate debt securities, but not those rated triple-B, as HQLA under the LCR, subject to such securities meeting all relevant qualifying criteria. This will also enable alignment between the LCR and the MLR (which will retain the LR recognition of single-A rated corporate debt) without weakening the MLR standard.
49. With respect to listed common equities, the HKMA considers that the significant price volatility associated with the Hong Kong stock market in the past will render such assets not suitable for inclusion as HQLA under the LCR. According to the HKMA's analysis, most of the Hang Seng Index constituent stocks will not be able to meet the qualifying criteria, as they are either issued by financial institutions or exceed the prescribed 40% one-month price volatility limit (see paragraph 41). Recognising listed common equities as HQLA also runs counter to the longstanding regulatory objective of seeking to constrain very substantial equity exposure on the part of AIs (through limitations imposed under section 87 of the Banking Ordinance) due to the potential risks involved. Recognition of equities as HQLA might also have the unintended consequence of affecting Hong Kong's eligibility for the adoption of the Alternative Liquidity

¹⁵ Outstanding stock of HKD denominated A-rated and BBB-rated non-financial corporate debt securities as of December 2012 amounted to HK\$27 billion and HK\$0.7 billion respectively (*Source: Bloomberg*).

Approaches (ALA) offered by the BCBS, by increasing substantially the available supply of HQLA for meeting AIs' potential liquidity needs. The HKMA therefore proposes not to recognise listed common equities as HQLA under the LCR. Such equities are also not recognised as liquefiable assets under the LR and hence will not be recognised under the MLR in future. Exclusion of listed common equities from the LCR therefore enables further alignment between the LCR and the MLR.

50. With respect to RMBS, although such assets are currently recognised as liquefiable assets under the LR, the recent global financial crisis has clearly shown how structured securities such as RMBS can quickly become illiquid when market confidence evaporates. Moreover, the global RMBS markets are still struggling to recover to their pre-crisis levels. In view of these considerations, the HKMA considers that a greater degree of scrutiny over the inclusion of RMBS in HQLA is warranted. Hence, the HKMA proposes that the HKMA's prior approval should be obtained on a case-by-case basis for the inclusion of qualifying RMBS in an AI's stock of HQLA. In other words, an AI should be prepared to demonstrate to the HKMA's satisfaction that the relevant RMBS holding can fully meet all qualifying criteria and the AI is able to manage the relevant risks.
51. In summary, of the three types of Level 2B asset introduced by the BCBS' January 2013 LCR Revision, the HKMA proposes to recognise only single-A rated non-financial corporate bonds and RMBS rated AA or above as HQLA for LCR purposes, subject to their meeting all relevant qualifying criteria and, in the case of RMBS rated AA or above, subject to the HKMA's case-by-case approval being obtained. The proposed scope of HQLA for LCR purposes in Hong Kong is summarised in **Schedule A in Annex 2.**
52. To align treatment under the LCR and the MLR, the HKMA proposes that Category 2 AIs should similarly be required to seek the HKMA's approval on a case-by-case basis for the inclusion of RMBS as liquefiable assets under the

MLR from 2015 when the MLR will be implemented. Some grandfathering provisions may be considered in respect of existing RMBS holdings which are recognised under the LR immediately (or at a specified date) prior to the introduction of the MLR.

53. The HKMA would welcome comments and suggestions from the industry (backed wherever possible by empirical evidence) on the HKMA's proposed treatment of Level 2B assets.

Other HQLA requirements

54. The HKMA proposes to largely follow the other HQLA-related requirements set out in the January 2013 LCR Revision. These include -

- General characteristics and operational requirements – The HKMA will have regard to the characteristics and requirements specified in the 2013 LCR Revision (paragraphs 24 to 43) when developing the qualifying criteria for recognition of assets as HQLA under the LCR;
- Use of HQLA in times of stress – The HKMA proposes to draft the LCR requirement in the BLR in such a manner that it is clear that Category 1 AIs can 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, the HKMA will develop supervisory guidance to set out the circumstances under which such usage may be allowed, and the considerations underlying the HKMA's supervisory response in such circumstances.

55. The treatment of HQLA should be considered in conjunction with the HKMA's proposals for the adoption of ALA in Hong Kong, which are set out in the next section.

Section 5

Adoption of Alternative Liquidity Approaches in Hong Kong

Background

56. Although the LCR is a metric which is to be calculated on an all-currency basis, the BCBS expects banks to maintain a stock of HQLA of a composition which is consistent with the distribution of their liquidity needs by currency (re paragraphs 42 and 173 of the January 2013 LCR Revision). Recognising however that some jurisdictions may not have a sufficient supply of HQLA denominated in their local currency to meet banks' aggregate demand for such assets, the BCBS has made three Alternative Liquidity Approaches (ALA) available to such jurisdictions to address this situation¹⁶. In order, however, to be able to use the ALA, jurisdictions must meet certain eligibility criteria and requirements, which are set out in paragraphs 55 to 67 of the January 2013 LCR Revision.

57. Given the limited supply of HQLA denominated in Hong Kong dollars, the HKMA expects Hong Kong to be a jurisdiction which needs to adopt the ALA for LCR purposes. To verify this expectation, the HKMA is conducting a self-assessment of Hong Kong's eligibility for using the ALA treatment.

Implementation of ALA in Hong Kong

58. Subject to the results of the self-assessment of eligibility to adopt ALA treatment, the HKMA would propose to roll out the details of the local ALA framework (including supervisory guidance governing the use of ALA by Category 1 AIs),

¹⁶ The three ALA options are:

- Option 1, the use of contractual committed liquidity facilities provided by the relevant central bank for a fee;
- Option 2, the use of foreign currency HQLA (after haircuts to cater for currency risk) to cover domestic currency liquidity needs; and
- Option 3, the additional use of Level 2A assets (i.e. above the 40% cap for Level 2 assets) with a higher haircut.

together with the LCR calculation methodology for industry consultation in the latter part of this year.

59. Set out below are the HKMA's current thoughts on some major aspects of the local ALA framework:

- The HKMA has assessed the three ALA options and considers that ALA Option 2, which allows for the use of foreign currency HQLA to cover local currency liquidity needs under the LCR¹⁷, is likely to be the most suitable option for use in Hong Kong having regard to local circumstances, including particularly the Linked Exchange Rate System which substantially limits the foreign exchange (FX) risk between the Hong Kong dollar and the US dollar; the size and activity of the FX markets in Hong Kong; and AIs' general experience and capacity in managing FX risks in such markets¹⁸.
- Under ALA Option 2, any foreign currency HQLA used for covering local currency liquidity needs should be subject to haircuts to cater for currency risk, and the foreign currency in question must be freely and reliably convertible into the local currency. Based on the HKMA's assessment in accordance with the methodology set out by the BCBS in the January 2013 LCR Revision, the HKMA would propose, if ALA Option 2 is adopted, to apply the following haircuts to assets denominated in foreign currencies:

¹⁷ ALA Option 1 is not considered an eminently suitable option for Hong Kong in the light of the constraints on the use of the Exchange Fund in the Exchange Fund Ordinance (EFO) and the need for the Exchange Fund to be freely available for, and capable of, swift deployment for the purposes set out in section 3 of the EFO. Moreover, the HKMA considers that Category 1 AIs should "self-insure" against liquidity risk without resorting to the use of central bank committed facilities as a first line of defence. That is, the central bank should not be regarded as the "lender of first resort". ALA Option 3 does not address the issue of insufficient HQLA in Hong Kong due to the limited supply of Level 2A assets (and of Level 2B assets that the HKMA proposes to be recognised as HQLA) denominated in Hong Kong dollars.

¹⁸ AIs' level of FX activity can be reflected from the fact that as of December 2012, around 60% of the aggregate banking assets and liabilities were denominated in foreign currencies.

Proposed haircuts
under ALA Option 2

| | |
|--|------------------|
| (a) HQLA denominated in US dollars | 2% ¹⁹ |
| (b) HQLA denominated in other major currencies with global transaction volume exceeding 10% of total global foreign currency market turnover (i.e. EUR, JPY and GBP) | 8% |
| (c) Other foreign currencies that are freely and reliably convertible into Hong Kong dollars | 10% |

- According to the January 2013 LCR Revision, assets denominated in “major currencies” (viz., the Euro, Japanese Yen and British Pound) should be subject to a haircut not lower than 8%. The HKMA proposes to apply this standard level of haircut to the HQLA denominated these “major currencies”. The US dollar is also, obviously, a major currency but this is covered in item (a) in the table above.
- The 2013 LCR Revision also provides that HQLA denominated in other currencies, i.e. category (c) in the table above should be subject to a haircut higher than the level applicable to the “major currencies”. The level of the haircut in these cases should be derived from a methodology that compares the historical monthly exchange rate volatilities between the currency pair concerned (i.e. between the Hong Kong dollar and the relevant “other currency”) over an extended period of time. Based on the HKMA’s assessment to date, a haircut of 10% should be sufficiently prudent to address the 30-day volatility of most currencies that are freely and reliably convertible into Hong Kong dollars.
- The HKMA also proposes that the third currency category should include all foreign currencies (other than USD, EUR, JPY and GBP) that are freely and

¹⁹ The haircut of 2% for USD assets is derived from the range of Convertibility Undertaking (i.e. 7.75 to 7.85) under the Linked Exchange Rate System. The calculation is: $(7.85 - 7.75) / 7.8 \approx 1.3\%$ (rounded up to 2%). This level of haircut reflects the limited FX risk under the HKD / USD peg arrangement.

reliably convertible into Hong Kong dollars. Assets denominated in these currencies will be subject to a standard haircut rate of 10%. It is the HKMA's intention to include under this category eligible assets denominated in renminbi (RMB), provided that the RMB proceeds generated from these assets can be converted into Hong Kong dollars under the RMB clearing arrangements established in Hong Kong. Normally, these RMB assets are traded in the markets outside Mainland China (the "CNH market"). The HKMA does not expect AIs to use RMB assets traded in the onshore market of Mainland China (the "CNY market") for ALA purposes, unless the RMB CNY market develops to a stage that allows onshore RMB assets to be freely and reliably convertible into Hong Kong dollars.

- To allow for a certain degree of cross-currency liquidity coverage under the LCR, the HKMA proposes that the haircuts for foreign currency HQLA used under ALA Option 2 will apply only to that portion of the foreign currency HQLA that exceeds a certain threshold²⁰. This threshold is to accommodate a certain level of currency mismatch that may commonly exist among banks in their ordinary course of business. Having assessed the "ordinary course" cross-currency liquidity coverage positions of banks revealed from the local QIS results, the HKMA proposes to set this threshold at 25%, which is the maximum level allowed under paragraph 61 of the January 2013 LCR Revision.
- The extent to which foreign currency HQLA can be used by a Category 1 AI to cover net cash outflows denominated in the local currency must be restricted within a limit, which should be set as a percentage of the net cash outflows denominated in the local currency (see paragraphs 63 to 65 of the January 2013 LCR Revision). This limit essentially means that relevant AIs are required to maintain a minimum amount of HQLA denominated in HKD

²⁰ This threshold is expressed as the amount of foreign currency HQLA used to cover liquidity needs in the local currency as a percentage of total net cash outflows in the local currency.

to cover HKD liquidity needs. With reference to the QIS results, the HKMA intends to set the maximum limit on the usage of ALA Option 2 at 80% of AIs' net cash outflows in Hong Kong dollars. In other words, Category 1 AIs have to maintain HKD HQLA to cover at least 20% of their HKD liquidity needs. It should, however, be noted that the proposed 80% limit on usage of ALA Option 2 is only a maximum allowable limit. The HKMA will agree with each individual Category 1 AI their own specific maximum level of usage taking into account their respective liquidity risk profile; their existing need to fill an LCR liquidity gap after taking other possible measures; and their foreign exchange risk management capacity.

- The HKMA further proposes that the foreign currency HQLA to be held by Category 1 AIs for ALA purposes should be confined to Level 1 assets. This is because the abundant global supply of Level 1 assets in foreign currencies should be amply sufficient to provide AIs with a wide range of choice for managing their HQLA portfolios under ALA Option 2. Moreover, the inclusion of Level 2 assets for this purpose may significantly increase the operational complexity of managing Level 2 assets in foreign currencies within the 40% cap on Level 2 assets and the 15% cap on Level 2B assets (which will then have to be monitored on a currency-specific basis)²¹.

²¹ The complexity associated with the 40% cap on Level 2 assets and the 15% cap on Level 2B assets is mainly due to the requirement (as set out in Annex 1 of the January 2013 LCR Revision) that these caps should be applied after unwinding secured funding, secured lending and collateral swaps transactions involving exchanges between different classes of HQLA. If Level 2 assets (including Level 2B assets) are included under ALA Option 2, the relevant cap(s) applicable to this class of assets would need to be applied on a currency-specific basis. As a result, AIs would need to install sophisticated systems and effective procedures to operationalise the cap(s) (and the “unwinding” methodology) on Level 2 (including Level 2B) assets. Therefore, the operating costs may outweigh the expected benefits if Level 2 assets are allowed under ALA Option 2.

Section 6

Treatment of cash-flow items under Liquidity Coverage Ratio

Background

60. In the January 2013 LCR Revision, the BCBS made various changes to the LCR that will affect the calculation of its denominator (i.e. “total net cash outflows over the next 30 calendar days”). These include: the recalibration of the stress assumptions for a number of cash-flow items (e.g. in respect of retail, and non-financial corporate, deposits and undrawn committed facilities); the inclusion of some additional cash outflow categories (e.g. in respect of secured funding and derivative transactions); and the provision of further guidance or clarification on various issues (e.g. operational deposits).
61. The HKMA proposes to closely follow the revised treatments of cash-flow items as specified in the January 2013 LCR Revision. For those areas where the BCBS has not provided specific guidance, including some definitional issues and some cash-flow rates which are subject to national discretion, the HKMA is conducting its own assessments having regard to local empirical experience. Reference will also be made to any potential approaches likely to be adopted in other major jurisdictions. The relevant details will be specified in the methodology for the calculation of the LCR being developed for consultation with the industry in the latter part of the year.
62. At this stage, the HKMA would like to invite the industry’s comments on its preliminary thinking on certain definitional issues and the specific treatment applicable to items subject to national discretion. The HKMA is particularly interested to learn whether the industry envisages practical difficulties in implementing the proposals.

Stable retail deposits

63. Paragraph 75 of the January 2013 LCR Revision defines “stable retail deposits” as:

“the amount of the deposits that are fully insured²² by an effective deposit insurance scheme or by a public guarantee that provides equivalent protection and where:

- the depositors have other established relationships with the bank that make deposit withdrawal highly unlikely; or*
- the deposits are in transactional accounts (e.g. accounts where salaries are automatically deposited).”*

64. As specified in the January 2013 LCR Revision (paragraph 78), the outflow rate for “stable retail deposits” should be 5%. A lower outflow rate of 3% may, however, be adopted by jurisdictions if such deposits are covered by a deposit insurance scheme that meets the following additional criteria:

- “the insurance scheme is based on a system of prefunding via the periodic collection of levies on banks with insured deposits;*
- the scheme has an adequate means of ensuring ready access to additional funding in the event of a large call on its reserves, e.g. an explicit and legally binding guarantee from the government, or a standing authority to borrow from the government; and*
- access to insured deposits is available to depositors in a short period of time (which is expected to be no more than seven business days) once the insurance scheme is triggered.”*

²² “Fully insured” means that 100% of the deposit amount, up to the deposit insurance limit, is covered by an effective deposit insurance scheme. Deposit balances up to the deposit insurance limit can be treated as “fully insured” even if a depositor has a balance in excess of the deposit insurance limit. However, any amount in excess of the deposit insurance limit is to be treated as “less stable”. See footnote 34 of the January 2013 LCR Revision for more details.

Furthermore, paragraph 78 of the January 2013 LCR Revision indicates that: *“Jurisdictions applying the 3% outflow rate to stable deposits should be able to provide evidence of run-off rates for stable deposits within the banking system below 3% during any periods of stress experience that are consistent with the conditions within the LCR.”*

65. The HKMA is of the view that the Deposit Protection Scheme (DPS) in Hong Kong is an “effective deposit insurance scheme” within the meaning of the LCR standard. However, the existing DPS may need some enhancement before it can fulfil all of the additional criteria to qualify for a 3% outflow rate for “stable retail deposits”²³. Until such time as the DPS can satisfy all relevant criteria, the HKMA proposes to apply an outflow rate of 5% to “stable retail deposits” for the purposes of local implementation of the LCR.

66. Some definitional issues concerning “stable retail deposits” might usefully be clarified to assist consideration by the industry of the proposals in this CP:

- Deposit insurance coverage is one of the essential factors for defining “stable retail deposits”. In Hong Kong, only “protected deposits” placed by an eligible depositor (who should not be an “excluded person”) with a licensed bank are covered by the local DPS, and the maximum protected amount of each person’s deposits placed with a bank is up to HK\$500,000. AIs subject to the LCR are expected to put in place appropriate systems and procedures to identify their “stable retail deposits”, taking into account the specific requirements for deposits to qualify for protection under the local DPS²⁴.

²³ Based on the HKMA’s assessment, the existing DPS in Hong Kong is able to meet most of the requirements set out in paragraph 78 of the January 2013 LCR Revision, except that the lead time for depositors to have access to their protected deposits once the DPS is activated will depend on actual circumstances, including, for example, the ability of individual banks to provide information to the DPS Board sufficiently & swiftly to facilitate payout. This means that the seven-day timeframe as required in the 2013 LCR Revision may not be achievable.

²⁴ The definitions of the specific terms (such as “protected deposits” and “excluded persons”) and the relevant requirements under the local DPS are provided in Schedule 1 to the Deposit Protection Scheme Ordinance

- Whether the depositors have “other established relationships” with the bank concerned, or whether the deposits are maintained in “transactional accounts”, is also a necessary condition for defining “stable retail deposits”. The HKMA proposes to apply these two terms in the local context as follows:
 - According to the LCR standard, “other established relationships” are relationships between a depositor and an AI that will make deposit withdrawal highly unlikely. The HKMA proposes to consider a depositor as having “other established relationships” with an AI if (i) the depositor has maintained one or more types of banking relationship (other than the placing of deposits) with the AI for at least 12 months; and (ii) the accounts underlying such relationships are not dormant or inactive. Such relationships may relate, for example, to the depositor maintaining a loan, credit card, investment, securities, or wealth management account with the AI.
 - The HKMA proposes to define “transactional accounts” as all types of deposit accounts that are designated by account-holders to receive funds

(DPSO). In brief:

“Protected deposits” include customer deposits, either denominated in Hong Kong dollars or foreign currencies, placed with the “Scheme members” of the local DPS (i.e. all licensed banks in Hong Kong) but excluding the following deposits and deposit-like instruments:

- structured deposits;
- bearer instruments;
- term deposits with a maturity exceeding 5 years;
- deposits the repayment of which are secured on the assets of the Scheme member;
- off-shore deposits;
- deposits held for the account of the Exchange Fund; and
- deposits held or owned by an excluded person.

An “excluded person” is:

- a related company of the Scheme member;
- a multilateral development bank as defined in section 2(1) of the Banking Ordinance;
- an AI, i.e. licensed banks, restricted licence banks and deposit-taking companies;
- a foreign bank which is not an AI in Hong Kong; or
- the senior management, controllers and directors of the Scheme member and its related companies.

(Source: Deposit Protection Board)

or make payments on a regular basis (e.g. through a standing instruction)²⁵.

Less stable retail deposits

67. The BCBS requires national supervisors to develop additional categorisation buckets, with higher outflow rates as necessary, for application to potentially “less stable retail deposits”, with a minimum outflow rate of 10% (re paragraphs 79 to 84 of the January 2013 LCR Revision). Such deposits may include deposits that are not fully covered by an effective deposit insurance scheme or a sovereign deposit guarantee; high-value deposits; deposits from sophisticated or high net worth individuals; deposits that can be withdrawn quickly (e.g. internet deposits) and foreign currency deposits, as determined by each jurisdiction. Having assessed the possible attributes of “less stable retail deposits” in the local context, the HKMA proposes to classify as “less stable retail deposits” all retail deposits (i) payable on demand or with a remaining term to maturity (or withdrawal notice period) of not more than 30 calendar days; and (ii) not meeting the criteria for “stable retail deposits”. The outflow rates for such deposits will be calibrated by reference to the amount of deposit because the HKMA considers that high-value deposits tend to be more volatile and less “sticky” (with characteristics akin to wholesale deposits).

| Less stable retail deposits payable on demand or maturing within 30 calendar days | Proposed run-off rates |
|--|-------------------------------|
| • Up to HK\$5 million | 10% |
| • From HK\$5,000,001 to HK\$10,000,000 | 15% |
| • Exceeding HK\$10,000,000 | 20% |

²⁵ The receipt of funds may relate, for example, to the receipt of salary income, rental income, or social welfare subsidies, whereas the payment of funds may relate, for example, to loan repayment, rental payment, payment for utilities or rates, etc.

68. The HKMA has also assessed the other factors suggested by the BCBS. It is, however, not proposed to adopt these factors for defining “less stable retail deposits” in Hong Kong due to the following considerations:

- The level of depositors’ net worth and sophistication may not be a significant factor for calibrating “less stable retail deposits”, as these depositors usually have other relationships (e.g. wealth management and lending) established with the AI and their deposits may not necessarily be less stable (e.g. highly sensitive to interest rate pricing) if they also take risk factors and overall service quality into account.
- Withdrawal channels are not considered a key factor for defining “less stable retail deposits” in Hong Kong, as there seems to be no strong evidence, locally, indicating that deposits that can be withdrawn through a specific channel (e.g. internet banking or phone banking) are necessarily less stable. Moreover, the variety of deposit withdrawal channels offered by AIs to depositors in Hong Kong also makes it difficult to classify deposits in terms of withdrawal channels.
- As for currency denomination, there is no evidence that foreign currency deposits are less stable than local currency deposits in Hong Kong. Actually, the placing of foreign currency deposits with AIs is common among retail depositors, as reflected in the fact that foreign currency deposits have tended to make up around 50% of aggregate local banking deposits over the years.

Retail term deposits

69. The BCBS also requires national supervisors to apply appropriate treatment to retail term deposits with a remaining term to maturity (or withdrawal notice period) of over 30 calendar days. In this regard, the January 2013 LCR Revision offers the following two approaches:

- Approach 1: Jurisdictions may apply a 0% outflow rate for retail term deposits, if early withdrawal of such deposits is disallowed legally or if early withdrawal will result in the depositor having to pay a significant early withdrawal penalty that is materially greater than the loss of interest²⁶. However, if a bank allows an early withdrawal of a retail term deposit even though the depositor has no legal right to make the withdrawal (or the bank allows the withdrawal without imposing a significant penalty charge on the depositor), the bank's whole portfolio of retail term deposits would then need to be treated in the same way as demand deposits for LCR purposes.
- Approach 2: Alternatively, jurisdictions may apply a non-zero outflow rate for the retail term deposits if withdrawal behaviour in respect of such deposits is considered to be similar to that for retail demand deposits in normal or stressed times.

70. In Hong Kong, although early withdrawal of retail term deposits is less common under normal circumstances, historical bank runs and other previous periods of stress provide strong empirical evidence that term depositors are in fact likely to have the similar propensity as demand depositors to withdraw their deposits from a troubled bank in times of crisis or loss of market confidence in a bank and the bank in turn is likely to allow such early withdrawal for reputational reasons. Therefore, the HKMA considers that Approach 2 better accommodates local banking practice and depositor behaviour, and, accordingly, proposes to apply an outflow rate of 5% for such deposits to align with that for stable retail deposits (recognising to some extent the relative stability of the deposit given its “term” feature).

²⁶ By reference to the policies and practices of some AIs, the HKMA would regard an early withdrawal penalty as significant if the penalty is equivalent to the loss of interest and 5% of the principal amount of the deposit.

Unsecured funding provided by small business customers (SBC funding)

71. Under the LCR standard, SBC funding consists of deposits (and other extensions of unsecured funds, if any) provided to banks by small business customers²⁷. This category of funding can be treated in line with retail deposits.
72. The HKMA intends to follow the BCBS definition and treatment of SBC funding for LCR purposes. In the local context, the HKMA proposes to define “small business customers” by adapting the definition of “loans extended to small businesses” in paragraph 231 of the Basel II framework, that are managed as retail exposures. As such, “small business customers” are those that meet the Basel II definition for “small business customers” and are generally considered to have similar liquidity risk characteristics to retail customers, provided that the total aggregated funding raised by a bank from any such customer is less than HK\$10 million (which is approximately equal to the €1 million specified in the January 2013 LCR Revision) on a consolidated basis where applicable²⁸.
73. Where an AI does not have any exposure to a small business customer that would enable it to use the definition mentioned above, the AI may recognise deposits (or unsecured funding, if any) taken from a non-retail customer as “SBC funding” provided that the aggregate amount of such funding raised from a non-retail customer is less than HK\$10 million on a consolidated basis where applicable, and the deposit is managed as a retail deposit. This means that the AI treats such deposits in its internal risk management systems consistently over

²⁷ Guidance on the definition of “small business customers” is set out in paragraphs 90 and 91 of the January 2013 LCR Revision.

²⁸ “Aggregated funding” means the gross amount (i.e. without netting any form of credit extended to the legal entity) of all forms of funding (e.g. deposits or debt securities or similar derivative exposures for which the counterparty is known to be a small business customer). In addition, applying the limit on a consolidated basis means that where one or more small business customers are affiliated with each other, they may be considered as a single entity such that the limit is applied to the total funding received by an AI from this group of customers.

time and in the same manner as other retail deposits, and that the deposits are not individually managed in a way comparable to larger corporate deposits.

Operational deposits

74. The BCBS recognises that financial and non-financial entities may place “operational deposits” with banks to facilitate specific types of activities (i.e. clearing, custody and cash management²⁹) that are conducted with substantive reliance on the services provided by the relevant banks. Subject to certain qualifying criteria³⁰, “operational deposits” may receive an outflow rate of 25%

²⁹ The BCBS requirements on “operational deposits” are set out in the January 2013 LCR Revision (paragraphs 93 to 104). Such deposits are associated with the activities of “clearing”, “custody” and “cash management” as defined below:

- A clearing relationship refers to a service arrangement that enables customers to transfer funds (or securities) indirectly through direct participants in domestic settlement systems to final recipients. Such services are limited to the following activities: transmission, reconciliation and confirmation of payment orders; daylight overdraft, overnight financing and maintenance of post-settlement balances; and determination of intra-day and final settlement positions.
- A custody relationship refers to the provision of safekeeping, reporting, processing of assets or the facilitation of the operational and administrative elements of related activities on behalf of customers in the process of their transacting and retaining financial assets. Such services are limited to the settlement of securities transactions, the transfer of contractual payments, the processing of collateral, and the provision of custody related cash management services. Also included are the receipt of dividends and other income, client subscriptions and redemptions. Custodial services can furthermore extend to asset and corporate trust servicing, treasury, escrow, funds transfer, stock transfer and agency services, including payment and settlement services (excluding correspondent banking), and depository receipts.
- A cash management relationship refers to the provision of cash management and related services to customers. Cash management services, in this context, refer to those products and services provided to a customer to manage its cash flows, assets and liabilities, and conduct financial transactions necessary to the customer’s ongoing operations. Such services are limited to payment remittance, collection and aggregation of funds, payroll administration, and control over the disbursement of funds.

The BCBS has also specified (in footnote 42 of the January 2013 LCR Revision) that the specific activities do not include “correspondent banking” and “prime brokerage” activities as defined below:

- “Correspondent banking” refers to arrangements under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services in order to settle foreign currency transactions (e.g. so-called nostro and vostro accounts used to settle transactions in a currency other than the domestic currency of the respondent bank for the provision of clearing and settlement of payments).
- “Prime brokerage” is a package of services offered to large active investors, particularly institutional hedge funds. These services usually include: clearing, settlement and custody; consolidated reporting; financing (margin, repo or synthetic); securities lending; capital introduction; and risk analytics.

Correspondent banking funds should be subject to the general requirements on interbank funds, while the cash-flow items associated with prime brokerage activities should be subject to the specific requirements on such activities as specified in other parts of the January 2013 LCR Revision.

³⁰ The qualifying criteria for “operational deposits” include the following:

under the LCR. Further, the portion of operational deposits fully covered by an effective deposit insurance scheme can receive the same treatment as “stable retail deposits”. The BCBS considers that supervisory approval should be given to ensure that banks utilising the treatment for operational deposits are in fact conducting the qualifying operational activities at a level indicated by the size of the operational deposits. Moreover, in order to guard against undue concentration in the operational deposits taken by a bank, the BCBS specifically envisages that supervisors may reject a bank’s application to use the relevant treatment for operational deposits if a significant portion of the bank’s operational deposits are taken from a small number of depositors.

75. In addition to the treatment of “operational deposits” received by a bank as an outflow item, the January 2013 LCR Revision (paragraph 98) requires that a depositing entity, which is itself a banking institution, should apply a 0% inflow rate on the “operational deposits” it places with another bank.
76. The HKMA proposes to allow AIs to apply the preferential treatment for “operational deposits” under the LCR, provided that the relevant requirements specified by the BCBS are fully satisfied. The HKMA will accordingly need to assess compliance in this regard. Hence, individual Category 1 AIs intending to apply the preferential treatment for “operational deposits” should establish appropriate methodologies, systems and procedures to identify such deposits in order to ensure compliance with the relevant requirements. Such AIs may seek

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- the depositor is reliant on the bank as an independent third party to provide the qualifying services in order to fulfil the depositor’s normal business operation over a one-month period. For example, this condition would not be met if the bank is aware that the depositor has adequate back-up arrangements;
 - the qualifying services must be provided by the bank to the depositor under a legally binding agreement that cannot be terminated within a one-month period (or early termination within one month shall result in significant switching costs to be borne by the depositing entities);
 - the “operational deposits” are by-products of the underlying services provided by the bank and not sought out in the wholesale market in the sole interest of offering interest income;
 - the deposits are held in specifically designated accounts and priced without giving an economic incentive for the depositing entities to leave any excess funds in these accounts;
 - excess balances in the operational deposit accounts that could be withdrawn and would still leave sufficient amount of funds to fulfil the qualifying activities should not be treated as “operational deposits”. Banks must determine the methodology for identifying excess deposits that are excluded from this treatment.

advice from the HKMA in case of any doubt. The HKMA will discuss with individual AIs the approaches and methodologies they intend to adopt and will assess their compliance with the relevant requirements through the usual supervisory process. Based upon this experience, the HKMA will develop codes of practice or supervisory guidance, where appropriate, to clarify relevant requirements and communicate observed best practices.

Unsecured wholesale funding (excluding operational deposits)

77. Under the January 2013 LCR Revision, unsecured wholesale funding (excluding “operational deposits”) received by a bank from non-financial corporates, sovereigns, central banks, multilateral development banks and public sector entities will be subject to an outflow rate of 40% (instead of the 75% originally specified in the 2010 Basel III package). The HKMA proposes to adopt the revised 40% outflow rate for unsecured wholesale funding.
78. The January 2013 LCR Revision also allows unsecured wholesale funding received from the aforesaid entities to be subject to a lower outflow rate of 20% if the entire amount of the deposit (which is not an “operational deposit”) is fully covered by an effective deposit insurance scheme³¹. The HKMA proposes to adopt this preferential treatment in Hong Kong. This would mean that the 20% outflow rate could be applied to deposits received from a non-financial wholesale entity (which should not be an “excluded person” under the local DPS³²) if the entire amount of the deposit is fully covered by the local DPS (i.e. currently up to HK\$500,000). Otherwise, the entire amount of the deposit should be subject to a 40% outflow rate.

³¹ It should be noted that under the LCR standard, the concept of “deposit insurance coverage” applicable to wholesale funding is more stringent than that applicable to retail deposits and SBC funding. While deposits taken by a bank from a retail depositor can be partially treated as “stable retail deposits” (if the deposits are partially covered by an “effective deposit insurance scheme” and the other requirements in respect of “other established relationships” or “transactional accounts” are satisfied, as mentioned in paragraph 63 of this CP), deposits taken by a bank from a wholesale depositor must be entirely protected in order to be treated with the lower outflow rates applicable to wholesale deposits.

³² Please refer to footnote 24 for the meaning of “excluded persons” under the local DPS.

Unsecured wholesale funding provided by other legal entities

79. Non-operational funding received from other wholesale entities (i.e. other than those described in paragraphs 77 and 78 above), including but not limited to financial institutions (banks, securities firms, insurance companies, etc.) and their affiliated entities, fiduciaries, beneficiaries, conduits and special purpose vehicles are subject to a 100% outflow rate under the LCR. The HKMA intends to follow the BCBS requirement and apply an outflow rate of 100% for unsecured wholesale funding within this category. Where necessary, more precise definitions for the relevant depositing entities will be included in the BLR or supervisory guidance.

Secured funding

80. For the purposes of the LCR standard, “secured funding” refers to those liabilities and general obligations that are collateralised by legal rights over specifically designated assets owned by the borrowing institution in the case of bankruptcy, insolvency, liquidation or resolution. The January 2013 LCR Revision prescribes the following outflow rates for secured funding:

| Categories of secured funding (maturing within 30 calendar days) | Outflow rates |
|--|----------------------|
| <ul style="list-style-type: none">• Backed by Level 1 HQLA; <u>or</u>• Conducted with central banks | 0% |
| <ul style="list-style-type: none">• Backed by Level 2A HQLA | 15% |
| <ul style="list-style-type: none">• Secured funding transactions conducted with domestic sovereigns, public sector entities (PSEs) or multilateral development banks that are not backed by Level 1 or 2A HQLA (Note: PSEs that receive this treatment are limited to those having a risk-weight of 20% or lower under the Basel III regulatory capital standard)• Backed by RMBS eligible for inclusion as Level 2B HQLA | 25% |
| <ul style="list-style-type: none">• Backed by other Level 2B assets (except RMBS) | 50% |
| <ul style="list-style-type: none">• All others | 100% |

81. The HKMA proposes to apply the above treatment for secured funding, but on the basis that the definition of HQLA will follow the proposed scope of HQLA to be adopted in Hong Kong (i.e. Level 2B assets will not include those not recognised by the HKMA). If the overseas branches or subsidiaries of a locally incorporated AI have secured funding from central banks in the relevant host jurisdictions in which they are established, the AI, in the calculation of the LCR covering its overseas operations, may apply the requirements adopted in those jurisdictions for the treatment of the secured funding received from the central banks concerned.

Other outflows associated with off-balance-sheet activities

82. The BCBS requires that the LCR should cover certain types of cash flows associated with off-balance-sheet activities³³. While the January 2013 LCR Revision provides some specific requirements on the treatment of these items, a number of them are subject to national discretion (such as the outflow rate for contingent obligations related to trade finance). The HKMA is conducting some quantitative analyses and seeking to draw reference from other major jurisdictions' policy proposals to determine the appropriate local treatment for these items. At this stage, the HKMA would like to invite the industry's comments on some preliminary ideas presented in **Schedule B of Annex 2**.

Cash inflows

83. The HKMA proposes to adopt the BCBS requirements on the treatment of cash inflow items³⁴ in the local LCR framework, which is illustrated in **Schedule C of**

³³ The relevant requirements on off-balance-sheet cash flows are provided in paragraphs 116 to 140 of the January 2013 LCR Revision.

³⁴ The relevant requirements on cash inflow items are provided in paragraphs 142 to 160 of the January 2013 LCR Revision.

Annex 2. It should be noted that the total amount of cash inflows that can be deducted from the denominator of the LCR is subject to a cap equivalent to 75% of total cash outflows (before application of the cash-flow rates). This cap effectively means that there is a minimum requirement for the holding of HQLA, equivalent to 25% of total cash outflows or, to put it another way, cash inflows cannot completely set off cash outflows so as to bring about a situation in which no HQLA is required to be held. The operation of this cap in the calculation of the LCR will be demonstrated when the HKMA rolls out its LCR calculation methodology for consultation in the latter part of this year.

Connected party funding and obligations

84. In response to the HKMA's previous consultations, some banks have expressed concern about the treatment of connected party funding and obligations under the LCR, which is an area subject to national discretion.
85. Empirical experience, in the observation of the HKMA, does not provide a clear indication of how an AI's connected parties will behave in stressed circumstances in terms of their lending to, or borrowings from, the AI, and their behaviour may depend very much on the circumstances of each case. There seems, therefore, to be no sufficient ground upon which a differentiated treatment for AIs' funding transactions with connected parties can be justified. Therefore, in line with the existing practice under the LR, the HKMA is presently minded to treat connected funding transactions in the same way as similar transactions conducted with unrelated third parties³⁵. If, however, the proposal in paragraph 29 of this CP (FBB Option 2) is adopted ultimately, special treatment for intra-group funding transactions may apply to FBBs if certain specified criteria are satisfied.

³⁵ For example, if the connected party is a regulated financial institution, an AI's on-balance sheet claims on, or borrowing from, its connected party will be subject to an inflow rate of 100% and an outflow rate of 100% respectively. If an AI has granted committed facilities to the connected party or received committed facilities from that party, the inflow and outflow rates will be 0% and 40% respectively.

Section 7

Modifications to Liquidity Ratio

Original proposals

86. In L1, the HKMA proposed to modify the LR to enhance its effectiveness as a local liquidity standard for application to Category 2 AIs. The HKMA's proposal took into account the need to reflect market developments over the years, lessons drawn from previous financial crises, and implementation experience. Initially, the HKMA proposed the following modifications to the LR:

- adjusting the definition of “liquefiable assets” to exclude all “cash inflow items”, e.g. eligible loan repayments and net bank placements (i.e. interbank placements (net of interbank borrowings)), in order to restrict the numerator to assets that are genuinely liquid and available;
- including some assets which qualify as HQLA under the LCR but are not otherwise included as “liquefiable assets” under the LR (e.g. central bank reserves or amounts due from the Exchange Fund), while at the same time considering the extent to which other “liquefiable assets” that do not qualify as HQLA under the LCR (e.g. gold, export bills and marketable securities of investment grade issued by financial institutions) can continue to be included by reference to their genuine “liquefiability”;
- applying the LCR concept of “net cash outflows” to the denominator of the LR by allowing AIs to deduct cash inflows due within one month from “qualifying liabilities” if the cash inflows can meet certain of the prescribed criteria for liquefiable assets (such as those under the Fourth Schedule to the Banking Ordinance) albeit that they do not qualify for inclusion in the numerator as “liquefiable assets”; and

- applying a cap to total cash inflows, similar to the 75% cap under the LCR (see paragraph 83 above), to ensure that an AI with “net cash inflows” must still maintain a minimum stock of “liquefiable assets” to cater for contingencies.

87. The proposed modifications are aimed to ensuring that only “stock” assets that are genuinely liquid and readily available for conversion into cash are counted as “liquefiable assets”, whereas “inflow items” are recognised only in the denominator of the ratio. Moving the “inflow items” to the denominator will help rectify a potential “overstatement” effect on an AI’s liquidity position³⁶ and encourage AIs not to rely too heavily on cash inflow items to meet the minimum LR requirement, given the risk that such inflow items may not in fact materialise and may not be readily available for conversion into cash.

Treatment of net bank placements

88. The proposed modifications to the LR will result in a higher liquidity standard to be observed by Category 2 AIs in order to further enhance banking liquidity resilience and keep up with latest market and regulatory developments. Nevertheless, the HKMA is aware of the industry’s concern that the proposed exclusion of “net bank placements” due within one month as “liquefiable assets” under the MLR (which will treat such placements as an “inflow item” to be deducted from the denominator) may limit the choices available to AIs for managing their liquefiable asset portfolios. Moreover, the proposed treatment of “net bank placements” may disincentivise AIs from utilising the interbank money market for daily liquidity management. From a systemic perspective, a less active interbank money market may result in lower efficiency in financial intermediation and a tighter liquidity environment for the whole banking system.

³⁶ The current treatment of inflow items arguably makes the LR less capable of reflecting AIs’ genuine liquidity positions because under the existing formulation, each dollar of inflow items included in the numerator can support up to four dollars of qualifying liabilities (which are outflow items) in the denominator. The current numerator of the LR, which includes both stock and flow items, does not clearly distinguish the amount of genuine liquidity reserves that are readily available for an AI to meet its liquidity needs.

89. On the other hand, the HKMA considers that there are also some potential concerns associated with reliance on interbank placements as a genuine and readily / constantly available source of liquidity that cannot be ignored. Particularly during a banking crisis, interbank transactions can be a source of contagion risk for participants in the interbank market, and significant disruptions in the market may have systemic implications. Experience in previous crises suggests that interbank placements might not always be repaid, especially when some interbank market participants are manifestly under stress³⁷.
90. The HKMA acknowledges that all of these concerns should be weighed appropriately in the deliberations over the future shape of the MLR framework. Recognising the potential interaction between the MLR and the interbank market, the HKMA is fleshing out some further options for the treatment of “net bank placements” under the MLR that can address the industry’s concerns but, at the same time, cater for some of the underlying risks. Altogether, there are three options under consideration:
- ***MLR Option 1: Adhering to the original proposal of moving “net bank placements” due within one month to the denominator*** – The rationale for adopting this option is explained in L1 (and in paragraphs 86 and 89 above). This option will ensure that only highly liquid assets, that are readily available for conversion into cash, can be recognised as “liquefiable assets” under the MLR. This approach is in line with the fundamental principle underlying the definition of HQLA under the LCR.
 - ***MLR Option 2: Allowing “net bank placements” to be recognised as liquefiable assets to the extent that the placements and borrowings concerned are withdrawable on demand (or mature overnight), while other net bank placements due within one month will be included in the denominator (bank borrowings as “qualifying liabilities” and bank***

³⁷ For example, an interbank borrower experiencing stress might go into default, or even prior to this, an interbank lender lending to a borrower which is experiencing stress might be tempted to withhold other payments to such a borrower as a prelude to set-off, on the assumption that the borrower is going to default.

placements as deductions to “qualifying liabilities”) – This option has the merit of including in the numerator of the MLR only items that are readily “liquefiable” (overnight interbank placements may be included because of their cash-like nature), while addressing the industry’s concern about the potential impact on the interbank market if no interbank placements can be included as “liquefiable assets” under the MLR.

- ***MLR Option 3: Retaining all net bank placements due within one month as “liquefiable assets”, subject to a more stringent “liquidity conversion factor” (say, around 80%) and a cap (say, 40%, expressed as a percentage of total qualifying liabilities (before deduction))*** – This option will minimise changes to the existing LR structure. The proposed adjustment to the “liquidity conversion factor” and the setting of a cap on “net bank placements” may help guard against over-reliance on “net bank placements” as a source of liquidity and reflect the contagion risk. Moreover, the potential impact on AIs’ liquidity management practices and interbank market operations will largely be mitigated.

91. The HKMA will need to further consider the implications of these options for “net bank placements” to ensure that the right incentives are pursued, and would welcome the industry’s comments. As regards “eligible loan repayments”, the HKMA maintains the view that such repayments should more appropriately be treated as a deduction from “total qualifying liabilities” in the denominator of the MLR. This takes into account the fact that inflows from “eligible loan repayments” will most likely be used for other lending activities, and hence cannot serve as a form of liquidity reserve for the AI concerned.

Scope of liquefiable assets

92. The industry has sought confirmation about the scope of “liquefiable assets” under the MLR. Except for the exclusion of “net bank placements” and “eligible loan repayments” proposed in L1, the HKMA proposes that the other categories

of liquefiable assets recognised under the LR will continue to be recognised under the MLR, save for some modifications, clarifications or adjustments (e.g. in respect of liquidity conversion factors) to reflect more appropriately their liquidity value. A new category of “liquefiable assets”, representing claims on, or reserves maintained with, central banks that are withdrawable on demand, will be added.

93. The HKMA has also developed specific proposals for modifying the LR in these and other aspects. Details of all of the proposed modifications, including the changes to “liquefiable assets” and “qualifying liabilities”, are presented in **Annex 3** for industry comment.

Annex 1

Responses to industry comments on proposals consulted upon in June 2012

| Industry comments on L2 | HKMA responses |
|---|---|
| Section 1: Approach and criteria for classifying Category 1 and Category 2 AIs | |
| <p><u>(I) General</u></p> <p>Based on comments received from previous consultations, the industry is broadly supportive of the two-tiered approach for application of the Basel III liquidity standards. Nevertheless, some banks expressed the preference to apply the Basel III liquidity standards to all AIs on the ground of maintaining a level playing field.</p> | <p>As explained in L1 and L2, the HKMA considers that an across-the-board application of the Basel III liquidity standards may not be the optimum choice for Hong Kong given the diversity of its AIs in terms of their size and complexity of operations as well as their level of significance to the local banking system.</p> <p>The Basel III liquidity standards are more suited for application to AIs with a significant role in the financial system, or whose safety and soundness may be regarded as crucial for the stability of the banking sector. For AIs whose business is relatively simple, small and localised, a suitably modified and enhanced LR (i.e. the MLR) should suffice to provide an adequate liquidity buffer requirement.</p> <p>As such, the HKMA continues to hold the view that a two-tiered framework should be pursued when implementing the liquidity standards in Hong Kong.</p> |
| <p><u>(II) Quantitative factors:</u></p> <p>The HKMA received diverse opinions on the quantitative factors to be adopted for classifying AIs under the two-tiered approach. These opinions include:</p> <p>(a) The “composition of balance sheet” and “sources and uses of liquidity” should also be taken into consideration.</p> <p>(b) The “significance benchmarks” for the two quantitative factors recommended by the HKMA should be raised by giving consideration to market share (e.g. to capture AIs that</p> | <p>(a) The HKMA considers that the industry’s suggestion of using quantitative factors such as “composition of balance sheet” and “sources and uses of liquidity” for classifying AIs may involve significant practical issues. It is difficult to derive uniform benchmarks for such factors across AIs which have different business models and liquidity risk profiles. The HKMA may, however, take into account such factors in the overall assessment of individual AIs’ classification status, e.g. in assessing their complexity of operations or potential impact on other banks, where appropriate.</p> |

| Industry comments on L2 | HKMA responses |
|---|--|
| <p>have 5% of market share in asset size).</p> <p>(c) The quantitative benchmarks should be able to allow room for continuous industry growth.</p> <p>(d) While the HKMA has proposed the significance benchmarks to be set at HK\$200 billion (asset size) and HK\$100 billion (international exposures) for local AIs, the industry expected the HKMA to clarify the levels of benchmarks applicable to foreign bank branches. In this regard, there is also an opinion that a single set of benchmarks should be applied to all AIs to ensure a level playing field.</p> <p>(e) There is also a view that exposures to intra-group entities should be excluded in the evaluation of external claims and liabilities.</p> | <p>(b) The HKMA is of the view that “market share” may not be a suitable measure for classifying AIs under the two-tiered approach in light of the existing market structure of the local banking sector (where an overwhelming majority of AIs do not constitute a significant share of the market). As reflected from past crisis experience, some AIs might still conceivably pose risks to local banking stability (either directly or through contagion channels) even if they do not have a significant market share (say, 5%). Moreover, a “relative” measure will be difficult to administer as it will be affected by changes in both the numerator (an AI’s total assets) and the denominator (total banking assets). Therefore, the HKMA favours using a “static” measure and conducting a periodic review of the measure to ensure it remains appropriate.</p> <p>(c) The HKMA agrees that the two quantitative benchmarks should be set appropriately to cater for industry growth. As proposed in <u>Section 1</u> of this CP, the HKMA is therefore now minded to raise each of the two benchmarks to HK\$250 billion to provide scope for further growth in the banking sector.</p> <p>(d) As proposed in Section 1 of this CP, the two revised quantitative benchmarks would apply to all AIs uniformly.</p> <p>(e) The HKMA considers that there is a case for including exposures to intra-group entities in the calculation of “total external claims and liabilities”. This is because these are still cross-border exposures that will pose risk to an AI.</p> |
| <p><u>(III) Qualitative factors</u></p> <p>(a) Clarification was sought on how the HKMA would assess an AI’s (i) “connections with other Category 1 AIs” to guard against potential</p> | <p>(a) The reason for looking into an AI’s “connections with other Category 1 AIs” is essentially out of concerns related to the potential for regulatory arbitrage which</p> |

| Industry comments on L2 | HKMA responses |
|---|--|
| <p>regulatory arbitrage; and (ii) “connections with other entities operating in Hong Kong or elsewhere” that may exert a potential impact on the local banking sector (e.g. whether such connections are relevant only if an AI under assessment is a <u>subsidiary</u> of a parent bank either operating in HK as a Category 1 AI or elsewhere).</p> <p><u>Foreign bank branches (FBBs)</u></p> <p>(b) Industry opinions were divided on the HKMA’s intention to attach more emphasis to qualitative factors (particularly the “home factors”) in classifying FBBs. While some AIs were receptive to this approach, another view expressed was that FBBs should be classified on the same basis as local AIs.</p> <p>(c) The industry expected the HKMA to clarify the approach to assessing the “home factors” of FBBs, including the following specific issues:</p> <ul style="list-style-type: none"> • whether the HKMA would require an FBB to provide a separate regulatory report or the HKMA would seek the home authority’s advice via the usual host / host regulatory communication channels – this process was suggested to be undertaken through bilateral discussions between the HKMA and the AI concerned; • in the case where several connected AIs are operating in Hong Kong, whether the HKMA would take a consolidated approach to classifying them; and • as a related issue, there was a comment to the effect that if an FBB decides to “opt in” as a Category 1 AI, the HKMA | <p>may be encouraged if two connected AIs are classified in different categories. The type of “connection” may take various forms, such as (i) parent and subsidiary / group entity relationship; (ii) relationship between sister branches; and (iii) relationship between a branch and a subsidiary / group entity.</p> <p>Such assessment will be made on a case-by-case basis. The focus will be less on subsidiaries of a Category 1 locally incorporated AI (which will likely be included in the calculation of the consolidated LCR of that Category 1 AI), but more on connected entities which are the Hong Kong branch of a foreign bank and the subsidiaries / group entities of that bank that are themselves AIs.</p> <p><u>Foreign bank branches (FBBs)</u></p> <p>(b) While the two-tiered approach will be applicable to all AIs, it is reasonable for the HKMA to take into account some FBB-specific factors in the assessment of such AIs. For example, the business model and mode of operation employed by potential Category 1 FBBs may be fundamentally different from that of local AIs. The liquidity risk of an FBB may be centrally managed by its banking group under a global funding model. Subject to both home and host liquidity risk supervision, these foreign banks will most likely be required to comply with both home LCR requirements at the group level and host LCR requirements at the branch level. Moreover, the liquidity risk of an FBB will inevitably be affected by the liquidity strength of, and liquidity support from, its banking group.</p> <p>In light of these specific factors, the HKMA considers it appropriate to adopt an approach that focuses more on the qualitative elements (including the “home” factors) in determining the classification status of FBBs.</p> |

| Industry comments on L2 | HKMA responses |
|--|--|
| <p>should develop an approach to allow for alignment of the HKMA’s host LCR requirements with the FBB’s home LCR requirements.</p> | <p>(c) The proposed approach for assessing the “home factors” of FBBs is set out in <u>Section 1</u> of this CP (re paragraphs 23 to 30). The HKMA’s responses to specific questions raised by the industry are as follows:</p> <ul style="list-style-type: none"> • The HKMA will utilise available channels to obtain information for the assessment of “home factors” relevant to an FBB. These channels may include bilateral discussion with the FBB, request for information from its head office, and direct communication with its home supervisor. • The HKMA would normally intend to assess AIs on an individual basis. However, there may be circumstances that warrant a consolidated approach to classifying connected AIs (such as aggregating the positions of the connected AIs as if they were a single entity) if, for example, the AIs’ operations in Hong Kong are closely integrated, or there is any specific plan for merging or consolidating the AIs’ businesses. • As most of the specific parameters set out under the LCR are internationally “harmonised” with prescribed values, the HKMA does not envisage significant differences between an FBB’s home LCR requirements and those imposed by the HKMA as a host supervisor, except for areas where national discretion is called for. The use of national discretion is specifically to cater for local circumstances in home / host banking systems and markets and hence, there may be little scope for further alignment in these areas to the extent that differences arise because of specific local conditions or past experience in the relevant jurisdiction. |

| Industry comments on L2 | HKMA responses |
|---|---|
| Section 2: Process and Procedure for Classification Framework | |
| <p>The industry raised the following comments on the proposed classification process and procedure:</p> <p>(a) The frequency and methodology for on-going review of the proposed quantitative benchmarks should be specified. These benchmarks should be updated annually with an automatic linkage to the industry’s growth during a 12-month period.</p> <p>(b) While there is no objection to the notion of a “forward-looking approach” (i.e. the HKMA will take into account the anticipated business growth of an AI in addition to its latest financial position), the HKMA was requested to clarify the operational details of this approach (e.g. the possible references to be drawn by the HKMA for assessing an AI’s anticipated business growth).</p> <p>(c) To avoid undue market perception on AIs’ liquidity positions, the classification results of individual AIs should not be made public.</p> | <p>(a) As already mentioned in L2, the HKMA proposes to periodically review the quantitative benchmarks to ensure their continuing appropriateness to the local banking environment. Normally, this type of review would be conducted annually. However, it is not appropriate for this review to incorporate automatic adjustments. The periodic review will be a supervisor-driven process that needs to take into account all relevant factors affecting the local banking system and environment.</p> <p>(b) As explained in this CP (paragraph 21) the HKMA will not only assess an AI’s position having regard to its latest available position but also refer to the AI’s reported positions since the last assessment. This is to avoid a point-in-time assessment that may not cater for temporary fluctuations in the AI’s position.</p> <p>Consistent with the adoption of a forward-looking approach (paragraph 22 of this CP), the HKMA proposes to take into account the effect of any forthcoming business development (in the next 12 months) on the AI’s classification status. Such business development may include any anticipated business expansion or contraction, merger or acquisition, and other business initiatives that may result in the AI concerned meeting, or not meeting, the classification criteria for Category 1 AIs in the next 12 months. In making the assessment, the HKMA would propose normally to refer to the AI’s business plan and budget and discuss its progress and timetable for meeting business targets.</p> <p>(c) The HKMA does not propose to publicise the classification results of individual AIs. Nevertheless, AIs should be aware that they are currently required to disclose their LR ratios under existing financial disclosure requirements. When the MLR is implemented, they will likewise be</p> |

| Industry comments on L2 | HKMA responses |
|--|--|
| | <p>required to disclose their MLR ratios. Similarly, subject to the LCR disclosure requirements to be set by the BCBS, it should be expected that some form of LCR disclosure will be necessary. Ultimately, this means that an AI’s classification status will become apparent to the public when the relevant MLR / LCR information is disclosed.</p> |
| <p>Section 3: Parallel reporting of MLR and LCR by selected AIs</p> | |
| <p>As a replacement for the original proposal of an “HQLA floor” made in L1³⁸, the HKMA subsequently proposed in L2 to adopt a “parallel reporting approach”, whereby selected AIs in Category 1 may be required to adopt the MLR as a liquidity monitoring tool and report both the LCR and the MLR to the HKMA periodically. Similarly (as proposed in paragraph 30 of L2), some Category 2 AIs may also be required to report the LCR or the NSFR together with the MLR to the HKMA to facilitate supervisory monitoring. This arrangement was proposed to be adopted for a transition period of 3 years (2015 – 2018).</p> <p>The industry expressed some concern over the “parallel reporting arrangement”, noting the additional compliance burden and operating costs to be imposed on selected AIs, and the possibility of creating level playing field issues. There were views that this arrangement should be avoided except under special circumstances (e.g. where reclassification of a Category 2 AI into Category 1 is envisaged in the near term). If the arrangement were to be adopted, the industry considered that the frequency of parallel reporting should be set appropriately (e.g. quarterly) and the transition period should be shortened.</p> | <p>As indicated in L2, the parallel reporting arrangement is only proposed to be imposed on an AI as a transitional measure if there is a necessary case for it. If the HKMA intends to apply this arrangement to a specific AI, the rationale and the detailed requirements (e.g. frequency of parallel reporting, duration of the arrangement, etc.) would be communicated to, and discussed with, the AI. Depending on the circumstances of each case, the HKMA will consider the possibility of allowing quarterly (instead of monthly) reporting of the MLR as a monitoring tool to alleviate the AI’s reporting burden. The three-year transition period may also be shortened, but this will depend on the results of analysing the parallel reporting data received.</p> |

³⁸ In L1, the HKMA originally proposed to require Category 1 AIs, in complying with the LCR, to observe a floor amount of HQLA equivalent to 25% of “qualifying liabilities (net of deductions)” as calculated under the MLR.

| Industry comments on L2 | HKMA responses |
|---|--|
| Section 4 : Basis of Calculation and Scope of Consolidation of Liquidity Standards | |
| <p>To enhance regulatory oversight and enable more comprehensive analysis of AIs' liquidity positions, the HKMA proposed that AIs may be required to report the applicable liquidity metrics on the following bases of calculation:</p> <ul style="list-style-type: none"> • Hong Kong office basis • Unconsolidated basis (i.e. legal entity basis) as a new position that may be applicable to local AIs; and • Consolidated basis <p>Whether an AI would need to report the applicable liquidity metrics on all (or any combination) of the above three bases would be determined on a case-by-case basis.</p> <p>The HKMA received the following responses to this proposal:</p> <p>(a) As a general principle, AIs should be required to apply the applicable liquidity standards on a Hong Kong office basis (instead of all three bases). The application of additional calculation bases should be adopted for relevant AIs as and when necessary. The industry expects the HKMA, as provided in paragraph 54 of L2, to enter into discussions with individual AIs in determining, inter alia, the applicable calculation bases and the scope of consolidation (should a consolidated basis be adopted);</p> <p>(b) If an AI is required to adopt the parallel reporting approach, consideration should be given to exempting the reporting of the monitoring tool on the new calculation basis (i.e. the unconsolidated entity position).</p> | <p>(a) For FBBs, the liquidity standards will only be applied on a Hong Kong office basis. For locally incorporated AIs, apart from applying the liquidity standards on a Hong Kong office basis, the application of the other two calculation bases will depend on an assessment of whether any of their (i) overseas branches and (ii) local and overseas subsidiaries (and associated entities where appropriate) need to be included, having regard to the liquidity risk posed by these branches, subsidiaries and entities. If, for example, only overseas branches (but not subsidiaries or associated entities) need to be included, the AI may only need to report on an unconsolidated basis in addition to the Hong Kong office basis. On the other hand, if some subsidiaries need to be included, the AI may have to report on a consolidated basis in addition to the Hong Kong office basis.</p> <p>In determining the scope of applying the liquidity standards to individual AIs, the HKMA proposes, in line with paragraph 54 of L2, to enter into discussions with the relevant AI to ensure that the scope of application is tailored appropriately to suit their liquidity risk profile, taking into account the business operations that may be undertaken by their subsidiaries (and associated entities where appropriate) and overseas branches if applicable.</p> <p>(b) If an AI is required to adopt the parallel reporting arrangement, the HKMA will assess, on a case-by-case basis, whether it is necessary for such an AI to report the two sets of liquidity metrics (i.e. LCR and MLR) on the same bases. This will be determined taking account of, inter alia, the liquidity risk profile of the AI (including the operations of its subsidiaries and overseas branches where applicable). The HKMA will seek to avoid imposing any undue compliance burden on AIs.</p> |

Annex 2

Liquidity Coverage Ratio - Illustrative Template

| <u>Schedule A: High Quality Liquidity Assets</u> ³⁹ | | Haircut | Ref. para, in January 2013 LCR Revision |
|---|--|----------------|--|
| 1. | Level 1 assets | | |
| 1.1 | Coins and banknotes | 0% | 50(a) |
| 1.2 | Central bank reserves (including required reserves), to the extent that the central bank policies allow them to be drawn down in times of stress | 0% | 50(b) |
| 1.3 | <p>Marketable securities representing claims on, or guaranteed by, sovereigns, central banks, public sector entities (PSEs), the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community, or multilateral development banks, and satisfying all of the following conditions:</p> <ul style="list-style-type: none"> • assigned a 0% risk-weight under the Basel II Standardised Approach for credit risk; • traded in large, deep and active repo or cash markets characterised by a low level of concentration; • have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions; and • not an obligation of a financial institution or any of its affiliated entities | 0% | 50(c) |
| 1.4 | Where the sovereign has a non-0% risk weight, debt securities issued in domestic currencies by the sovereign or central bank in the country in which the liquidity risk is being taken or in the AI's home country | 0% | 50(d) |
| 1.5 | Where the sovereign has a non-0% risk weight, domestic sovereign or central bank debt securities issued in foreign currencies (eligible up to the amount of the AI's stressed net cash outflows in that specific foreign currency stemming from the AI's operations in the jurisdiction where the AI's liquidity risk is being taken) | 0% | 50(e) |

³⁹ AIs are expected to include in the calculation of HQLA under the LCR only assets that can meet the general characteristics and operational requirements set out in paragraphs 24 to 42 of the January 2013 LCR Revision.

Schedule A: High Quality Liquidity Assets

| | | Haircut | Ref. para, in January 2013 LCR Revision |
|------------|--|---------|--|
| 2. | Level 2A assets | | |
| 2.1 | <p>Marketable securities representing claims on, or guaranteed by, sovereigns, central banks, PSEs or multilateral development banks that satisfy all of the following conditions:</p> <ul style="list-style-type: none"> • assigned a 20% risk-weight under the Basel II Standardised Approach for credit risk; • traded in large, deep and active repo or cash markets characterised by a low level of concentration; • have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price not exceeding 10% or increase in haircut not exceeding 10 percentage points over a 30-day period during a relevant period of significant liquidity stress (The HKMA’s proposal on the assessment of price volatility is stated in the <u>Note</u> below); and • not an obligation of a financial institution or any of its affiliated entities <p><i>(Note: AIs should establish appropriate systems and methodologies for conducting ongoing reviews (i.e. not only at the time of purchase) of the relevant assets’ 30-day price volatility (including the assets specified in items 2.1, 2.2, 3.1 and 3.2 of this Schedule). As practical guidance, the HKMA would propose that such reviews cover a period starting from 1 January 2007 (or from the date of issuance if that date falls after 1 January 2007). The HKMA would further propose that periodic reviews should thereafter be conducted at least monthly and that AIs should also establish appropriate “management action triggers” that can prompt timely reviews as and when necessary.)</i></p> | 15% | 52(a) |
| 2.2 | <p>Corporate debt securities (including commercial paper) and covered bonds that satisfy all of the following conditions:</p> <ul style="list-style-type: none"> • in the case of corporate debt securities: not issued by a financial institution or any of its affiliated entities; • in the case of covered bonds: not issued by the bank itself or any of its affiliated entities; • either (i) have a long-term credit rating from a recognised external credit assessment institution (ECAI) of at least | 15% | 52(b) |

Schedule A: High Quality Liquidity Assets

| | | Haircut | Ref. para, in January 2013 LCR Revision |
|------------|---|---------|--|
| | <p>AA- or, in the absence of a long term rating, a short-term rating equivalent in quality to the long-term rating⁴⁰; or (ii) do not have a credit assessment by a recognised ECAI but are internally rated as having a probability of default (PD) corresponding to a credit rating of at least AA-;</p> <ul style="list-style-type: none"> traded in large, deep and active repo or cash markets characterised by a low level of concentration; and have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price not exceeding 10% or increase in haircut not exceeding 10 percentage points over a 30-day period during a relevant period of significant liquidity stress | | |
| 3. | Level 2B assets | | |
| 3.1 | <p>Corporate debt securities (including commercial paper) that satisfy all of the following conditions:</p> <ul style="list-style-type: none"> not issued by a financial institution or any of its affiliated entities; either (i) have a long-term credit rating from a recognised ECAI between A+ and A-, or in the absence of a long-term rating, a short-term rating equivalent in quality to the long-term rating; or (ii) do not have a credit assessment by a recognised ECAI but are internally rated as having a PD corresponding to a credit rating of between A+ and A-; traded in large, deep and active repo or cash markets characterised by a low level of concentration; and | 50% | 54(b) |

⁴⁰ The following provides the credit rating scales of three major ECAs for AIs' reference:

| Moody's Investors Service, Inc. | | Standard and Poor's Corporation | | Fitch Ratings | |
|---------------------------------|------------|---------------------------------|------------|---------------|------------|
| Long-term | Short-term | Long-term | Short-term | Long-term | Short-term |
| Aaa | P-1 | AAA | A-1+ | AAA | F1+ |
| Aa1 | | AA+ | | AA+ | |
| Aa2 | | AA | | AA | |
| Aa3 | | AA- | | AA- | |
| A1 | | A+ | | A+ | |
| A2 | P-2 | A | A-1 | A | F1 |
| A3 | | A- | A-2 | A- | F2 |

With reference to the existing criteria for "qualifying credit rating" under the LR, the HKMA proposes to accept the ratings of P-1 (Moody's), A-1 (Standard and Poor's) and F1 (Fitch) as the minimum short-term ratings for LCR purposes. Since Moody's short-term rating scale is less granular than the other two major ECAs' rating scales, the HKMA proposes to regard Moody's short-term rating of P-1 as equivalent to S&P's rating of A-1 or Fitch rating of F1.

Schedule A: High Quality Liquidity Assets

| | | Haircut | Ref. para, in January 2013 LCR Revision |
|------------|--|----------------|--|
| | <ul style="list-style-type: none"> have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price not exceeding 20% or increase in haircut not exceeding 20 percentage points over a 30-day period during a relevant period of significant liquidity stress | | |
| 3.2 | <p><u>Subject to the HKMA's approval on a case-by-case basis, residential mortgage backed securities (RMBS) that satisfy all of the following conditions:</u></p> <ul style="list-style-type: none"> not issued by, and the underlying assets have not been originated by, the AI itself or any of its affiliated entities; have a long-term credit rating from a recognised ECAI of AA or higher, or in the absence of a long-term rating, a short-term rating equivalent in quality to the long-term rating; traded in large, deep and active repo or cash markets characterised by a low level of concentration; have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price not exceeding 20% or increase in haircut not exceeding 20 percentage points over a 30-day period during a relevant period of significant liquidity stress; the underlying asset pool is restricted to residential mortgages and cannot contain structured products; the underlying mortgages are "full recourse" loans (i.e. in the case of foreclosure the mortgage owner remains liable for any shortfall in sales proceeds from the property) and have a maximum loan-to-value ratio (LTV) of 80% on average at issuance; and the securitisations are subject to "risk retention" regulations which require issuers to retain an interest in the assets they securitise | 25% | 54(a) |
| | <i>(Note: The HKMA does not propose to recognise common equities and triple-B corporate bonds as HQLA. See Section 4 of this CP for the relevant discussion.)</i> | | |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|--|---------------------|--|
| 1. | <u>Retail cash outflows</u> | | |
| 1.1 | Stable retail deposits | 5% | 75-78 |
| 1.2 | Less stable retail deposits | | 79-81 |
| | 1.2.a HK\$5 million or below | 10% | |
| | 1.2.b HK\$5,000,001 to HK\$10,000,000 | 15% | |
| | 1.2.c Exceeding HK\$10,000,000 | 20% | |
| 1.3 | Retail term deposits | 5% | 82-84 |
| 2. | <u>Small business customer funding (SBC funding)</u> | | 89-92 |
| 2.1 | Stable SBC funding | 5% | |
| 2.2 | Less stable SBC funding | | |
| | 2.2.a HK\$5 million or below | 10% | |
| | 2.2.b HK\$5,000,001 to HK\$10,000,000 (<i>Note: By definition, SBC funding will not exceed HK\$10 million.</i>) | 15% | |
| 2.3 | SBC term funding | 5% | |
| 3. | <u>Unsecured wholesale funding</u> | | |
| 3.1 | Operational deposits (generated from clearing, custody and cash management activities) | | |
| | 3.1.a With the entire amount fully covered by an effective deposit insurance scheme | 5% | 104 |
| | 3.1.b Not included in 3.1.a | 25% | 93-103 |
| 3.2 | Unsecured wholesale funding (provided by non-financial corporates, sovereigns, central banks, multilateral development banks, and PSEs that are not operational deposits) | | |
| | 3.2.a With the entire amount fully covered by an effective deposit insurance scheme | 20% | 108 |
| | 3.2.b Not included in 3.2.a | 40% | 107 |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|---|---------------------|--|
| 3.3 | Unsecured wholesale funding not included in 3.1 and 3.2 (provided by other institutions - banks, securities companies, insurance companies, fiduciaries, beneficiaries, conduits and special purpose vehicles, affiliated entities of the AI and any other entities) | 100% | 109 |
| 3.4 | Debt securities issued by the AI and redeemable in 30 days | 100% | 110 |
| 4. | <u>Secured funding</u> | | 112 -115 |
| 4.1 | Secured funding transactions: | | |
| | 4.1.a Backed by Level 1 assets or conducted with domestic central banks | 0% | |
| | 4.1.b Backed by Level 2A assets | 15% | |
| | 4.1.c Conducted with domestic sovereign, PSEs (with a risk-weight of 20% or lower) or multilateral development banks that are <u>not</u> backed by Level 1 or 2A assets | 25% | |
| | 4.1.d Backed by RMBS eligible for inclusion in Level 2B assets | 25% | |
| | 4.1.e Backed by other level 2B assets | 50% | |
| 4.2 | All other secured funding transactions | 100% | |
| 5. | <u>Derivative and other transactions</u> | | |
| 5.1 | Derivatives cash outflows (i.e. the sum of all net cash outflows payable under derivative transactions) <i>(Note:</i> - <i>This item is aimed to capture some derivative transactions which require the counterparties to make payments to each other from time to time throughout the contractual period. Typical examples to be captured in this item include interest rate swaps, currency swaps and transactions embedded with options that may generate cash flows upon exercise during the contractual period.</i> - <i>AIs should calculate expected contractual derivative cash inflows and outflows in accordance with their usual mark-to-market valuation methodologies applicable to such derivatives transactions.</i> - <i>Calculation on a net basis (i.e. inflows can offset</i> | 100% | 116-117 |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|---|---------------------|--|
| | <p><i>outflows) by counterparty is allowed only if there exists a valid master netting agreement.</i></p> <p>- <i>Where derivatives payments are collateralised by HQLA, cash outflows should be calculated net of any corresponding cash or collateral inflows that would result from contractual obligations for cash or collateral to be provided to the AI, if the AI can re-use such HQLA collateral in a new cash-raising transaction once the collateral is received.)</i></p> | | |
| 5.2 | Outflows or additional collateral requirements triggered by downgrade of credit rating | 100% | 118 |
| 5.3 | Outflows related to changes in collateral positions | | |
| | <p>5.3.a Potential valuation changes on collateral posted to secure derivative and other transactions, <u>if such collateral is not Level 1 HQLA</u></p> <p><i>(Note:</i></p> <p>- <i>The 20% outflow rate is applicable on the basis of the notional amount of the collateral (which is not Level 1 HQLA) posted by the AI after any haircuts that may be applicable to the collateral category.</i></p> <p>- <i>In case the AI also receives collateral from the same counterparty in reciprocity, such collateral received by the AI can be netted off in the calculation of item 5.3a, provided that such collateral received can be reused or rehypothecated.</i></p> <p>- <i>Any collateral in a segregated margin account can only be used to offset outflows that are associated with payments that are eligible to be offset from the same account.)</i></p> | 20% | 119 |
| | <p>5.3.b Excess non-segregated collateral held by the AI that could contractually be called at any time by the counterparty</p> <p><i>(Note: This item requires AIs to maintain liquidity to fully address the possibility that counterparties may withdraw excess collateral at any time.)</i></p> | 100% | 120 |
| | <p>5.3.c Contractually required collateral on transactions for which the counterparty has not yet demanded the collateral be posted</p> | 100% | 121 |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|---|---------------------|--|
| | 5.4.d Contracts that allow collateral substitution to non-HQLA assets <i>(Note: This item is to address the situation where an AI's counterparty may have the contractual right to substitute non-HQLA collateral for HQLA collateral, thereby resulting in leakage of HQLA collateral from the AI.)</i> | 100% | 122 |
| 5.4 | Outflows due to potential market valuation changes on derivative or other transactions <i>(Note: The January 2013 LCR Revision requires that this item should be approximated by "the largest absolute amount of net 30-day collateral flow realised during the preceding 24 months." National authorities may adjust the treatment according to local circumstances. The HKMA will provide further details in respect of calculation of this item in the LCR calculation methodology upon which the industry will be consulted later this year.)</i> | 100% | 123 |
| 6. | <u>Outflows associated with asset-backed securities, covered bonds and other structured financing instruments issued or sponsored by the AI</u> | | |
| 6.1 | Asset-backed securities, covered bonds and other structured financing instruments issued by the AI maturing within the 30-day period | 100% | 124 |
| 6.2 | Potential loss of funding on asset-backed short-term financing, conduits, securities investment vehicles and other such financing facilities | | 125 |
| | 6.2.a Structured financing instruments maturing within the 30-day period | 100% | |
| | 6.2.b Embedded options in financing arrangements that allow for the return of assets or potential liquidity support – the estimated outflows should be (i) the amount of assets that could potentially be returned to the AI; or (ii) the liquidity required to be provided by the AI <i>(Note: This item is aimed to address the situation that an AI may incur liquidity risks if its structured financing activities are disrupted under stressed conditions. Such liquidity risks include, but are not limited to, (i) inability to refinance maturing debt (particularly short-term structured instruments such as asset-backed commercial paper) and (ii) derivative or derivative-like components contractually</i> | 100% of (i) or (ii) | |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|--|---------------------|--|
| | <p><i>embedded in the structured financing arrangements, which would allow the “return” of assets in a financing arrangement or that require the original asset transferor to provide liquidity, effectively ending the financing arrangement within the 30-day period.</i></p> <p><i>Where the structured financing activities of an AI are conducted through a special purpose vehicle, conduit or structured investment vehicle, the AI should cater for the liquidity risks inherent in these entities even if they may not be covered in the AI’s consolidated position.)</i></p> | | |
| 7. | <u>Committed facilities and contractual obligations</u> | | |
| 7.1 | Committed credit and liquidity facilities (undrawn portion) | | |
| | 7.1.a To retail customers and SBC | 5% | 131(a) |
| | 7.1.b To non-financial corporates, sovereigns, central banks, PSEs and multilateral development banks: | | |
| | • Credit facilities | 10% | 131(b) |
| | • Liquidity facilities ⁴¹ | 30% | 131(c) |
| | 7.1.c To banks subject to prudential supervision | 40% | 131(d) |
| | 7.1.d To other financial institutions: | | |
| | • Credit facilities | 40% | 131(e) |
| | • Liquidity facilities | 100% | 131(f) |
| | 7.1.e To other legal entities | 100% | 131(g) |
| 7.2 | Other contractual lending obligations to financial institutions not captured elsewhere | 100% | 132 |

⁴¹ As defined in the January 2013 LCR Revision, a “liquidity facility” is an committed, undrawn back-up facility that would be utilised to refinance the debt obligations of a customer in situations where such a customer is unable to rollover that debt in financial markets (e.g. pursuant to a commercial paper programme, secured financing transactions, obligations to redeem liabilities, etc). For the purpose of the LCR, the amount of the commitment to be treated as a liquidity facility is the amount of the currently outstanding debt issued by the customer (or proportionate share in case of a syndicated facility) maturing within a 30-day period that is backstopped by the facility. The portion of a liquidity facility that is backing debt that does not mature within the 30-day period is excluded from the scope of the definition of liquidity facility. Any additional capacity of the facility (i.e. the remaining commitment) would be treated as a committed credit facility. General working capital facilities for corporate entities (e.g. revolving credit facilities in place for general corporate or working capital purposes) will not be classified as liquidity facilities, but as credit facilities.

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|---|------------------------|--|
| 7.3 | <p>Excess of (a) total other contractual obligations to extend funds to retail and non-financial corporate customers over (b) 50% of the total contractual inflows from these customers</p> <p><i>(Note: This item is aimed to ensure comprehensive treatment of funding obligations granted by AIs to retail and corporate customers. The requirement specified in this item should be understood in conjunction with the treatment of inflows from retail (including SBC) and non-financial corporate customers.</i></p> <p><i>Under the LCR, inflows from retail and non-financial corporate customers are subject to a 50% inflow rate (see items 2.1 and 2.2.a in the table of Cash Inflows in Schedule C), on the assumption that one half of such inflows would be lent out by banks to these customers as a continuation of financial intermediation. Taking this inflow treatment into account, the BCBS sets the corresponding outflow treatment in such a way that if a bank's contractual obligations granted to retail and non-financial corporate customers (not captured in other outflow items) do not exceed 50% of the total amount of inflows from these customers, it will not be necessary for the bank to cater for such funding obligations as this has been addressed on the side of inflow treatment. If these funding obligations exceed 50% of the contractual inflows from these customers, the excess portion should be captured fully with a 100% outflow rate.)</i></p> | 100% | 133 |
| 8. | <u>Other contingent funding obligations</u> | | 134-140 |
| 8.1 | Non-contractual contingent funding obligations related to potential liquidity draws by unconsolidated joint ventures or minority investments in entities which rely on the AI as the major liquidity provider | To be agreed with HKMA | 137 |
| 8.2 | Contingent funding obligations related to trade finance | | 138-139 |
| | 8.2.a Shipping guarantees | 2% | |
| | 8.2.b Other contingent funding obligations related to trade finance (including documentary trade letters of credit, documentary and clean collection, import and export bills, and other guarantees or undertakings granted by the AI in trade financing transactions) | 5% | |
| | <p><i>(Note: This item is aimed to address the situation where an AI has</i></p> | | |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|--|---------------------|--|
| | <p><i>undertaken various types of contingent obligations in the course of providing trade financing services. Typical examples include the issuance of letters of credit, shipping guarantees or other similar types of trade finance instruments. Under the LCR, contingent obligations related to trade finance can be subject to a lower range of outflow rate (0-5%), provided that such obligations are underpinned by genuine import or export of goods or services. To avoid doubt, lending commitments, such as direct import or export financing for non-financial corporates, are not included in this item. Such credit facility commitments should be covered under item 7 above.</i></p> <p><i>Having assessed the attributes and transaction behaviour of some major types of trade finance products, the HKMA considers that the likelihood for the contingent funding obligations to crystallise for AIs may vary across different types of trade finance products. For example, the possibility of being called on shipping guarantees is considered to be lower than that of other trade finance products. Therefore, the HKMA’s current proposal is to apply a 5% outflow rate for trade finance contingent obligations, except for shipping guarantees which may receive a 2% outflow rate.)</i></p> | | |
| 8.3 | Unconditionally revocable “uncommitted” credit and liquidity facilities | 0% | 140 (1 st bullet) |
| 8.4 | Guarantees and letters of credit unrelated to trade finance obligations | 10% | 140 (2 nd bullet) |
| 8.5 | Non-contractual obligations where customer short positions are covered by other customers’ collateral that are not qualified as HQLA | 50% | 140 (5 th bullet) |
| | <p><i>(Note: If an AI has internally used the collateral of a customer (Customer A) (which is not qualified as HQLA) to cover a short trading position taken by another customer (Customer B), possible withdrawal of collateral (by Customer A) may make it necessary for the AI to incur outflows or to seek additional funding. The HKMA proposes to specify the potential outflow / liquidity need as 50% (which is the minimum requirement set by the BCBS) of the market value of the customer collateral that is internally used by the AI to cover the trading position of other customers.)</i></p> | | |

Schedule B : Cash Outflows (over next 30 days)

| | | Outflow rate | Ref. para, in January 2013 LCR Revision |
|------------|--|---------------------|--|
| 8.6 | <p>Other non-contractual obligations</p> <p><i>(Note: These obligations may include (a) potential repurchases of securities issued by the AI (or related conduits, securities investment vehicles); (b) non-contractual obligations to maintain marketability of structured products issued by the AI; (c) managed funds (such as money market mutual funds or other types of stable value collective investment funds) that are marketed by the AI with an objective of maintaining a stable value.)</i></p> | 10% | 140 (3 rd bullet) |
| 9 | <p><u>Any other contractual cash outflows</u></p> <p><i>(Note: This is a residual item to capture all other contractual cash outflows not included elsewhere. These outflows may include, but are not limited to, outflows to cover unsecured collateral borrowing, uncovered short positions, dividends or contractual interest payments. However, outflows related to operating costs are not included in the LCR.)</i></p> | 100% | 141, 147 |

Schedule C : Cash Inflows (over next 30 days)

| | | Inflow rates | Ref. para, in January 2013 LCR Revision |
|------------|--|---------------------|--|
| 1. | <u>Inflows from secured lending</u> (including reverse repo and securities borrowing) | | |
| 1.1 | Secured lending backed by the following types of assets (provided that the collateral is not used to cover other short positions): | | 145-146 |
| | 1.1.a Level 1 assets | 0% | |
| | 1.1.b Level 2A assets | 15% | |
| | 1.1.c Level 2B assets – eligible RMBS | 25% | |
| | 1.1.d Level 2B assets – others | 50% | |
| | 1.1.e other collateral | 100% | |
| | 1.1.f Margin lending backed by non HQLA collateral | 50% | |
| 1.2 | Secured lending – if the collateral obtained is used to cover short positions <i>(Note: If an AI is using collateral received from secured lending (or if an AI is borrowing collateral) to cover its short position in such asset, it should assume that such a position will be maintained throughout the LCR's 30-day period, thereby generating no cash inflow.)</i> | 0% | |
| 2. | <u>Other inflows by counterparty</u> (from fully performing loans) | | |
| 2.1 | Retail and small business customers | 50% | 153 |
| 2.2 | Wholesale customers | | |
| | 2.2.a Non-financial wholesale counterparties | 50% | 154 |
| | 2.2.b Central banks | 100% | 154 |
| | 2.2.c Financial institutions | | |
| | • Held as operational deposits | 0% | 156 |
| | • Other loans and deposits | 100% | 154 |
| 3. | <u>Other cash inflows</u> | | |
| 3.1 | Contractual inflows from maturing securities not included in the stock of HQLA | 100% | 155 |
| 3.2 | Derivative cash inflows (may be calculated on a net basis by counterparty when a valid master netting agreement exists) | 100% | 158-159 |
| 3.3 | Other contractual cash inflows | 100% | 160 |

Annex 3

Modified Liquidity Ratio - Illustrative Template

As provided in the Fourth Schedule to the Banking Ordinance, the Liquidity Ratio (LR) of an AI shall be calculated as the ratio, expressed as a percentage, of the net weighted amount of its *liquefiable assets* (as determined in accordance with paragraph 4 of the Schedule) to its *qualifying liabilities* (as determined in accordance with paragraph 6 of the Schedule). In L1, the HKMA proposed to modify the LR to improve its effectiveness as a liquidity standard for application to Category 2 AIs.

The proposed modifications (highlighted in blue) are set out in the table below. The Modified Liquidity Ratio (MLR) will largely maintain the structure of the LR as a ratio of liquefiable assets to qualifying liabilities, except that some “cash inflow” items currently recognised as liquefiable assets under the LR will not be included in the numerator of the MLR as liquefiable assets. Instead, such items will be deducted from qualifying liabilities in the denominator of the MLR. There are other proposed changes, such as adjustments to certain liquidity conversion factors (LCFs) and the application of a cap on the total amount of “deduction from qualifying liabilities”, similar to the 75% cap under the LCR (see paragraph 83 of this CP), to provide a minimum holding requirement for liquefiable assets, particularly for those AIs which may have “negative” qualifying liabilities⁴², to cater for contingencies.

| A. LIQUEFIABLE ASSETS | LCF |
|---|------------------------|
| 1. <u>Currency notes and coins</u> | 100% |
| 2. <u>Gold</u> <u>Note:</u> The HKMA proposes to lower the LCF for gold from the existing 100% to 90% to account for potential fluctuations in the market value of gold. | 100% 90% |
| 3. <u>Claims on, or reserves maintained with, central banks that are withdrawable on demand (or mature overnight)</u> <u>Note:</u> Currently, the treatment of AIs’ claims on central banks is not specified clearly under the LR, except that the Exchange Fund is treated in the same way as “relevant banks” as provided in the Fourth Schedule to the Banking Ordinance. In line with the treatment of such items under the LCR, the HKMA proposes to: <ul style="list-style-type: none"> • recognise an AI’s claims on, or reserves maintained with, central banks as liquefiable assets (with 100% LCF) to the extent that such claims and reserves can be withdrawn by the AI on demand (or mature overnight); | 100% |

⁴² This situation will occur if the amount of “deduction from qualifying liabilities” exceeds the amount of “qualifying liabilities”.

| A. LIQUEFIABLE ASSETS | LCF |
|--|--|
| <ul style="list-style-type: none"> • include any “one-month liabilities” (as defined in the Fourth Schedule to the Banking Ordinance) to central banks as “qualifying liabilities” (see item B1 below); and • where an AI has any claims on, or reserves maintained with, central banks that can be withdrawn within one month (other than those included under item A3), such claims or reserves should be deducted from “qualifying liabilities” in the denominator (see item C1). <p>As a result of this modification, the Exchange Fund will be treated as a central bank under the MLR (instead of being treated as a “relevant bank” under the LR). Claims on central banks in other jurisdictions (e.g. renminbi funds placed with fiduciary accounts opened with the People’s Bank of China) may also be recognised as liquefiable assets.</p> | |
| <p>3a The amount, if any, by which the total one-month liabilities of the AI to relevant banks are exceeded by the total one-month liabilities of relevant banks to it (“Net due from banks”)</p> <p><u>Note:</u></p> <p>As discussed in <u>Section 7</u> of this CP, the HKMA is considering the following policy options:</p> <p><u>Option 1:</u> Do not recognise “net due from banks” as liquefiable assets, but include this item in the denominator (i.e. “total one-month liabilities of the AI to relevant banks” as “qualifying liabilities” and “total one-month liabilities of relevant banks to the AI” as “deduction from qualifying liabilities”). <u>If this Option is adopted, item A3a will not exist under the MLR.</u></p> <p><u>Option 2:</u> Recognise “net due from banks” that can be withdrawn on demand (or mature overnight) as liquefiable assets (with 100% LCF); while other “net due from banks” maturing within one month will be included in the denominator (i.e. “one-month liabilities of the AI to relevant banks” as “qualifying liabilities” and “one-month liabilities of relevant banks to the AI” as “deduction from qualifying liabilities”). <u>If this Option is adopted, item A3a will only capture “the amount, if any, by which the total one-month liabilities of the AI to relevant banks that are withdrawable on demand (or mature overnight) are exceeded by the total one-month liabilities of relevant banks to it that are withdrawable on demand (or mature overnight)”.</u></p> <p><u>Option 3:</u> Recognise “net due from banks” as liquefiable assets, subject to</p> <ul style="list-style-type: none"> (i) a lower LCF, which is proposed to be set at 80% to reflect the fact that a part of the amount of net due from banks maturing in one month is actually not readily “liquefiable”; and (ii) a cap, which is proposed to be set at 40% of “qualifying liabilities” (before deduction) to avoid over reliance on this item, as currently observed in some AIs, for meeting the statutory minimum liquidity requirement. The cap will operate such that the amount of “net due from banks” exceeding the cap will be included in the denominator as “deduction from qualifying liabilities”. <u>If this Option is adopted, item A3a will be retained, but the</u> | <p>N.A.</p> <p>[100%]</p> <p>[80%]</p> |

| A. LIQUEFIABLE ASSETS | LCF |
|---|---|
| <p style="text-align: center;"><u>LCF will be lowered to 80% and the amount can only be recognised up to 40% of “qualifying liabilities” (before deduction).</u></p> | |
| <p>4. <u>Export bills</u> which are –</p> <p>(a) payable within one month and which are either drawn under letters of credit issued by, or accepted and payable by, relevant banks; or</p> <p>(b) covered by irrevocable re-discounting facilities approved by the MA⁴³;</p> <p><u>Note:</u></p> <p>The HKMA proposes to retain export bills as liquefiable assets (in light of their “negotiable” nature), but proposes to lower the applicable LCF to 90% to reflect associated risks (e.g. credit risk) and the possible negotiation discount.</p> <p>For clarity’s sake, the HKMA will specify that an AI should not regard export bills as liquefiable assets if the AI is the paying bank of the bills.</p> | <p>100% 90%</p> <p>100% 90%</p> |
| <p>5. <u>Marketable debt securities or prescribed instruments</u>⁴⁴ –</p> <p>(a) Issued or guaranteed by –</p> <p>(i) the Hong Kong Government, the Exchange Fund or a public sector entity in Hong Kong or multilateral development bank with a remaining term to maturity of –</p> <p>(A) not more than 1 year</p> <p>(B) more than 1 year</p> <p><u>Note:</u> “Multilateral development bank” (MDB) is moved to item 5(b)(i), and marketable debt securities issued or guaranteed by MDBs will continue to be subject to an LCF of 100% or 95%. As a result of this modification, item 5(a)(i) will capture securities issued or guaranteed by local authorities and public sector entities only, while item 5(b)(i) will capture overseas authorities, MDBs and other international organisations.</p> | <p>100%</p> <p>95%</p> |

⁴³ According to the Completion Instructions to the Return of Liquidity Position (MA(BS)1E), the re-discounting facility covering the export bills must meet the following criteria:

- it is provided by a third party relevant bank;
- it is irrevocable before its expiry;
- it allows usance bills to be re-discounted on a without recourse basis; and
- it provides for the proceeds of bills re-discounted to be remittable to the reporting institution within 1 month.

These criteria will be maintained.

⁴⁴ “Prescribed instruments” are defined in section 137B of the Banking Ordinance as being those instruments specified in the Sixth Schedule to the Ordinance. In brief, they refer to transferable certificates of deposit and transferable instruments (other than bills of exchange and promissory notes) documenting an obligation of the issuer to pay a determined amount of money to the bearer or to order. The HKMA proposes to move these definitional provisions into the future BLR or into supervisory guidance supplementing the BLR.

| A. LIQUEFIABLE ASSETS | LCF |
|--|------|
| (ii) an AI incorporated in Hong Kong or the Hong Kong branch of an AI incorporated outside Hong Kong with a remaining term to maturity of – | |
| (A) not more than 1 month | 100% |
| (B) more than 1 month but not more than 1 year | 95% |
| (C) more than 1 year | 90% |
| (b) With a qualifying credit rating, issued or guaranteed by – | |
| (i) the central bank or central government of any country, multilateral development bank, or other relevant international organization , with a remaining term to maturity of – | |
| (A) not more than 1 year | 100% |
| (B) more than 1 year | 95% |
| <u>Note:</u> | |
| “Multilateral development bank” is reclassified from item 5(a)(i) to item 5(b)(i). | |
| “Other relevant international organizations” will be defined to include Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community. The inclusion of these entities in this item is to align with the requirement under the LCR that marketable debt securities issued or guaranteed by these organisations are recognised as HQLA. | |
| (ii) a relevant bank, other than one referred to in paragraph (a)(ii), with a remaining term to maturity of – | |
| (A) not more than 1 month | 100% |
| (B) more than 1 month but not more than 1 year | 95% |
| (C) more than 1 year | 90% |
| (iii) a regional government of any country or other institution with a remaining term to maturity of – | |
| (A) not more than 1 year | 90% |
| (B) more than 1 year but not more than 5 years | 85% |
| (C) more than 5 years | 80% |
| <u>Note:</u> For clarity’s sake, “other institution” includes corporate entities and non-bank financial institutions. | |

| A. LIQUEFIABLE ASSETS | LCF |
|--|----------------------------|
| (c) Without a qualifying credit rating, issued or guaranteed by a relevant bank, other than one referred to in paragraph (a)(ii), with a remaining term to maturity of not more than 1 month (d) Approved for inclusion by the Monetary Authority (e) Not included elsewhere in this item with a remaining term to maturity of not more than 1 month | 100% 80% 80% |
| 6. Eligible loan repayments <u>Note:</u> As discussed in L1, the HKMA proposes not to recognise “eligible loan repayments” as “liquefiable assets” to reflect the fact that such repayments are <u>not readily available</u> for conversion into cash. Instead, this inflow item will be treated as a “deduction from qualifying liabilities” under the MLR (see item C3 below). | 80% |
| 7. <u>Residential mortgage loans in respect of which there has been issued by the HKMC an irrevocable commitment to purchase which is approved by the MA</u> ⁴⁵ | 90% |
| 8. <u>Deduction from total “liquefiable assets”:</u> Debt securities or prescribed instruments with a remaining term to maturity of not more than 1 month issued by the AI ⁴⁶ ; | 100% |

⁴⁵ According to the Completion Instructions to the Return of Liquidity Position, AIs should seek prior approval from the MA before recognising any amount of mortgage loans as a liquefiable asset under this item. The amount of mortgage loans to be recognised must be covered by the HKMC’s irrevocable Forward Commitment Facility (“Facility”) and must be immediately saleable to HKMC. Such loans must conform to the HKMC’s purchasing requirements and satisfy any conditions as set out in its Forward Commitment Facility Letter Agreement approved by the MA for this purpose. The total amount of loans recognised as liquefiable assets cannot exceed the amount of commitment agreed under the Facility less any commitment amount utilised. If the HKMC, under the facility agreement, requires the AI to repurchase default mortgages, the obligation to repurchase the mortgage should be included as “qualifying liabilities” if the repurchase is to be made within 1 month. These requirements will be maintained.

⁴⁶ According to the Completion Instructions to the Return of Liquidity Position, this item is either deducted from liquefiable assets, or included in qualifying liabilities if the AI can demonstrate that the liabilities have similar rollover characteristics to other qualifying liabilities.

| B. QUALIFYING LIABILITIES (BEFORE DEDUCTION) | LCF |
|---|------------|
| <p>1. <u>The amount of total one-month liabilities to central banks with a remaining term to maturity of not more than one month</u></p> <p>Note: See item A3 above.</p> | 100% |
| <p>2. <u>[The amount, if any, by which the total one-month liabilities of relevant banks to the AI are exceeded by the total one-month liabilities of the AI to relevant banks]</u> (“Net due to banks”)</p> <p>Note:</p> <p><u>If Option 1 under item A3a above is adopted, this item will only capture “the amount of total one-month liabilities of the AI to relevant banks” (with 100% LCF). “The amount of total one-month liabilities of relevant banks to the AI” will be included in item C2 below (as a “deduction from qualifying liabilities”).</u> [100%]</p> <p><u>If Option 2 under item A3a above is adopted, this item will only capture “the amount of total one-month liabilities of the AI to relevant banks (excluding any amount included in item A3a)” (with 100% LCF). “The amount of total one-month liabilities of relevant banks to the AI (excluding any amount included in item A3a)” will be included in item C2 below (as a “deduction from qualifying liabilities”).</u> [100%]</p> <p><u>If Option 3 under item A3a above is adopted, this item will only capture “the amount of total one-month liabilities of the AI to relevant banks (if not included in item A3a)” (with 100% LCF). “The amount of total one-month liabilities of relevant banks to the AI (if not included in item A3a)” will be included in item C2(i) below (as a “deduction from qualifying liabilities”). Such amounts are to be reported by AIs with a “net due to banks” position. For AIs with a “net due from banks” position that exceeds the cap mentioned in item A3a above, the excess portion will be included in item C2(ii) as a “deduction from qualifying liabilities”.</u> [100%]</p> | |
| <p>3. <u>The total of other one-month liabilities</u></p> | 100% |

| C. DEDUCTION FROM QUALIFYING LIABILITIES | LCF |
|--|---|
| <p>1. <u>The amount of one-month liabilities of central banks to the AI (other than the amount included in item A3)</u></p> <p><u>Note:</u> See item A3 above.</p> | 100% |
| <p>2. <u>If Option 1 under item A3a above is adopted</u> The amount of total one-month liabilities of relevant banks to the AI</p> <p><u>If Option 2 under item A3a above is adopted</u> The amount of total one-month liabilities of relevant banks to the AI (excluding the amount included in item A3a)</p> <p><u>If Option 3 under item A3a above is adopted</u></p> <p>(i) The amount of total one-month liabilities of relevant banks to the AI (if not included in item A3a). (This item is for AIs with a “net due to banks” position.)</p> <p>(ii) The amount, if any, by which the total one-month liabilities of the AI to relevant banks are exceeded by the total one-month liabilities of relevant banks to the AI that exceeds the 40% cap mentioned in item A3a above. (This item is for AIs with a “net due from banks” position exceeding the 40% cap.)</p> | <p>[100%]</p> <p>[100%]</p> <p>[100%]</p> <p>[100%]</p> |
| <p>3. <u>Eligible loan repayments</u></p> <p><u>Note:</u> See item A6 above.</p> | 80% |
| <p>Maximum amount that can be deducted from Qualifying Liabilities</p> <p><u>Note:</u> As discussed in L1, the HKMA intends to apply a cap on the total amount of “deduction from qualifying liabilities”. The objective of this proposed cap is to ensure that an AI with negative “qualifying liabilities” (i.e. having its “qualifying liabilities” exceeded by “deduction from qualifying liabilities”) would still maintain a minimum stock of liquefiable assets to cater for contingencies. Taking account of the proposed structure of the MLR and AIs' liquidity profiles, the HKMA proposes to set this cap at 75% of qualifying liabilities (before deduction).</p> | |