Annex

The HKMA's Approach to Applying Some Key Requirements in the Banking (Liquidity) Rules[1]

1. Designation of authorized institutions as category 1 institutions under rule 3[2]

Specified grounds

1.1 Under rule 3, the HKMA[3] may designate an authorized institution (AI) as a category 1 institution if the HKMA is satisfied that any of the grounds specified in Part 1 of Schedule 1 ("specified grounds") is applicable to the institution. In determining whether an AI has met any of these grounds, the HKMA will have regard to all relevant factors, including the major factors (quantitative and qualitative) highlighted below.

(a) Ground 1: The AI is internationally active

In determining whether an AI is internationally active, the HKMA will assess the level of the AI's international exposure, as measured by the aggregate amount of its external claims and liabilities[4], against a quantitative benchmark of HK$250 billion[5]. The adoption of this measure recognises that AIs with a significant level of external claims and liabilities tend to be more vulnerable to spill-over effects from crises and shocks that

[1] The interim guidance provided in this Annex has previously been the subject of industry consultation through the issue of 3 consultation papers entitled "Implementation of Basel III Liquidity Standards in Hong Kong" ("L1", "L2" and "L3") published by the HKMA on 20 January 2012, 18 June 2012 and 12 July 2013 respectively, and has taken into account comments received from, and subsequent discussions with, the industry on those proposals. The 3 consultation papers are available at: http://www.hkma.gov.hk/eng/key-functions/banking-stability/basel-3.shtml

[2] Unless the context otherwise requires, a reference to a "rule", "Part", "Schedule", "section" or "subsection" (under a Schedule), or "Division" in this Annex means a rule, Part, Schedule, section or subsection (under a Schedule), or Division in the Banking (Liquidity) Rules ("BLR").

[3] For the purposes of this Annex, the term "HKMA" refers to "Monetary Authority" (the person exercising the legal authority under the Banking Ordinance) or "Hong Kong Monetary Authority" (the office of the Monetary Authority), as the context so requires.

[4] The HKMA relies mainly on the data reported by an AI in Part I of the *Return of International Banking Statistics* (MA(BS)21A) to assess the level of its external claims and liabilities against the quantitative benchmark. Under this benchmark, the external claims and liabilities associated with an AI's intra-group entities are not excluded on the premise that such claims and liabilities result from banking activity involving entities in different jurisdictions, and thus still pose a degree of cross-border risk to the AI concerned.

[5] The HKMA has consulted the industry on the use of this HK$250 billion benchmark in its L3 consultation paper.

may occur in other jurisdictions.

The quantitative benchmark of HK$250 billion is subject to periodic review by the HKMA, taking into account the prevailing circumstances of the local banking sector, including (but not limited to) the medium- to long-term trend of the banking sector's aggregate amount of international exposure. If the HKMA envisages a need to modify this benchmark, the industry will be consulted.

(b) Ground 2: The AI is significant to the general stability and effective working of the banking system in Hong Kong

In assessing the level of significance of an AI to the local banking system, the HKMA will pay particular attention to the following factors:

(i) the size of the AI's business operation, as measured by the amount of its total assets (after provisions), against a quantitative benchmark of HK$250 billion.[6] The adoption of this measure recognises that AIs with a sizable operation tend to pose a higher level of risk and have a potentially greater impact on local banking stability if they encounter financial problems. As with the quantitative benchmark for international exposure mentioned in paragraph (a) above, the size of the benchmark for total assets (after provisions) is subject to the HKMA's periodic review; and

(ii) the AI's role (including any special function undertaken) or level of participation in the local banking system or financial markets[7]. Primary focus will be placed on whether the AI may act as a significant conduit for transmitting liquidity problems across AIs, or may exert significant impact on the local banking system, financial markets and/or other stakeholders (e.g. depositors, retail investors, etc.) should the AI get into financial trouble or should the relevant financial role or function performed by the AI, or its participation in a particular market activity, be disrupted.[8]

[6] The industry has been consulted on this quantitative benchmark in the HKMA's L3 consultation paper. The HKMA will compare the amount of "total assets (after provisions)" reported by an AI in the *Return of Assets and Liabilities of an Authorized Institution* (MA(BS)1) against the benchmark. For a locally incorporated AI, the HKMA will normally refer to the AI's combined position of its Hong Kong office and overseas branches (if any). In the case of a foreign bank branch, the benchmark will be applied to the position of its Hong Kong office.

[7] Such markets may relate to wholesale funding, derivatives, securitization or other traded markets.

[8] The crucial roles that an AI may play, or important functions that it may undertake, in the local banking system include, but are not limited to, the note-issuing function and serving as a clearing and settlement bank for

(c) Ground 3: The liquidity risk associated with the AI is material

The HKMA assesses the liquidity risk of an AI as part of its ongoing risk-based supervision. For the purposes of rule 3, the HKMA will have special regard to the nature and complexity of an AI's business operation and its risk profile, with a view to assessing whether there may be material liquidity risks inherent in such operation that warrant the application of a more sophisticated and granular liquidity metric (i.e. the LCR) to the AI. For example, the HKMA may assess, among other things, whether the AI is active in derivative, securitization and other structured financing transactions or has significant exposures to complex financial instruments, as well as the adequacy of its systems and controls for managing liquidity risks arising from such transactions or instruments.

(d) Ground 4: The AI is so connected to another AI (being a category 1 institution) that if the first-mentioned AI were not to be designated as a category 1 institution, such connection would prejudice, or may potentially prejudice, the calculation of the LCR by the second-mentioned AI, the calculation of the LMR by the first-mentioned AI, or both

As differences exist in the calibration of the LCR and LMR, there may be potential for connected AIs that are not in the same category (i.e. category 1 or category 2[9]) to engage in a degree of regulatory arbitrage (e.g. through intra-group transfers of assets and liabilities) for the purpose of reducing their regulatory liquidity requirements. As a safeguard, if the likelihood of regulatory arbitrage for such connected AIs is considered to be high, the HKMA may decide to designate all of them as category 1 institutions even though they do not all meet the other grounds for such designation.

Where there may be a potential risk of regulatory arbitrage for a group of connected AIs, the HKMA will assess the risk based on the specific circumstances of the case. Some relevant factors for consideration include the corporate structure, business size and risk profile of the connected AIs concerned, and any track record of intra-group interactions observed in the course of supervision.[10]

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major payment and settlement systems in Hong Kong.

[9] AIs under category 2 (i.e. category 2 institutions) are those AIs not designated as category 1 institutions.

[10] The concern over regulatory arbitrage is less on the banking subsidiaries of a locally incorporated category 1 institution which are included in the calculation of the consolidated LCR of that institution, but more on those AIs connected to the category 1 institution that are not subject to the HKMA's consolidated supervision in

1.2 Whilst the HKMA expects that in most cases the major factors mentioned above will be sufficient for its assessment, there may still be limited circumstances in which the applicability of the specified grounds to an AI (e.g. its significance to the banking system) only becomes apparent or falls to be satisfied based on other relevant factors. The HKMA will discuss the rationale behind the designation with the AI concerned if necessary.

1.3 The HKMA will adopt, as appropriate, a forward-looking approach in applying the specified grounds by taking into account any forthcoming business plan or development affecting an AI (such as anticipated business expansion or contraction, mergers or acquisitions, or any other new, or change in, business strategy) that may result in the AI meeting, or no longer meeting, the specified grounds.

1.4 The HKMA will normally assess whether an AI should be designated under rule 3 on a single entity basis. However, there may be circumstances that warrant a group approach to determining the designation of connected AIs (such as by consolidating the positions of the connected AIs as if they were a single entity) if, for example, the AIs' business operations in Hong Kong are closely integrated, or there is any specific plan for merging the AIs' business activities.

1.5 It can be expected that in normal circumstances, most of the non-bank AIs (i.e. restricted licence banks and deposit-taking companies) will not fall within category 1 by virtue of their relatively small, simple and localised operations, which typically will render the first 2 of the specified grounds not applicable to them.

Foreign bank branches ("FBBs")

1.6 It is not uncommon for an FBB that belongs to a large international banking group to operate within a global liquidity management model and be covered by the consolidated LCR requirements imposed on the group (of which the FBB is a part) by the relevant home supervisor. In the light of this, the HKMA considers it reasonable to allow some degree of reliance on the "group" liquidity of FBBs, which will accordingly be taken into account in exercising its power of designation under rule 3. Pursuant to rule 3(4) the HKMA may decide not to designate a foreign bank (which operates an FBB in Hong Kong) as a category 1 institution in the circumstances specified in Part 3 of Schedule 1 ("specified circumstances")[11],

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respect of their liquidity positions. For example, assume that there are 2 connected AIs within the same banking group (one is a locally incorporated banking subsidiary of a foreign bank and the other is the branch of that foreign bank operating in Hong Kong), their liquidity positions are not normally consolidated for LCR purposes.

[11] The specified circumstances applicable to an AI incorporated outside Hong Kong relate to –

notwithstanding that the bank may otherwise meet the conditions for designation under any of the specified grounds.

1.7 In determining whether a foreign bank (which operates an FBB in Hong Kong) falls within the specified circumstances, the HKMA will have regard to, among other things, the following factors:

(a) Adequacy of liquidity requirements in home jurisdiction – The liquidity requirements applicable to the foreign bank should be comparable to international liquidity standards[12];

(b) Group compliance with liquidity requirements in home jurisdiction – The foreign bank should demonstrate that its banking group is able to meet the relevant liquidity requirements in the home jurisdiction;

1.8 The HKMA may also, in its review of the factors under paragraph 1.7 above, take into account other related factors, such as -

(a) Global liquidity risk management system – The foreign bank's global liquidity risk management system should enable its Hong Kong branch to fulfil the HKMA's liquidity requirements in all major aspects (including the requirements set out in the BLR and other relevant requirements on liquidity risk management and controls, as specified in the SPM module "Sound Systems and Controls for Liquidity Risk Management" (LM-2))[13]; and

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(i) the AI's particular circumstances providing reasonable justification for it not to be designated as a category 1 institution;
(ii) the AI's calculation of its LMR under Part 8 not being materially prejudiced if it were not designated as a category 1 institution;
(iii) the AI being adequately supervised in respect of liquidity risk in its home jurisdiction; and
(iv) the AI being compliant with the liquidity requirements in its home jurisdiction which are comparable to the provisions of the BLR that apply to category 1 institutions.

The last 2 items are specific to AIs incorporated outside Hong Kong.

[12] The international liquidity standards are those set out in both: (i) *Principles for Sound Liquidity Risk Management and Supervision* published by the Basel Committee on Banking Supervision ("BCBS") in September 2008; and (ii) *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* issued by the BCBS in January 2013 (referred to in this Annex as the "BCBS LCR Document").

[13] 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, the AI should be able to demonstrate 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.

(b) Effective home-host information-sharing arrangements – There should be in place effective communication and information-sharing channels between 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.

1.9 The HKMA will utilise available channels to obtain information for the assessment of the above "group 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.

Newly authorized AIs

1.10 The HKMA will assess whether a newly authorized AI should be designated as a category 1 institution on the basis of supervisory judgement, by reference to the AI's medium-term business plan (usually covering 3 years) and other information provided to the HKMA for authorization purposes. After authorization, the HKMA will monitor the AI's actual operation to decide whether the designation should be changed.

Application for designation (or revocation of designation)

1.11 Pursuant to rule 3(2)(b)(ii), an AI that does not meet any of the specified grounds for designation as a category 1 institution may still apply for such designation by the HKMA. In these cases, the HKMA has to be satisfied that all the grounds specified in Part 2 of Schedule 1 are met by the AI, i.e. there is reasonable justification for such designation[14], and the AI has the capacity (including system and resources) to comply with the LCR requirements under the BLR.

1.12 Pursuant to rule 3(5), the HKMA may, on its own volition or on application[15] by the institution, revoke the designation of an AI as a category 1 institution if the HKMA is satisfied that the institution concerned no longer meets any of the specified grounds, or such grounds will not be met in the near future (e.g. due to a permanent change in its business plan or strategy). The HKMA may require the institution to provide any information or documentary evidence as is deemed necessary in the circumstances of the case.

[14] For example, a category 2 institution, as part of a foreign banking group which implements the LCR at the group level, may have a case for applying the LCR on a group-wide basis to facilitate LCR reporting and monitoring.

[15] The application will not be considered if the circumstances affecting the AI's designation are temporary or sporadic in nature (e.g. due to short-term fluctuations in the AI's total asset size).

Ongoing review of designation

1.13 As part of its ongoing risk-based supervision, the HKMA will review from time to time the designation of category 1 institutions, including whether any category 2 institution needs to be designated as a category 1 institution. Normally such reviews will be conducted annually, or whenever the HKMA is aware of a significant change in circumstances in respect of an AI that may affect the HKMA's decision under rule 3 (i.e. to designate, or revoke the designation of, the AI as a category 1 institution). If a category 2 institution foresees any material change in its business plan or circumstances that may result in it satisfying any of the specified grounds, it must notify the HKMA as soon as practicable, as required under rule 15.

1.14 If and when the HKMA envisages the need to designate, or revoke the designation of, an AI as a category 1 institution, the HKMA will enter into discussions with the AI concerned to explain the ground for making the change. When a decision is made, the AI will be given a grace period (as denoted by the effective date of the designation or revocation in the HKMA's notice to the AI, as the case may be) to prepare for implementation of the LCR or LMR to which it will become subject. The length of the grace period, which will normally be not less than 6 months, will be determined by the HKMA taking into account the actual circumstances of each case.

Application to Banking Review Tribunal

1.15 As provided in rule 3(7), a decision made by the HKMA under rule 3(1) (regarding the designation of an AI as a category 1 institution) or rule 3(5) (regarding the revocation of a designation made under rule 3(1)) is a decision to which section 101B(1) of the Banking Ordinance ("BO") applies. In other words, an AI aggrieved by any such decision made by the HKMA may apply to the Banking Review Tribunal, within the period specified in section 101B(3) of the BO, for a review of the decision.

2. Supervisory monitoring of AIs' compliance with minimum LCR or LMR requirements

Minimum LCR & phase-in arrangement

2.1 The LCR of a category 1 institution is a ratio, expressed as a percentage, of the amount of the institution's high quality liquid assets ("HQLA") to the amount of the institution's total net cash outflows, as calculated in accordance with Parts 4

and 7. In line with the BCBS phase-in timetable for implementing the LCR, category 1 institutions are required, under rule 4(1) and (2), to maintain their LCR at not less than the minimum level specified as follows:

	2015	2016	2017	2018	From 2019
Minimum LCR	60%	70%	80%	90%	100%

2.2 The HKMA's adoption of the BCBS phase-in arrangement will enable those category 1 institutions, that need more time, to adjust their liquidity risk management systems and funding strategies to cope with the LCR standard in a more orderly manner. However, it will not be acceptable for a category 1 institution to engage in any attempted "race to the bottom" during the phase-in period in the sense of managing down its liquidity position or slowing down its pace of conforming to the requirements under the LCR standard (related to risk management or otherwise). The HKMA will maintain close scrutiny of the LCR positions of category 1 institutions during the phase-in period to guard against such activity.

Minimum LMR

2.3 The LMR of a category 2 institution is a ratio, expressed as a percentage, of the amount of the institution's liquefiable assets to the amount of the institution's qualifying liabilities (after deductions), as calculated in accordance with Parts 4 and 8. As required under rule 7, a category 2 institution must maintain an LMR of not less than 25% on average in each calendar month.[16] There is no phase-in period for a category 2 institution to comply with this 25% minimum LMR requirement.

Setting of internal targets

2.4 The HKMA expects all AIs to establish internal targets for complying with the liquidity standard (i.e. LCR or LMR) applicable to them. Such internal targets serve to provide an AI with a safety cushion above the regulatory minimum requirement that is appropriate to its liquidity risk profile.

2.5 Category 1 institutions should set their internal LCR targets for every year during the phase-in period taking into account, among other relevant factors, the historical

[16] Under rule 48(1), the average LMR of a category 2 institution for each calendar month is calculated based on the sum of the net weighted amounts of the institution's liquefiable assets and the sum of the net weighted amounts of the institution's qualifying liabilities (after deductions) for each working day of the month, unless the institution receives a notice issued by the HKMA under rule 48(2) that allows the institution to calculate its average LMR by reference to such days during the month as specified in that notice.

level and trend of their LCR positions. Absent the required historical level and trend at the initial stage of implementation of the LCR, category 1 institutions should set their internal LCR targets for 2015 by reference to their LCR positions reflected from the Quantitative Impact Studies ("QIS") conducted by the HKMA prior to 2015. For example, a category 1 institution that has maintained an LCR at a relatively low level or has exhibited a volatile trend in its LCR, as reflected from the QIS results, may need to provide for a more prudent cushion in its internal LCR target to ensure ongoing compliance with the regulatory minimum LCR requirement. If a category 1 institution's LCR has already reached a level that is above the minimum level required in any of the years during the phase-in period, the institution should set its internal LCR target starting at a level that is not less than the level it has already been able to achieve.[17]

2.6 Category 2 institutions are required to comply with a minimum LMR requirement of 25% on average in each calendar month. Whilst this requirement is not to be complied with "at all times" (unlike the case of the LCR), it is still imperative for category 2 institutions to maintain a stable and robust liquidity position as measured by the LMR. Therefore, these institutions are also expected to set their internal LMR targets to facilitate ongoing management of their liquidity positions.[18] In determining their internal LMR targets, category 2 institutions may refer to their previous internal targets adopted for the liquidity ratio ("LR") in force before 2015. However, they should have due regard for the modifications already made under the LMR (compared to the LR).[19]

Periodic projections and stress-testing

2.7 As the minimum LCR requirement is applicable to a category 1 institution at all times, it is reasonable to expect the institution to conduct regular projections and stress-testing of its LCR position, as part of its liquidity risk management process,

[17] For example, if a category 1 institution has demonstrated the capacity to maintain its LCR at a level above 80% (say, in the past 12 months), the HKMA would expect the institution to set its internal LCR target at the start of the phase-in period at a level that is not lower than 80%.

[18] If a category 2 institution's LMR calculated from time to time demonstrates a volatile trend that makes it unable to meet its internal LMR target on some occasions, the HKMA may, in the course of its risk-based supervision, exercise closer supervisory scrutiny of that institution's liquidity position. In the event that the daily LMR of a category 2 institution has fallen below 25% on one or more occasions, the HKMA will expect the institution to promptly investigate the circumstances and assess whether this would potentially lead to more serious consequences, e.g. the institution's failure to meet the minimum average LMR requirement (which requires notification to the HKMA under rule 8).

[19] For example, if a category 2 institution has relied principally on interbank placements or eligible loan repayments as a category of liquefiable assets to meet the previous LR requirement, the modified treatments in respect of these categories of assets may cause the institution to report its LMR at a lower level (or may result in larger fluctuations in its LMR). These impacts should be taken into account when the institution determines its internal LMR target.

in order to identify risk drivers that may lead to drastic fluctuations in such position.

2.8 In its risk-based supervisory process, the HKMA may request an AI to explain the rationale for its internal liquidity target, and elaborate on its methodologies for conducting projections and stress-testing in respect of its liquidity position. If it is considered prudent or reasonable to do so (e.g. if an AI's liquidity position has exhibited significant fluctuations from time to time), the HKMA may subject the AI to closer supervisory scrutiny, or require the AI to raise its internal liquidity target within a reasonable timeframe. In line with existing supervisory practices, where a material decline in an AI's liquidity position is noted, the HKMA would expect the AI to provide explanations for the decline, and to take prompt remedial action to restore its liquidity position as appropriate.

2.9 In the periodic evaluation of an AI's CAMEL rating, or in the course of conducting the supervisory review process on a locally incorporated AI, the HKMA will consider, among other things, the level and trend (or stability) of the AI's liquidity position, as measured by the LCR or LMR, as the case may be, and other relevant liquidity metrics. Any significant weakening of the AI's liquidity position during the review period will be taken into account.

3. Notification of liquidity events to the HKMA

3.1 AIs have various obligations under the BLR to notify the HKMA of matters that may have a significant effect on their LCR or LMR positions.

3.2 Under rule 5, category 1 institutions are required to notify the HKMA of any event which, whether by itself or in conjunction with any other event, may cause the institutions' failure to maintain an LCR as required under rule 4. A similar requirement applicable to category 2 institutions is set out in rule 8.[20]

3.3 Pursuant to section 97I of the BO regarding ***prescribed notification requirement***, AIs are required to notify the HKMA immediately of any ***relevant liquidity event*** specified in rule 14(3) and provide any particulars of the event that the HKMA requires.[21]

[20] The notification requirements set out in rules 5 and 8 enable the HKMA (i) to be informed as soon as practicable by an AI that envisages any major risk of complying with the applicable minimum liquidity requirement; and (ii) to enter into discussion with the AI so that prompt actions can be taken to prevent further deterioration in the AI's liquidity position.

[21] Every director, chief executive and manager of an AI that fails to comply with a prescribed notification requirement applicable to the AI commits an offence under section 97I of the BO.

(a) In respect of a category 1 institution, a relevant liquidity event means that –

(i) the institution fails to comply with the minimum LCR requirement specified in rule 4 and such failure does not arise from the institution's taking action (under rule 6) to monetize its HQLA to meet its financial obligations (re rule 14(3)(a)(i));

(ii) the institution is taking, or is about to take, action under rule 6 to monetize its HQLA to meet its financial obligations to the extent that the action will cause (or could potentially cause) the institution's failure to maintain an LCR as required under rule 4 (re rule 14(3)(a)(ii));

(iii) the institution has received a notice from the HKMA setting out the conditions under rule 16(1) to address an event falling within item (ii) above, but fails to comply with any of the conditions (re rule 14(3)(a)(iii)); or

(iv) the institution, being a rule 37 institution[22], fails to comply with rule 37(d) which requires the institution to maintain an amount of HKD-denominated HQLA (that are level 1 assets) that is not less than 20% of its HKD-denominated total net cash outflows (re rule 14(3)(a)(iv)). Rule 37(d) is one of the pre-requisites for a category 1 institution to use foreign currency-denominated HQLA to cover its HKD LCR mismatch in the calculation of its LCR (referred to as ALA Option 2 for the purposes of this Annex). (See section 6 below for more details.)

(b) In respect of a category 2 institution, a relevant liquidity event means that the institution fails to comply with the minimum 25% LMR requirement specified in rule 7 (re rule 14(3)(b)).

3.4 In the case of a relevant liquidity event that falls within the meaning of rule 14(3)(a)(i) or (b) (re an AI's failure to meet the minimum LCR required under rule 4 or the minimum LMR required under rule 7), pursuant to section 97J of the BO, the HKMA may, after holding discussions with the AI, issue a notice to the AI requiring it to take remedial actions as specified in the notice[23,24]. Such remedial

[22] A rule 37 institution refers to a category 1 institution that makes use of ALA Option 2 in the calculation of its LCR in accordance with rule 37.

[23] Every director, chief executive and manager of an AI that fails to comply with a requirement specified in the notice commits an offence under section 97J of the BO.

actions will likely include, but may not be limited to, the requirement for the AI to restore within a reasonable timeframe its LCR or LMR position such that the minimum requirement under rule 4 or 7, as the case may be, is met. Depending on the circumstances of each case, the HKMA may also take other supervisory measures as appropriate.

3.5 In dealing with a relevant liquidity event that falls within the meaning of rule 14(3)(a)(ii) (i.e. relating to the monetization of HQLA by a category 1 institution under rule 6), the HKMA may adopt the approach described in section 4 below.

4. Monetization of HQLA in a period of financial stress

Relevant BLR provisions

4.1 Consistent with the Basel III LCR standard[25], category 1 institutions are required to maintain a minimum level of LCR under rule 4(1) or (2) at all times, unless any failure by a category 1 institution to maintain an LCR as required is otherwise allowed by virtue of rule 6 (which sets out the circumstances under which the institution may monetize its HQLA to the extent of not maintaining an LCR as required under rule 4). These provisions in rules 4 and 6, together with other relevant provisions in rules 14 and 16, are intended to enable category 1 institutions to utilise their HQLA to withstand a period of financial stress, subject to certain safeguards. The application of, and the policy intention behind, these provisions are elaborated as follows:

(a) Circumstances under which monetization of HQLA is allowed (rule 6) – This rule sets out the circumstances that must be met before a category 1 institution may monetize its HQLA to the extent of maintaining an LCR less than as required under rule 4. These circumstances are –

(i) the institution is undergoing significant financial stress;

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[24] As provided in section 97J(3) of the BO, a decision made by the HKMA to impose a requirement on the AI in the notice is a decision to which section 101B(1) of the BO applies.

[25] As reflected from paragraph 17 of the BCBS LCR Document, banks are required to comply with the minimum LCR requirement (100% after the phase-in period) on an ongoing basis, absent a situation of financial stress. This minimum requirement is in line with the underlying objective of the LCR which seeks to ensure that banks maintain a stock of HQLA to serve as a defence against the potential onset of liquidity stress. During a period of financial stress, banks are however allowed to use their stock of HQLA (despite any consequential decrease in their LCR below the minimum requirement) in order to avoid producing undue negative effects on banks and other market participants.

(ii) the institution's financial circumstances are such that, in order to meet its financial obligations as they fall due, it has to monetize its HQLA to the extent necessary to meet those obligations;

(iii) the institution has no reasonable alternative other than to monetize its HQLA in such financial circumstances; and

(iv) the action to monetize the institution's HQLA might cause it to maintain an LCR less than as required under rule 4.

(b) Failure to maintain LCR as required in rule 4 not a contravention if this is due to rule 6 (rule 4(3)) – This is in line with the BCBS objective that the minimum LCR requirement applies absent a period of financial stress. This provision also removes any impediment for a category 1 institution to monetize its HQLA if such action meets the circumstances specified in rule 6.

(c) Prescribed notification of monetization of HQLA under rule 6 (rule 14(1), (2) and (3)(a)(ii)) – Pursuant to section 97I of the BO (re prescribed notification requirement), these reporting provisions oblige a category 1 institution which is taking, or is about to take, action to monetize its HQLA under rule 6 to immediately notify the HKMA of this event under rule 14(1) and provide the HKMA with relevant information about the event under rule 14(2) (e.g. assessment of the institution's liquidity position, contributing factors for the event, etc.). Through these provisions, the HKMA will be able to assess, and address, the situation as soon as it is notified by the AI concerned of this situation.

(d) Imposition of conditions after notification of monetization of HQLA under rule 6 (rule 16) – After being notified by a category 1 institution under rule 14(1) of its action to monetize HQLA under rule 6, the HKMA will assess the situation and devise a supervisory response that is appropriate to the circumstances (see paragraph 4.2 below for more details). Generally speaking, the HKMA will enter into discussions with the institution and, depending on the HKMA's assessment of the circumstances, require the institution concerned by notice in writing to comply with certain conditions specified in the notice. Among other things, the conditions are intended to ensure that the institution will take timely and suitable measures to restore its liquidity position to a normal level, whilst at the same time allowing some headroom for the institution to deal with the liquidity stress and putting in place any necessary safeguards to preserve the general stability of the banking system and protect the interest of depositors (including potential depositors).

As reflected from rule 16(4), the conditions that may be specified by the HKMA include, but are not limited to, the following:

(i) a condition that the institution must at all times maintain an LCR of not less than the percentage specified in the notice (which percentage must not be more than that required under rule 4). This is to ensure that a minimum level of liquidity can still be maintained by the institution, taking into account its latest liquidity position, the severity of the stress and any other measures available to deal with the situation;

(ii) a condition that the institution must submit to the HKMA a plan to restore the institution's LCR to a level required under rule 4 within a reasonable period as specified in the notice. If the HKMA is satisfied with the plan, another condition will be imposed to require the institution to start implementing the plan;

(iii) a condition that the institution must reduce its liquidity risk exposures in such manner, or adopt such measures, as are specified in the notice which, in the opinion of the HKMA, will cause the institution to maintain, within a period reasonable in all the circumstances of the case, an LCR as required under rule 4. This seeks to reduce or contain the institution's liquidity risk exposures to avoid further deterioration of its situation; and/or

(iv) a condition that the institution must make such reports regarding its LCR to the HKMA as are specified in the notice. This is to ensure that the HKMA is kept abreast of the institution's latest liquidity position and developments.

Supervisory response

4.2 In determining its supervisory response to a category 1 institution's monetization of its HQLA under rule 6, the HKMA will have regard to the guiding principles set out in paragraph 18 of the BCBS LCR Document as well as the actual circumstances of each case. Some major considerations include, among other things, the contributing factors and seriousness of the event, the nature of the financial stress (e.g. idiosyncratic or market-wide) the institution is faced with, the state of affairs of the institution and its risk management systems and profile, the potential contagion effects to the financial system and possible implications for

availability of credit and market liquidity, and the availability of other contingent funding sources or measures to address the situation.

4.3 The HKMA has a range of policy options and tools at its disposal, which will be tailored to the circumstances of each case. As mentioned in paragraph 4.1(d) above, the HKMA is mindful of the need to provide sufficient time for the category 1 institution concerned to restore its liquidity levels in order not to put additional stress on the institution and on the financial system as a whole (especially in cases where the financial stress concerned is particularly severe). However, the HKMA may consider taking more serious supervisory measures[26] if the following circumstances are established:

(a) the relevant event occurring in respect of a category 1 institution is not due to the circumstances specified in rule 6;[27]

(b) the category 1 institution is the subject of a notice issued by the HKMA under rule 16(1), but it has failed to comply with one or more of the conditions specified in that notice (or subsequent amendment to that notice as may be made by the HKMA under rule 16(2))[28]; or

(c) the HKMA is satisfied that there is no better alternative than to take more serious supervisory actions which, in the opinion of the HKMA, are necessary to safeguard the general stability of the banking system and the interests of depositors (including potential depositors).

Application to Banking Review Tribunal

4.4 As provided in rule 16(6), a decision made by the HKMA under rule 16(1) or (2)(a) (regarding the imposition of new conditions or amendment of existing conditions) in response to a category 1 institution's prescribed notification of its monetization of HQLA under rule 6 is a decision to which section 101B(1) of the BO applies. In other words, an AI aggrieved by any such decision made by the HKMA may

[26] These may include, for example, ring-fencing the institution's business activities (including deposit-taking activities), reviewing the fitness and propriety of any person who is acting as a controller, director, chief executive, manager or taking any other position in the institution, exercising the powers under Part X of the BO to assume control over the institution, and suspending or ultimately revoking the institution's authorization. The suitability of taking any such measures will be carefully assessed having regard to the circumstances of each case.

[27] For example, the event may have been caused by the institution's mis-management, deficiencies in its internal controls or operating procedures, or misconduct of its staff.

[28] Any such failure by a category 1 institution to comply with conditions specified in the notice under rule 16(1) or (2) is a relevant liquidity event (as specified in rule 14(3)(a)(iii)) that is subject to the prescribed notification requirement set out in section 97I of the BO.

apply to the Banking Review Tribunal, within the period specified in section 101B(3) of the BO, for a review of the decision.

5. Recognition of assets as HQLA (or liquefiable assets) under LCR (or LMR)

Ongoing assessment and management of HQLA (or liquefiable assets)

5.1 Pursuant to rule 25, a category 1 institution is required to ensure that (i) the assets included in the institution's HQLA for the calculation of LCR satisfy all requirements specified in Schedules 2 to 4 (relating to asset class, characteristic and operational requirements respectively) that are applicable to the assets; and (ii) the institution satisfies all operational requirements specified in Schedule 4 that are applicable to the institution insofar as those operational requirements relate to the assets.

5.2 To ensure that the stock of HQLA maintained by a category 1 institution is reliably monetizable at all times (especially during a period of liquidity stress), the HKMA expects the institution to have adequate systems and procedures in place for managing its HQLA and related risks (including foreign exchange risk and concentration risk), as required under rules 27 and 28. In particular, a category 1 institution must assess, and ascertain, on an ongoing basis whether all the requirements applicable to the inclusion of assets in its HQLA are, or will continue to be, met. A category 1 institution should conduct such assessment of the eligibility of assets included in its stock of HQLA regularly to ensure that any asset that no longer satisfies any applicable requirement is identified as soon as practicable so that prompt action can be taken to replace the asset.[29]

5.3 Similar requirements to those mentioned above apply to the recognition of assets as liquefiable assets under the LMR, as well as the ongoing assessment and management of such assets. See rule 49(1) and (2) for the requirements that must be satisfied before an asset can be included as liquefiable assets for the calculation of the LMR, and rule 50 for the requirements applicable to the management of liquefiable assets and related risks.

Inclusion of residential mortgage-backed security ("RMBS") as HQLA

5.4 In the revised LCR standard issued by the BCBS in January 2013, RMBS is among the few types of asset introduced as an additional class of level 2B assets that

[29] Ideally, this type of assessment should be conducted daily. For practical reasons, the HKMA would normally expect category 1 institutions to conduct such assessment at least monthly and whenever they are aware of any changes in circumstances relating to particular assets (or particular types of asset) that may affect their eligibility for inclusion as HQLA.

national authorities may choose to recognise as HQLA in their national LCR regulations, subject to the relevant qualifying criteria being met by the assets concerned. In the light of the 2007/2008 Global Financial Crisis which demonstrated how structured securities such as RMBS could quickly become illiquid when market confidence evaporated, the HKMA considers that a greater degree of scrutiny over the inclusion of RMBS by category 1 institutions in their HQLA is warranted.

5.5 As required under section 8 in Part 3 of Schedule 2, a category 1 institution must apply for the HKMA's approval in order to include any issue of RMBS in its HQLA. The applying institution must demonstrate to the HKMA's satisfaction that the RMBS, which is the subject of the application, meets –

(a) the characteristics and operational requirements applicable to HQLA in general (as set out in Schedules 3 and 4); and

(b) those qualifying criteria specified in respect of RMBS under section 8 in Part 3 of Schedule 2.

5.6 Moreover, the applying institution must demonstrate to the HKMA's satisfaction that it has the required capacity to manage the risks arising from the holding of the RMBS concerned.

5.7 It is therefore necessary for the applying institution to conduct a detailed assessment of the relevant RMBS and provide the relevant information for the HKMA to consider its application. An application without the required detailed assessment will not be considered.

Inclusion of RMBS as liquefiable assets

5.8 When the LR was still in force as a liquidity standard prior to 1 January 2015, individual AIs might have included some mortgage-backed debt securities as "liquefiable assets" for the calculation of their LR. Under the new LMR regime, any category 2 institution that intends to include RMBS in its "liquefiable assets" must seek the HKMA's approval under rule 49(4), regardless of whether such RMBS had been recognised as "liquefiable assets" under the LR prior to 1 January 2015.

5.9 To maintain the level playing field between category 1 institutions and category 2 institutions in relation to the treatment of RMBS, the HKMA will apply the same set of qualifying criteria for determining AIs' applications to include RMBS as HQLA under the LCR or as "liquefiable assets" under the LMR. Therefore, the guidance provided under paragraphs 5.5 to 5.7 above is similarly applicable for

LMR purposes. In other words, no approval will be granted to an AI for inclusion of RMBS for LMR purposes, unless the HKMA is satisfied that (i) the relevant RMBS is able to meet the qualifying criteria comparable to those applicable to the recognition of RMBS for LCR purposes; and (ii) the AI has sufficient capacity to manage the relevant risks associated with its holding of such RMBS.

5.10 Any application for inclusion of RMBS under the LCR or LMR will be carefully assessed by the HKMA. Where necessary, the HKMA may attach conditions to an approval, such as imposing a maximum limit for the inclusion of a certain issue, or the entire portfolio, of RMBS by an AI as HQLA (or liquefiable assets), if this is warranted by the circumstances of the case.

Eligibility criteria for recognition as HQLA

5.11 The HKMA's approach to applying (or interpreting) certain of the criteria for recognising assets as HQLA under the LCR may be summarized as follows:

(a) Large, deep and active markets (re Schedule 2, Part 3, sections 1 & 4 to 8) – One of the qualifying criteria for an asset to be included as HQLA, which is commonly applicable to marketable debt securities, covered bonds and RMBS, is that the asset must be traded in "large, deep and active markets". As a primary consideration, the HKMA will tend to regard an asset as being traded in a "large, deep and active market" if the asset is (i) listed on a "recognized exchange"[30]; or (ii) traded over-the-counter with multiple recognised dealers or market makers that are committed to maintaining market liquidity. In addition, if an asset is recognised by the HKMA as collateral for the provision of intraday or overnight liquidity, the market liquidity of such assets is considered to be more reliable.

The HKMA will also take into account other relevant factors, such as the daily market transaction volume of an asset, the level and stability of bid-ask spreads, and the number of market participants engaged in the market transactions involving a particular type of assets, in order to form a view as to whether such assets are traded in a "large, deep and active market". It is however recognised that not all market information or data required for assessment may be readily available, especially in markets which are relatively less developed as compared with markets in advanced economies.

[30] For the purposes of such assessment, the HKMA will have regard to the meaning of "recognized exchange" set out in section 2(1) of the Banking (Capital) Rules. In brief, "recognized exchange" refers to any of those exchanges specified in Part 2 or 3 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

In such cases, the HKMA will expect AIs to be able to provide additional information demonstrating the market liquidity of the assets concerned.

(b) Reliable source of liquidity (re Schedule 2, Part 3, sections 1, & 4 to 8) – Another qualifying criterion for an asset to be included as HQLA, which is commonly applicable to marketable debt securities, covered bonds and RMBS, is that the asset traded in "large, deep and active markets" must have a proven record as a "reliable source of liquidity" in those markets, even during a period of financial stress. In satisfying this criterion, the asset is in some cases required to meet certain quantitative requirements, such as not exceeding a 10% (in case of level 2A assets) or 20% (in case of level 2B assets) decline in market price, or an increase in haircut of more than 10 or 20 percentage points (as the case may require) during a specified period (including during a relevant period of significant liquidity stress), as specified in subsection (3) of sections 4 to 8. The HKMA will adopt the approach described in paragraph 5.11(a) above, coupled with an assessment of whether the asset meets the relevant quantitative requirements (if applicable), in considering whether an asset has a proven record as a reliable source of liquidity in the markets (including repo and outright sale markets).

(c) Relevant period of significant liquidity stress (re Schedule 2, Part 3, sections 4 to 8) – The quantitative requirements set out in subsection (3) of sections 4 to 8 for a marketable debt security, covered bond or RMBS, as indicated in paragraph 5.11(b) above, should cover (a) any period of 30 calendar days during a "relevant period of significant liquidity stress"; or (b) (if no such relevant period of significant liquidity stress is applicable to the marketable debt security, covered bond or RMBS) any period of 30 calendar days since the relevant asset was issued. The requirement under (b) is to cater for any newly issued marketable debt security, covered bond or RMBS which has not gone through any liquidity stress since the asset was issued.

Regarding what constitutes a "relevant period of significant liquidity stress", the HKMA considers that such liquidity stress should be significant enough as to disrupt the liquidity conditions and/or effective operation of financial markets in the jurisdiction(s) affected by the stress or crisis. Historical examples of such stress events include the 1997 Asian Financial Crisis and the 2007/2008 Global Financial Crisis.

6. Adoption of Alternative Liquidity Approach

6.1 Whilst the LCR standard is a ratio calculated on an all-currency basis (i.e. the calculation covers HQLA (numerator) and total net cash outflows (denominator)

denominated in all currencies), the BCBS expects banks to maintain a stock of HQLA with a composition that is consistent with the distribution of their liquidity needs by currency. 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 provides 3 options under Alternative Liquidity Approaches ("ALA") for such jurisdictions to address this issue.[31]

6.2 Division 4 of Part 7 provides for the adoption of ALA Option 2 by category 1 institutions[32]. The mechanics for the operation of this ALA Option are incorporated in the standard calculation templates included in the *Return of Liquidity Position of an Authorized Institution* (Form MA(BS)1E) (and accompanying completion instructions). The HKMA will assess from time to time whether it is necessary and appropriate to adopt ALA, and review whether ALA Option 2 continues to be the most suitable option for implementation in Hong Kong, taking into account the development of the Basel III liquidity standards and local circumstances.[33]

6.3 As provided under rule 37, a category 1 institution may use foreign currency-denominated HQLA to cover its HKD-denominated total net cash outflows (i.e. ALA Option 2) subject to meeting certain circumstances and requirements specified as follows:

(a) the institution can demonstrate to the satisfaction of the HKMA that it has a genuine need to use such HQLA to comply with rule 4;[34]

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[31] The three ALA options are:
(i) Option 1 – the use of contractual committed liquidity facilities provided by the relevant central bank for a fee;
(ii) Option 2 – the use of foreign currency HQLA (after haircuts to cater for currency risk) to cover domestic currency liquidity needs; and
(iii) Option 3 – the additional use of level 2A assets (i.e. above the 40% cap for sum of level 2A assets and level 2B assets) with a higher haircut.

[32] The reasons for the HKMA to adopt ALA Option 2 are discussed in its L3 consultation paper.

[33] It is the HKMA's intention to review the local circumstances once every 5 years to determine whether there continues to be a need to offer any ALA option, and if so which option(s) should be offered, to category 1 institutions for LCR purposes.

[34] This essentially means that a category 1 institution should not make use of the provisions of rule 37 to use foreign currency-denominated HQLA to cover HKD-denominated total net cash outflows simply as an economic choice for the sole purpose of profit-maximization. Rather, the application of rule 37 by a category 1 institution should mainly be driven by the existence of a substantive shortfall in HQLA denominated in Hong Kong dollars (versus the institution's HKD-denominated total net cash outflows) for the purposes of rule 27(2)(c), that cannot be easily or aptly addressed due to various practical issues (such as the difficulty for the institution to materially change the currency composition of its stock of HQLA or liquidity risk profile within a short period of time, or to acquire enough HKD-denominated HQLA having regard to market circumstances, in order to reduce its level of currency mismatch under the LCR).

(b) such HQLA are level 1 assets[35] and have not already been used by the institution to cover its foreign currency-denominated total net cash outflows;

(c) the institution applies the foreign exchange haircuts (as required under rule 38) in the calculation of its LCR;

(d) the use of such HQLA does not result in the institution holding HKD-denominated level 1 assets of less than 20% of its HKD-denominated total net cash outflows[36]; and

(e) the institution can demonstrate to the satisfaction of the HKMA that it has the necessary systems and capacity to manage the level of foreign exchange risk associated with the use of such HQLA.[37]

6.4 A category 1 institution is not required to apply for the HKMA's prior approval for the purposes of adopting ALA Option 2. However, it must be able to demonstrate, if requested by the HKMA, that it has satisfied all of the above conditions in order to be eligible for it to apply the provisions of rule 37 for calculating its LCR.

6.5 Among the circumstances and requirements specified in rule 37, it is particularly crucial for a category 1 institution to always maintain HKD-denominated level 1 assets of not less than 20% of its HKD-denominated total net cash outflows. A category 1 institution which is not able to meet this requirement must notify the HKMA immediately (as this is a ***relevant liquidity event*** specified in rule 14(3)(a)(iv)) and provide an explanation of the reasons for its failure to do so.

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[35] This is because the abundant global supply of level 1 assets in foreign currencies should be sufficient to provide category 1 institutions with a wide range of choice for managing their HQLA portfolios under ALA Option 2.

[36] Despite the 20% minimum holding level for HKD-denominated HQLA, if a category 1 institution has a need to adopt ALA Option 2, the institution cannot hold more foreign currency-denominated HQLA that is necessary to cover its HKD LCR mismatch, by virtue of rule 37(a) (re genuine need to use such HQLA). Hence, if, for example, the institution's HKD LCR mismatch ratio is only 30%, its maximum level of usage of ALA Option 2 should not exceed 30% (which is equivalent to a minimum HKD HQLA holding level of 70% if the minimum LCR requirement is 100%).

[37] This condition is in line with the provision in rule 27. In the course of supervision, the HKMA may review a category 1 institution's risk management systems and procedures by reference to relevant supervisory guidelines (e.g. section 6 of the SPM modules "Sound Systems and Controls for Liquidity Risk Management" (LM-2) and "Foreign Exchange Risk Management" (TA-2)). Such review will serve as a "reasonableness test" to enable the HKMA to form a view as to whether the institution is complying with the risk management requirements set out in rule 27, and is not intentionally using the provisions under Division 4 of Part 7 for profit-maximization or other purposes.

6.6 After being notified by a category 1 institution of this event, the HKMA will engage in discussion with the institution concerned to agree on a remedial action plan to address the issue. Among other things, the HKMA will assess whether there are any special market circumstances resulting in the event, or whether it is an indication of weaknesses in the institution's controls to ensure compliance with the relevant requirement. Depending on the circumstances of each case, the HKMA may consider allowing the institution to continue to apply rule 37 subject to certain conditions, such as –

(a) requiring the institution to institute measures to meet the minimum 20% requirement, for example, by switching some foreign currency-denominated HQLA into HKD-denominated HQLA, scaling down its liquidity risk exposures in Hong Kong dollars, or both, within an agreed timeframe;

(b) agreeing with the institution on a set of more prudent foreign exchange haircuts to be applied to the portion of its foreign currency-denominated HQLA that is used for rule 37 purposes (through the exercise of the power under section 97K(1) of the BO); or

(c) imposing any other conditions that may be considered necessary and prudent by the HKMA in the circumstances of the case.

6.7 It should also be noted that the 20% minimum holding level for HKD-denominated HQLA by category 1 institutions is binding at all times, whether within or beyond the phase-in period. If, for example, the minimum LCR requirement is 100%, the maximum level of foreign currency-denominated HQLA that can be used by a category 1 institution for ALA purposes will be 80% (i.e. the difference between 100% and 20%) of the institution's HKD-denominated total net cash outflows. The maximum ALA usage by a category 1 institution during the phase-in period will be restricted further according to the applicable minimum LCR requirement at different stages during that period. For example, in 2017, the allowable ALA usage is 60% (i.e. the difference between 80% (applicable minimum LCR requirement in 2017) and 20%). See the Completion Instructions for the *Return of Liquidity Position of an Authorized Institution* (Form MA(BS)1E) (re paragraph 6 under Annex 1) for more details.

7. Treatment of retail deposits under LCR

7.1 Under the BLR, the term "retail deposits" refers to deposits taken by a category 1 institution from retail customers (defined as customers who are individuals). Such deposits are distinguished from those taken from wholesale customers (e.g.

sole proprietorships, partnerships or corporates). For the purposes of the LCR, retail deposits comprise –

(a) stable retail deposits;

(b) less stable retail deposits; and

(c) retail term deposits.

7.2 The definitions of these 3 types of retail deposits are provided in rule 39, whilst the manner of calculating the expected cash outflows arising from these 3 types of retail deposits under the LCR are respectively set out in clauses 3 to 5 of the Banking (Liquidity Coverage Ratio – Calculation of Total Net Cash Outflows) Code ("CoP").

7.3 During the consultation process, the HKMA explained its policy thinking behind the treatment of retail deposits and discussed with a number of banks the approach to addressing certain implementation issues, including what constitutes a "significant penalty" for the purposes of retail term deposits and the treatment of "less stable retail deposits". These issues are clarified below.

Retail term deposits

7.4 Under rule 39, the term "retail term deposit" means a retail deposit, taken by a category 1 institution from a retail customer, that has a remaining term to maturity, or a withdrawal notice period, greater than the LCR period, and in respect of which–

(a) the retail customer has no legal right to withdraw the deposit within the LCR period; or

(b) any early withdrawal of the deposit will result in the retail customer being charged a significant penalty that is materially greater than the loss of interest that may arise from the early withdrawal.

7.5 Whether a category 1 institution can effectively charge a "significant penalty" to deter early withdrawal of term deposits placed by retail customers (re paragraph 82 of the BCBS LCR Document) is a crucial factor for determining whether such deposits can be treated as "retail term deposits".[38] In light of the diversity of

[38] Under the LCR, retail deposits that meet the definition of "retail term deposit" are subject to a 5% outflow rate; those that do not meet this definition will either be subject to a 5% outflow rate (if they qualify as "stable retail deposits") or to a 10% minimum outflow rate (if they qualify as "less stable retail deposits").

policies and practices adopted by category 1 institutions for charging early withdrawal penalties, it would appear not to be practically possible for the HKMA to prescribe a standard definition or benchmark for "significant penalty" in this context. Nonetheless, the concept of "significant penalty" should not be interpreted loosely in order to ensure that the amount of retail term deposits determined by individual category 1 institutions is fairly stated.

7.6 Having regard to the above considerations, the HKMA expects each category 1 institution to develop its own internal methodology for determining the amount of "retail term deposits" for LCR purposes, in accordance with the definition for such deposits provided in rule 39. In this regard, a category 1 institution should have a clearly defined policy for charging the early withdrawal penalty for such deposits.

7.7 In the course of its ongoing risk-based supervision, the HKMA may review the relevant methodology, as well as the policy and practices, adopted by a category 1 institution relating to the charging of penalties for early withdrawal of retail term deposits. Whenever such supervisory review is conducted by the HKMA, the institution concerned should be able to demonstrate that the level of early withdrawal penalty charged by it can effectively reduce the risk of early withdrawal of term deposits placed by its retail customers (e.g. by reference to historical data on early withdrawal cases, whether in normal or stressed situations, under the institution's charging policy for early withdrawal penalties).

7.8 Where appropriate, the HKMA may compare the level of early withdrawal penalty charged by a category 1 institution with those of other AIs. For this purpose, the HKMA may, depending on actual circumstances, use a common benchmark (set according to prevailing market circumstances) to facilitate comparison of the relevant policies and levels of early withdrawal penalty adopted by different category 1 institutions.[39]

Less stable retail deposits

7.9 Under the BCBS LCR Document, the outflow rate for less stable retail deposits[40] should not be less than 10%. National supervisors are expected to develop as

[39] The HKMA may set this benchmark as a certain multiple of the interest accrued on a term deposit. The level of the multiplier may be adjusted from time to time according to the interest rate environment. (For example, under the existing low interest rate environment for Hong Kong dollar funding, it would seem appropriate to set this multiplier at 200%. This means that the HKMA would not normally regard an early withdrawal penalty set by a category 1 institution, irrespective of what approach is adopted by the institution to determine the penalty, as "significant" for LCR purposes, if the penalty is less than 2 times the interest accrued on the term deposits concerned, unless the institution concerned can demonstrate to the HKMA's satisfaction that there are adequate justifications for the level of penalty otherwise set by the institution.)

[40] As defined under rule 39, a less stable retail deposit refers to a retail deposit taken by a category 1 institution

necessary additional buckets of less stable retail deposits to which higher outflow rates are applied.

7.10 During the consultation process, the HKMA proposed and discussed various policy options for the treatment of less stable retail deposits.[41] Having considered all relevant factors (including analysis of available data and relevant industry feedback), the HKMA ultimately decided to apply a standard outflow rate of 10% for this type of deposits. This policy decision was largely due to the lack of sufficient and reasonably consistent data to support a differentiated outflow treatment for such deposits. However, if the HKMA is satisfied that the liquidity risks associated with all or part of a category 1 institution's less stable retail deposits are such that it is prudent and reasonable to apply a higher level of outflow rate (i.e. higher than 10%) to those deposits,[42] the HKMA may do so through exercising the power under section 97K(1) of the BO.

7.11 Over the longer term, the HKMA will continue to monitor and review relevant information for the purpose of determining whether there is sufficient evidence to justify a more differentiated treatment for less stable retail deposits.

8. Treatment of operational deposits under LCR

8.1 As defined in rule 39, the term "operational deposit" refers to a deposit placed, by a wholesale customer (other than a small business customer), with a category 1 institution in the course of the institution providing to that customer "operational services" (i.e. clearing, custodial-related or cash management services) on which the customer has become significantly dependent for its business operation, and that deposit does not arise from the institution's provision of correspondent banking services or prime brokerage services to the customer.

8.2 Compared to other types of unsecured wholesale funding, a preferential outflow rate is provided for operational deposits under the LCR (i.e. 5% for fully insured portions of operational deposits and 25% for other operational deposits). Nevertheless, such preferential treatment is only available to an operational deposit placed with a category 1 institution by a customer if the conditions set out in clause 7(2) of the CoP, summarised as follows, are satisfied:

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that is not a stable retail deposit or retail term deposit.

[41] For example, see L3 consultation paper (paragraphs 67 and 68).

[42] For example, if a category 1 institution has competed aggressively for retail deposits, and this situation has persisted for a considerable period of time, there may be a strong case for the HKMA to assess whether the 10% minimum outflow rate is still adequate to reflect the funding liquidity risk arising from less stable retail deposits taken by the institution.

(a) Significant dependency on operational services - the customer has become significantly dependent on the institution for the provision of operational services as an independent third party to support the customer's business operations, and the institution is unaware of any adequate back-up arrangements of the customer that the customer could call upon should the institution not be able to provide those operational services to the customer;

(b) Legally binding agreement - the operational services must be provided by the institution to the customer under a legally binding agreement, and such agreement is not due for expiry within the LCR period and cannot be terminated by the customer by giving the institution a notice of less than 30 calendar days;

(c) Significant costs for early termination of agreement - in the event of early termination of the agreement within the LCR period, any such early termination will result in significant costs being borne by the customer for moving its operational deposits out of the institution within the LCR period (e.g. in terms of legal, information technology or transaction costs for setting up new arrangements for such operational services);

(d) By-product of underlying operational services - the deposit is a by-product of the underlying operational services provided by the institution, and has not been solicited by the institution from the wholesale funding market solely through the offering of interest income;

(e) No economic incentive to maintain excess operational deposit[43] – the deposit is kept in a specifically designated account (i.e. an operational deposit account) and priced at a level, or coupled with other benefits, that does or do not give the customer an economic incentive to maintain excess operational deposit in that account;

(f) Effective methodology for identifying excess operational deposit – the institution must have in place an effective methodology for identifying the amount of excess operational deposit maintained in the customer's operational deposit account, having regard to all relevant factors affecting the risk of withdrawal of the excess operational deposit by the customer when the institution is in financial stress. Such factors include (i) the

[43] In this context, the term "excess operational deposit" means that portion of an operational deposit maintained in the designated account that is in excess of the level of operational deposit that is necessary for the institution to provide operational services to the customer to meet its operational needs.

likelihood that the customer will have above average balances in its operational deposit account in advance of specific payment needs; and (ii) appropriate indicators (e.g. the ratio of a customer's account balances to its level of payment or settlement activity or to its assets under custody) to identify those customers that are not actively or efficiently managing their respective operational deposit accounts.

Any portion of the customer's operational deposit identified as excess operational deposit does not qualify for the preferential treatment available to "operational deposits"; and

(g) Risk of over-reliance on operational deposits not established – the operational deposits identified by the institution for preferential treatment under the LCR are not provided by a small number of customers that may potentially expose the institution to the risk of over-reliance on funding provided by those customers.

8.3 In view of the diversity of business nature and customer profile across category 1 institutions, the HKMA does not intend at this stage to prescribe a standardized approach for the determination of the amount of operational deposits to be subject to preferential outflow treatment under the LCR (including the methodology for identifying excess operational deposits). Individual institutions may develop their own internal approaches for this purpose.[44] Nonetheless, the system and methodology adopted by a category 1 institution should adhere to the following principles:

(a) the relevant system and methodology should be sufficient to facilitate ongoing assessment of the eligibility of deposits to be included by a category 1 institution as operational deposits. Such assessment is required under clause 7(4) of the CoP. The frequency and level of sophistication of

[44] As observed by the HKMA to date, in the case of developing a methodology for identifying excess operational deposits, some category 1 institutions may adopt statistical methodologies (e.g. based on the concept of moving average, percentile or confidence level, or a combination of those concepts) as a baseline for assessing the stability of deposits in "operational deposit accounts". On top of such statistical approaches, some institutions may also apply internal limits (for example, by reference to the average deposit balance maintained in operational deposit accounts covering a certain period of time) to restrict the amount of deposits in those accounts that can be included as operational deposits for LCR calculation purposes. Such approaches may be adopted by category 1 institutions as building blocks for developing their internal systems and methodologies for identifying excess operational deposits, on the premise that the relevant details (such as the underlying assumptions and parameters) specified by the institutions are commensurate with, and suitable for, their actual circumstances and business profile. The HKMA will keep the need for providing more guidance under review, taking into account evolution of industry best practices and any further guidance from the BCBS.

this type of assessment should be commensurate with the institution's liquidity risk profile.[45]

(b) the assessment should be conducted in a sufficiently granular manner, taking into account relevant factors that may affect the risk of withdrawal of operational deposits, particularly in times of stress (see also paragraph 8.2(f) above). The relevant factors may include a customer's business relationships with the institution, the extent to which the customer has relied on the institution's operational services, and the historical trend of deposit balances placed with the institution (taking into account, for example, the absolute level and volatility of deposit balances).

(c) the assessment should ensure that deposits and other funding that are apparently not qualified for being regarded as operational deposits are fully identified and carved out. For example,

(i) deposits and funding which are not received in the course of the provision of operational services by a category 1 institution should not be regarded as operational deposits. In this connection, deposits that are eligible to be treated as operational deposits are expected to be maintained in an operational deposit account the operation of which is subject to a legally binding agreement demonstrating that the institution provides operational services to the customer through that account;

(ii) deposits and funding which are taken from retail customers and small business customers, or received in the course of correspondent banking and prime brokerage activities, are not to be regarded as operational deposits; and

(iii) deposits and funding earning a level of interest (or coupled with other benefits) that is or are preferential when compared to the institution's interest rates / benefits normally offered to customers in respect of other deposits which are not regarded as operational deposits.

[45] For example, if a category 1 institution consistently reports a considerable amount of deposits as "operational deposits" (say, exceeding 5% of the institution's total unweighted amount of expected cash outflows), there may be a case for the institution to conduct this type of assessment more frequently (say, more than once a month). In any case, a category 1 institution should have adequate systems and procedures in place to cater for the possibility that it may be requested by the HKMA to conduct this type of assessment more frequently as and when necessary.

8.4 By virtue of clause 7(3) of the CoP, if a category 1 institution is unable to determine the amount of excess operational deposit in a customer's operational deposit account, the entire balance of the deposit in that account is to be treated as if the deposit were not an operational deposit.

8.5 The HKMA may disallow a category 1 institution from applying the outflow treatment available to "operational deposits" to all or any part of its operational deposits, if the HKMA is satisfied that those deposits do not qualify as operational deposits based on any failure to meet one or more of the conditions set out in paragraph 8.2 above. When reviewing a category 1 institution's categorisation of operational deposits, the HKMA will particularly assess, among other things, whether –

(a) pursuant to paragraph 8.2(g) above, a significant portion of the institution's operational deposits is provided by such a small number of customers that this may increase, or potentially increase, the risk of over-reliance by the institution on funding provided by those customers; and

(b) the level of operational services provided by the institution to a customer who placed an operational deposit is not at a level that will likely render the customer substantially dependent on those services for the conduct of its normal business operations.