Guideline No. 6.3

Our Ref : CB/POL/6/3 17 July 1996

The Chief Executive
All Licensed Banks

Dear Sir/Madam,

Real Time Gross Settlement System

You are probably aware that the interbank payment system in Hong Kong is scheduled to change to a Real Time Gross Settlement (RTGS) system in early December this year. All licensed banks should be aware of the settlement procedures under the new system and their implications for the banks' liquidity management. This letter sets out the important liquidity management issues arising from the implementation of the RTGS system to which licensed banks should have regard.

There are a number of important changes comparing this new system with the existing:

	Existing	**New**
(i)	Settlement either directly or indirectly across the books of the HongkongBank.	Settlement directly across the books of the Monetary Authority (MA) for the account of the Exchange Fund.
(ii)	Only one settlement time each day for all interbank payments.	Final and irrevocable settlement at any time of the business day for individual clearing items. Several designated times for the settlement of bulk clearing items like cheques and electronic clearing of the preceding working day.
(iii)	No need for intraday liquidity because of final settlement on a net	Intraday liquidity is needed to fund outgoing payments and settlement obligations of bulk clearing items at

basis the next day. specified times during a business day.

Arising from these changes banks should be aware of the implications for the arrangements, procedures and controls relating to their liquidity management.

(a) As the MA assumes the role of a settlement institution, a notice pursuant to section 3A of the Exchange Fund Ordinance will be served on banks to notify them of the setting up of the settlement accounts with the MA and the related procedures in operating the accounts.

(b) It should be noted that banks are primarily responsible for managing their own payment flows. As intraday liquidity is required under the RTGS system, banks need to review their likely need for funds to meet their settlement obligations. The size of the funding needs may be greater as each payment, apart from bulk clearing items like cheques and electronic clearing, has to be settled on a gross basis. Banks should appreciate the significance of this intraday funding capability as no unsecured overdraft will be allowed on the settlement accounts with the MA.

To facilitate banks intraday borrowing, the MA will however provide intraday repo facilities on the basis of Exchange Fund Bills and Notes (but not paper eligible for LAF purposes in general). Banks who wish to rely on this facility should apply for a recognized dealer status with the MA so that the Exchange Fund papers can be registered in their names with the Central Moneymarkets Unit (CMU) of the MA.

Banks can obtain intraday repo facilities from the MA on either a "discretionary" or "automatic" basis. For the latter arrangement, banks should enter into the Master Sale and Repurchase Agreement with the MA so that an intraday repo will be triggered automatically whenever the banks settlement account maintained with the MA has insufficient funds to meet the next outgoing payment item, provided adequate Exchange Fund papers are maintained in the banks repo account with the CMU. Intraday repos not reversed at the end of the day will be converted to overnight LAF repos.

As an alternative, banks may wish to raise funds in the interbank market to meet their commitments.

(c) The bulk clearing items will be settled according to the processing schedule stipulated in the Clearing House Rules. Banks must ensure that there are sufficient funds in their settlement account maintained with the MA at the relevant times to meet these settlement obligations as failure to settle may result in the suspension of clearing facilities of the bank concerned. There will be preliminary advice during the day as well as final advice (net of return items) of the exact settlement figure at least 15 minutes prior to each settlement time. However, these arrangements do not remove the need for institutions to plan for their intraday funding needs well in advance.

Banks should also note that in the RTGS system cheques are for next day value as regards the passing of value between banks. In other words the settlement of these bulk clearing items at definite times during the day are for previous day items. It is therefore not possible for banks to use cashiers orders to settle same day value obligations as in the current situation.

(d) If the balance in the settlement account is insufficient to meet the next payment and automatic intraday repo cannot be triggered, the bank concerned may need to re-sequence or break down the value of the payment instructions in its queue so that there will not be a large payment item blocking the other outgoing payments. Banks should be fully aware of the need to manage their payment flows in order to reduce/eliminate the chance of long queues being developed and avoid giving the impression to counterparties that they are unable to meet their commitments.

In this regard banks should define clearly the responsibilities of individual units/personnel in managing and operating the settlement account. These include the monitoring of account balance, the processing of settlement obligations and managing the payment queue. There should be a centralised monitoring of the settlement account, adequate controls to ensure prompt and complete processing of all settlement obligations, and defined responsibility to manipulate the payment queue. Clearly defined roles and responsibilities involving both the front (e.g. dealing room) and back (e.g. settlement department) offices should be put in place.

The operation of the RTGS is done through Member Bank Terminals (MBTs) as well as the Central Moneymarkets Unit Terminals (CMTs) where intraday repo is involved. These terminals should be installed in

the relevant offices of the bank depending on the definition of roles and assignment of responsibilities by the management and taking account of the need to maintain strict segregation of duties. In this connection, access levels relating to individual users should be well defined and the necessary password controls properly installed.

Many of these procedures and controls will be necessary even without RTGS and should already be in place. However, RTGS particularly calls for constant monitoring of the settlement account balance and the payment queue throughout the day i.e. the intraday liquidity position, so that any intraday funding need is identified and handled promptly. This requires close liaison between the front and back offices.

(e) As there will be deals involving HK dollars transacted before the implementation of RTGS but with settlement obligations after, banks will need to amend the settlement instructions of such transactions so that settlement with counterparties will be effected through the bank's settlement account with the MA instead of that with its existing settlement bank. This is particularly important where the transaction involves an overseas bank. Banks should diarize the affected transactions to ensure that the necessary changes to the settlement instructions are effected in time.

(f) Banks should acquaint themselves with all the arrangements and procedures under the RTGS. For this purpose a list of the circulars on matters relating to RTGS issued by the Hong Kong Association of Banks is attached. Banks should ensure that they obtain a full set of these circulars and that all staff to be involved in the operation of RTGS have access to them.

(g) The MA will be organising a simulation test for RTGS in October/November 1996. Banks should participate in this exercise so as to verify their technical readiness for RTGS and to familiarize themselves with the system functionalities of the MBTs and the CMTs. Banks will also be able to practise the liquidity management under RTGS and estimate their intraday funding need.

As regards the MAs liquidity supervisory regime, section 102 of the Banking Ordinance requires that an authorized institution (AI) shall maintain a minimum liquidity ratio of 25% in each calendar month as calculated according to the Fourth Schedule. The liquidity ratio shall be calculated on the basis of the sum of the net weighted amount of the liquefiable assets and the sum of the

qualifying liabilities for each working day of that month or as permitted by the MA, such days during the month. In other words, the statutory requirement relates to the average liquidity position of the AI for the month. This will continue to be measured as at present on the basis of the end of day position for each relevant day during the month.

The MA has set out in its Policy Paper on the Management of Liquidity that it has no intention to impose a minimum daily liquidity ratio, but that AIs should aim to maintain adequate liquidity on a daily basis and should avoid extreme fluctuations in their ratio during the course of the month. For this purpose, AIs are required to report their lowest liquidity position during the month and the position as at the end of the month. These positions will also continue to be measured as at the end of the relevant days. The introduction of RTGS and intraday repo will not therefore lead to any change in the MAs existing practice in monitoring the liquidity ratio.

Yours faithfully,

D. T. R. Carse
Deputy Chief Executive

Encl.

c.c. The Chairman, HKAB
The Chairman, DTC Association
President, Hong Kong Society of Accountants
Auditors of authorised institutions