POLICY STATEMENT ON THE ROLE OF THE HONG KONG MONETARY AUTHORITY AS LENDER OF LAST RESORT

Background

This statement sets out the policy of the Hong Kong Monetary Authority ('HKMA") in respect of its role as lender of last resort ("LOLR") to the banking system. This follows the report arising from the Banking Sector Consultancy Study commissioned by the HKMA in 1998 which noted that there was "quite a high degree of misunderstanding among bankers on whether the HKMA is the lender of last resort and what this role involves".

2. The principles on which the HKMA would be prepared to act as LOLR were in fact set out in a speech by the Chief Executive of the HKMA which was published in the Quarterly Bulletin for November 1994. Notwithstanding this, the consultants' report recommended that it would be appropriate for the HKMA to formalise its policy in this area and to explain this policy, especially to market participants. This policy statement is intended to fulfil that purpose.

The nature of LOLR support

3. The funding or liquidity support provided by central banks or monetary authorities to commercial banks can be broadly classified into the following three categories:

   (a) the provision of intra-day or overnight liquidity to alleviate short-term cash flow shortages;

   (b) the provision of LOLR support to banks experiencing funding difficulties on a short-term basis; and

   (c) the provision of longer-term liquidity support and/or capital support.

4. This policy statement focuses on the second type of liquidity support, the objective of which is to provide some breathing space to an institution facing short-term funding problems to implement corrective measures. The aim is to prevent illiquidity from precipitating a situation of insolvency, and to prevent the contagion effect of bank runs. The LOLR function should be distinguished from the provision of intra-day liquidity under the RTGS system and overnight liquidity through the Discount Window, the main objective of which is to ensure the smooth functioning of the interbank payment system. It should also be differentiated from longer-term liquidity support and/or capital support, which should be decided on a case by case basis, having regard to the implications of a bank failure for the stability of the monetary and financial systems of Hong Kong.

The resources available to the HKMA

5. The means available to the HKMA to take on the role of LOLR are provided by the Exchange Fund, the use of which is governed by the Exchange Fund Ordinance. Section 3(1) of the Ordinance states that the Fund "shall be used primarily for such purposes as the Financial Secretary thinks fit affecting, either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto".

6. Section 3(1A) of the Ordinance further provides that:

   "In addition to using the Fund for its primary purpose, the Financial Secretary may, with a view to maintaining Hong Kong as an international financial centre, use the Fund as he thinks fit to maintain the stability and integrity of the monetary and financial systems of Hong Kong."

7. Under section 5B of the Ordinance, the Financial Secretary has delegated day-to-day decisions on the use of the Exchange Fund under Section 3(1A) to the Monetary Authority. The Monetary Authority shall have regard to the primary purpose of the Fund in exercising this power.

8. Sections 3(1) and 3(1A) of the Ordinance make it clear that the use of the Exchange Fund, including for the purposes of LOLR support, must be for <u>systemic</u> purposes. This means that in considering whether to provide LOLR support to an individual authorised

institution, the guiding principle must be whether the failure of that institution would, either by itself or through spreading contagion to other institutions, damage the stability of the exchange rate or the monetary and financial systems. Such a contagion effect could arise, for example, where other institutions are heavily exposed to the troubled institution or share similar characteristics which could be interpreted as the origin of its problems. The vulnerability of other institutions to the contagion effect will also depend on the general tone of sentiment at the time, e.g. whether there is heightened nervousness about the stability of the banking or the monetary systems.

Compatibility of the LOLR function with the currency board system

9. The LOLR function should be organised in a way consistent with the currency board arrangements in Hong Kong. Temporary liquidity injections into banks with liquidity problems can be funded through borrowing from the interbank market or a sale of foreign currency assets of the HKMA (outside the assets earmarked for the Backing Portfolio), leaving the Aggregate Balance of the banking system unchanged. Alternatively, the HKMA may resort to repos using Exchange Fund paper or US dollar assets. All of these options would be consistent with the rules of the currency board arrangements as the Hong Kong dollar liquidity thus created is matched either by a decline in another component of the monetary base (i.e., the Exchange Fund paper) or an increase in US dollar assets. Moreover, the HKMA has, on previous occasions, stated that when there is a risk that large scale Hong Kong dollar transactions could create extreme conditions in the interbank market and affect the stability of the exchange rate, the HKMA may lend to or borrow Hong Kong dollars from the interbank market temporarily to dampen such extreme conditions. In the event where bank problems lead to extreme conditions in the money market and such a situation is not associated with any downward pressure on the Hong Kong dollar exchange rate, the HKMA may consider direct injection of liquidity into the interbank market to relieve market tightness and restore systemic stability.

The preconditions for LOLR support

10. As already noted, the basic precondition for LOLR support to be provided is the judgement of the HKMA that the failure of a troubled institution, if it is deprived of liquidity assistance, would damage the stability of the exchange rate, monetary or financial systems, (i.e. systemic risk). In addition, the following preconditions for LOLR support would apply:

(a) the institution has a sufficient margin of solvency;

(b) the LOLR support will be adequately collateralised;

(c) the institution has sought other reasonably available sources of funding before seeking LOLR assistance;

(d) the shareholder controllers of the institution have made all reasonable efforts to provide liquidity and/or capital support as a demonstration of their own commitment;

(e) there is no prima facie evidence that the management is not fit and proper, or that the liquidity problem is due to fraud; and

(f) the institution must be prepared to take appropriate remedial action to deal with its liquidity problems.

11. As a measure of whether an institution has a sufficient margin of solvency, the HKMA will generally require the institution to demonstrate that it maintains a capital adequacy ratio of at least 6% after making adjustment for any additional provisions that might be necessary.

The instruments used to provide LOLR support

12. Because there is not a large Government debt market in Hong Kong, the range of collateral against which LOLR support would be provided must necessarily be wider than in some other economies. There are three basic instruments which would be used by the HKMA to provide LOLR support to a troubled institution:

    (a) purchase of the institution's placements with other banks which are acceptable to the HKMA - the purpose would be to assist the institution to turn its existing liquid assets into readily available cash;

    (b) repos of eligible Hong Kong dollar securities - these would consist of (i) Exchange Fund Bills and Notes; (ii) other securities eligible for rediscount at the Discount Window; (iii) other investment grade securities. Investment grade securities refer to securities with a rating at or above the minimum acceptable rating from a recognised credit rating agency as set out in **Appendix A**.

    (c) credit facility against the security of the institution's residential mortgage portfolio - preference would be given to HOS/PSPS mortgages and those mortgages which satisfied the purchasing criteria of the Hong Kong Mortgage Corporation, although other residential mortgages would also be eligible as security provided that they were not "delinquent" at the time of purchase[1].

13. Liquidity support provided by way of repos or provision of a credit facility would be provided only on a short-term basis since the purpose is to provide the institution with a temporary breathing space in which to sort out its difficulties. Such funding would be provided for an initial term not exceeding 30 days although there would be provision for it to be rolled over for a further 30 days on maturity.

14. In order to mitigate the risk of the Exchange Fund, the value of the collateral used to secure LOLR funding in the form of repos or the credit facilities would exceed the principal amount of the funding according to the haircuts and loan to valuation ratios set out at **Appendix B**.

15. The interest rate charged on LOLR support would be at a rate which is sufficient to maintain incentives for good management but not at a level which would defeat the purpose of the facility i.e. to prevent illiquidity from precipitating insolvency. For repo transactions, the interest charged would be incorporated into the repurchase price to be paid by the institution to purchase an equivalent amount of the securities from the HKMA. For credit facilities, interest would be payable on the repayment date of the facility. The interest rates would be set at the prevailing Base Rate plus a margin to be determined taking into account current market conditions. For purchase of bank placements, the purchase price would be calculated at a discount using the prevailing market yield.

16. Notwithstanding the availability of suitable collateral, the HKMA will set a limit on the maximum amount of LOLR support provided to an individual institution via repos or the credit facility. The limit would normally be set between 100% to 200% of the capital base (as defined in the Banking Ordinance) of the institution concerned depending on the margin of solvency the institution can maintain, subject to a cap of HK$10 billion. An institution which meets the minimum pre-conditions for LOLR support (i.e., a capital adequacy ratio of 6%) would be able to obtain liquidity support up to a maximum of 100% of its capital base. An institution, which can maintain a capital ratio above its statutory minimum, would be

1 In the sense that none of the mortgagors should have been in default in making payment for more than 30 days from the due date for any payment under their mortgage loan during the preceding 6 months.

able to obtain liquidity support up to a maximum of 200% of its capital base. In either case, the HKMA would retain the discretion to lend less than the maximum.

LOLR support for branches of foreign banks

17. The above policy applies to the provision of liquidity to locally incorporated authorised institutions whose failure might have systemic implications. It would not normally be the policy of the HKMA to provide LOLR support to branches of foreign banks operating in Hong Kong. This recognises the fact that the liquidity of a branch cannot readily be divorced from that of the bank as a whole. It follows therefore that the head office of the branch, supported if necessary by the lender of last resort in its home country, would be expected to provide enough funding to enable its branch in Hong Kong to meet its obligations. If it were unable to do so, there would be no alternative but for the branch to close its operations in Hong Kong. In such circumstances, the Monetary Authority would consider whether to use his powers under Section 52 of the Banking Ordinance to appoint a Manager to take control of the affairs, business and property of the branch in Hong Kong.

18. There are however two circumstances where the HKMA might provide financial assistance to a branch with funding problems. The first would be for the HKMA to swap Hong Kong dollars for US dollars held by the branch if no suitable counterparty could be found in the market. The second would be to provide urgently required bridging finance on a secured basis to a branch pending receipt by it of funds from head office. This would only be done if the HKMA was wholly satisfied that the funds from head office would indeed be forthcoming and on the basis of assurances from the home supervisor that this would be the case.

Funding support requiring specific approval from the Financial Secretary

19. The preceding paragraphs set out the criteria on the basis of which the HKMA will normally be prepared to provide LOLR support. Any such support would be provided at the discretion of the Monetary Authority. Where the criteria are not met, funding support would only be provided with the specific prior approval of the Financial Secretary. This would include the following situations:

 (a) The institution is unable to comply with the preconditions for LOLR support set out in paragraphs 10 and 11 above. This would involve more serious situations falling outside what the HKMA would consider to justify LOLR support (in particular those falling within paragraph 3(c) above);

 (b) It is considered necessary to give the institution a breathing space longer than that provided for in paragraph 13;

 (c) It is considered necessary to provide funding support which exceeds the LOLR support limits set out in paragraph 16;

 (d) The taking of security other than the types listed at Appendix B.

20. Any funding provided in these circumstances would have to be considered on its merits in the light of the implications for systemic stability. In addition, the Monetary Authority would consider whether to appoint a Manager under Section 52 of the Banking Ordinance to safeguard the assets of the institution and to protect the interests of depositors and other creditors.

Default situations

21. Where LOLR support is not repaid on maturity and the HKMA is not prepared to rollover the funding, the Monetary Authority would have to consider a number of options including the appointment of a Manager under Section 52 of the Banking Ordinance to manage the affairs, business and property of the institution.

- Prepared by the Banking Development Division

APPENDIX A

Investment grade securities acceptable for repo with the HKMA for the purpose of LOLR funding are those with a rating at or above the minimum acceptable rating from a recognised credit rating agency set out below:

Recognised credit rating agency	Minimum acceptable rating
Moody's Investors Service, Inc.	Baa3
Standard & Poor's Corporation	BBB-
IBCA Ltd.	BBB-
Thomson BankWatch	BBB+
R&I	BBB+

Type of funding

Repo of:	Haircut[1]
- Exchange Fund Bills	2.5%
- Exchange Fund Notes	Minimum of 5%
- Other floating rate securities eligible for rediscount at the Discount Window	5%
- Other fixed rate securities eligible for rediscount at the Discount Window	Minimum of 5%
- Other investment grade securities[2]	Minimum of 10%
Credit facility secured by:	**Loan to value ratio[3]**
- HOS/PSPS mortgages[4]	95%
- HKMC compliant mortgages	90%
- Other residential mortgages	80%

Notes:

1) The haircut under the repo arrangement would be applied to the market price of the security at the time of the transaction. The actual haircut applied to Exchange Fund Notes, other fixed rate securities eligible for rediscount at the Discount Window and other investment grade securities would be determined based on the factors including the tenor, the quality of the security and actual terms of the repo arrangement.
2) Liquidity support to banks may also be funded through repos of US dollar investment grade securities. The haircut applied and the interest rate charged would depend on the quality of the underlying security.
3) The loan to value ratio represents the amount of LOLR support over the book value of the portfolio of mortgages provided by the institution as collateral.
4) Subject to Housing Authority's prior written consent to transfer the guaranteed loan.