

Consultation Paper

Implementation of Basel III Liquidity Standards in Hong Kong (L2)

Purpose

1. This paper invites the industry's comments on the HKMA's proposals in respect of the approach, criteria and process for the determination of which authorized institutions (AIs) should be subject to –
 - the Basel III liquidity standards, viz., the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR);and which AIs should be subject to –
 - the modified liquidity ratio (MLR), which is a modified version of the existing 25% minimum liquidity ratio (LR) under the Banking Ordinance (BO). The MLR was described in the Consultation Paper (L1) issued in January 2012.
2. Also included in this consultation are proposals relating to –
 - the replacement of the “floor” requirement (proposed in the Consultation Paper (L1)) on high-quality liquid assets (HQLA) for AIs subject to the LCR, with a parallel reporting requirement; and
 - the basis of calculation and scope of consolidation that the HKMA will adopt when applying the liquidity standards to AIs.

Overview

3. On 20 January 2012, the HKMA issued the Consultation Paper (L1) to seek the industry's views on some preliminary proposals on the scope of application of the Basel III liquidity standards in Hong Kong. In particular, the HKMA proposed to adopt a two-tiered approach whereby –
 - the LCR and NSFR will apply to a group of AIs which meet certain criteria specified by the HKMA (Category 1 AIs); and
 - the MLR will apply to all other AIs (Category 2 AIs).
4. The HKMA would like to consult the industry further on the approach, criteria and process for classifying Category 1 and Category 2 AIs. The proposed classification framework has, where appropriate, taken into account comments

raised by the industry concerning the two-tiered approach in the industry's response to the Consultation Paper (L1).

5. This paper is made up of the following sections:

- Section 1 sets out the proposed approach and criteria for classifying Category 1 and Category 2 AIs, including the respective treatment of locally incorporated banks and branches of overseas incorporated banks which may differ in some aspects;
- Section 2 supplements Section 1 by describing the process and procedures associated with the proposed classification framework, including the initial determination and ongoing review of the classification of AIs;
- Section 3 discusses the replacement of the “floor” requirement on HQLA (proposed in the Consultation Paper (L1)) for AIs subject to the LCR with a parallel reporting requirement as mentioned in paragraph 2 above; and
- Section 4 highlights the basis of calculation and scope of consolidation pertaining to the liquidity standards.

Next steps

6. The HKMA will take into account the industry's comments in response to this consultation paper in further developing the classification framework under the two-tiered approach. The framework will form the basis for drawing up a list of potential Category 1 and Category 2 AIs. The HKMA will notify individual AIs of their preliminary classification status (i.e. whether they will fall within Category 1 or Category 2) based on latest available information. This will be done as soon as practicable (anticipated to be within this year) in order to facilitate AIs' preparation for implementation of the applicable liquidity standards.
7. In the second half of the year, the HKMA will continue to consult the industry on other aspects of the liquidity standards, including the treatment of intra-group transactions and commitments, the methodology for the calculation of the MLR, and the methodology for the calculation of the LCR (including the treatment of items subject to national discretion).

Section 1

Approach & Criteria for Classifying Category 1 and Category 2 AIs

General considerations

8. As proposed in the Consultation Paper (L1), the HKMA is minded to adopt a two-tiered approach to the application of liquidity standards. This approach is considered to be more appropriate for Hong Kong given the diversity of AIs in terms of their nature, size and complexity of operations. The new Basel III liquidity standards (i.e. the LCR and NSFR), being stress-based measures of liquidity adequacy, are more suited for application to AIs with a significant role in the local banking sector (in terms of, for example, sizable / complex business activities) or substantial cross-border exposures. On the other hand, the LR, with appropriate modifications to enhance its effectiveness, should continue to be a sufficient regulatory liquidity standard for other AIs whose business is relatively small, simple and domestic.
9. The classification framework proposed in this paper will provide a consistent and systematic approach for the HKMA to determine whether AIs should be assessed as Category 1 or Category 2. Both qualitative and quantitative factors will be used to support the assessment, with the latter serving as reference rather than as hard-coded requirements. This should enable an adequate assessment to be undertaken of all of the key attributes of a Category 1 AI (see paragraph 13 below).
10. The application of the proposed classification framework to locally incorporated AIs and branches of overseas incorporated AIs may differ to a certain extent, in light of distinct differences in the business and risk profiles of these two groups of AI. For example, local banks are mostly engaged in retail-based traditional banking activities, while foreign bank branches tend to be more wholesale-oriented and diverse in their business operations. The approach to liquidity risk regulation adopted by the home supervisors of foreign banks, and the extent of the assurance that the HKMA may obtain from such regulation and supervision, present a further dimension for consideration. The proposals in this paper represent the broad framework for application to AIs. Some details of application, particularly relating to foreign bank branches, require further deliberation. The industry's feedback to the HKMA's proposed approach, as described in this paper, will be useful to inform the relevant policy considerations.
11. In developing the classification framework, the HKMA has looked into the approaches which other overseas supervisors appear likely to adopt. A variety of approaches are being contemplated, including applying the LCR and NSFR to (i) all banks (including foreign bank branches); or to (ii) selected banks (including

foreign bank branches) based on qualitative assessment or type of bank; or to (iii) all locally incorporated banks. In the absence of a consistent international approach, the HKMA has devised its proposed framework by reference to the specific characteristics of the Hong Kong banking sector.

12. While Category 2 banks (local and foreign) will be subject to the MLR as a regulatory standard, the HKMA may for supervisory monitoring purposes require some Category 2 banks to report their LCR / NSFR ratios to the HKMA (as a monitoring tool rather than a binding standard) (see paragraphs 30 and 31 below for more details).

Classification of Category 1 AIs

Key attributes of Category 1 AIs

13. The HKMA will determine whether an AI should fall within Category 1 having regard to its significance to the Hong Kong banking system. The relevant aspects for assessment include, but would not be limited to, the following:
 - an AI's role in the financial system;
 - the nature, size or complexity of an AI's banking activity;
 - the potential impact on the banking sector, financial markets (e.g. interbank / derivatives markets and participants) or other stakeholders (e.g. depositors, retail investors) should an AI get into financial difficulty; and
 - an AI's potential vulnerability to spill-over effects from crises or shocks that may occur outside Hong Kong. This will typically affect AIs that have substantial cross-border exposures or operations.
14. Given the focus of the assessment on the above areas, it is unlikely that non-bank AIs (i.e. restricted licence banks (RLBs) and deposit-taking companies (DTCs)) will be Category 1 AIs because of their relatively smaller-scale operations and deposit-taking restrictions under the Banking Ordinance (BO)¹. The HKMA therefore envisages that Category 1 AIs will primarily be licensed banks.

Assessment approach and criteria

15. The HKMA is considering various criteria for the purpose of assessing the attributes listed above, and hence whether an AI should fall within Category 1. Current thinking is to regard an AI as Category 1 if it meets any one of the following criteria:

¹ Unlike licensed banks which can conduct the full range of banking and deposit-taking activities, RLBs and DTCs are subject to various deposit-taking restrictions set out in sections 12 and 14 of the BO. For example, both RLBs and DTCs are prohibited from taking deposits on current, savings or other similar account repayable on demand, and the amount of each deposit taken must not be less than HK\$500,000 (for RLBs) and HK\$100,000 (for DTCs). In addition, DTCs are prohibited from taking short-term deposits (i.e. with an original term to maturity of less than three months).

- Size or complexity of business operation or level of international exposure considered to be significant by the HKMA. At least two quantitative indicators are proposed to be used by the HKMA for benchmarking purposes in making this assessment.
 - (i) Size of business operation : “Total assets (after provisions)”² are proposed as a proxy indicator of an AI’s overall size of business activity and operation. This measure recognises that AIs with a sizable operation tend to pose a greater risk and have a potentially greater impact on domestic banking stability;
 - (ii) Level of international exposure : “Total external claims and liabilities”³ are proposed as a proxy indicator of an AI’s level of international exposure. As mentioned above, this measure recognises that AIs with significant cross-border exposures tend to be more vulnerable to the spill-over effects from crises or shocks that may occur in other jurisdictions. This measure is also consistent with the Basel III requirement that the new liquidity standards should apply to “internationally active banks”.

In the case of local banks, the HKMA’s current thinking is that the quantitative benchmarks of “significance” for the size of business operation and level of international exposure should tentatively be set at HK\$200 billion and HK\$100 billion respectively, having regard to prevailing circumstances in the banking sector. The appropriate quantitative benchmarks to be used for foreign bank branches require some further deliberation, in order to cater for the specific features of their business profiles in Hong Kong.⁴

When assessing a local bank’s position against the quantitative benchmarks, the HKMA would propose to refer normally to the bank’s combined positions of its Hong Kong offices and overseas branches (if any). In the case of a foreign bank, the quantitative benchmarks would be applied to the position of its Hong Kong branch.

In addition to this quantitative assessment, the HKMA would propose to consider other relevant factors that reflect an AI’s complexity of business operation or its potential impact on the banking system. Particular focus would be placed on the following factors:

² This would be based on the item “Total assets (less provisions)” reported in the Return of Assets and Liabilities of an Authorized Institution.

³ This would be based on the sum of external claims and liabilities reported in Part I of the Return of External Positions.

⁴ For example, there is no branch capital requirement for foreign banks in Hong Kong, and foreign bank branches naturally tend to have more international exposures because of their affiliation with overseas banking groups.

- (i) an AI's role and level of participation in banking / financial markets (including wholesale funding, derivatives, securitization or other traded markets);
- (ii) its size and complexity of derivatives / off-balance sheet exposures; or
- (iii) its potential impact on other banks, financial markets and/or other stakeholders (e.g. depositors, retail investors, etc.).

It is the HKMA's present view that there is no suitable quantitative benchmark that can address the diversified features of derivatives, securitization and traded market transactions. Therefore, in assessing items (i) and (ii) above, the HKMA would have regard to the nature, size and riskiness of an AI's exposures to complex financial instruments based on relevant available information that can be obtained from the AI (including data reported in the semi-annual survey on off-balance sheet activity) or from other sources.

- Connection with a Category 1 AI. The HKMA would propose to assess on a case-by-case basis whether, and the extent to which, AIs which would themselves fall within Category 2 but which are subsidiaries of a Category 1 AI should ultimately be included in Category 1. The purpose of such inclusion would be to avoid the potential for regulatory arbitrage of liquidity requirements by connected AIs that are not in the same category.
 - Classification as a Category 1 AI justified on other grounds. While the HKMA expects that in most cases the key factors listed above will be sufficient for its assessment, there may be limited circumstances in which an AI's significance to the banking system only becomes apparent or falls to be observed from other exceptional factors. In such cases, the HKMA would fully discuss with and explain to the AI concerned the rationale behind its classification.
 - Opt-in as a Category 1 AI. AIs may, subject to the consent of the HKMA, elect to be classified as Category 1. This may occur, for example, in the case of a foreign bank branch which is not itself a Category 1 AI in Hong Kong but where the bank of which it forms a part is nonetheless subject to the LCR / NSFR in its home jurisdiction and the branch prefers to adopt the same standards locally.
16. In applying the above criteria, the HKMA would propose to employ a forward-looking approach by taking into account any forthcoming business expansion or development that will likely materialise within 12 months. For example, if an AI's operation in Hong Kong would be significantly increased in the near term due to a change in business strategy, the HKMA may decide to classify the AI as a Category 1 AI before the effects of business expansion are fully realised.

17. As many AIs are associated with, or form a part of, local or foreign banking groups, there may be a risk of contagion between individual AIs and their major subsidiaries or group entities operating in Hong Kong or overseas. In the context of a foreign bank, the situation of, or matters affecting, its head office and overseas offices may also affect the Hong Kong branch in a group-wide crisis. The HKMA would, where appropriate, seek to assess the potential impact of an AI on the local banking sector and local markets by taking into account in turn how the group, of which the AI is a part, may affect the AI's operation in Hong Kong.
18. The HKMA may, in exceptional circumstances, determine that there are overriding reasons for not classifying individual AIs notwithstanding that they may meet any of the above criteria as Category 1 AIs. For example, if the authorization (e.g. banking licence) of an AI will soon be revoked on a voluntary basis then, even though the AI meets the quantitative benchmarks, the HKMA may decide not to include that AI in Category 1 in view of the impending revocation. Such discretion is expected to be used only sparingly. The process of screening out AIs will be tightly controlled to ensure that the decisions made are fully justified and consistently applied.
19. The HKMA expects to conduct a review of the classification of Category 1 and Category 2 AIs at least annually (see Section 2 for more details). The level of the quantitative benchmarks will also be subject to review from time to time to ensure that they remain appropriate.

Application to local banks

20. The HKMA has considered other options for determining the extent to which local banks should be classified as Category 1 AIs. One potential option is for all local banks to be made subject to the LCR and NSFR standards. The HKMA is, however, aware that local banks vary widely in terms of business size and risk profile, with the majority having relatively small-scale operations and low levels of international exposure. Therefore, requiring all, or most, local banks to observe the LCR and NSFR as regulatory standards may not be the most optimal approach. From the supervisory perspective, the application of the MLR to the smaller local banks should suffice as a regulatory liquidity standard, given that such banks generally have relatively simple and retail-based business models.
21. The application of the proposed criteria in paragraph 15 above to local banks is somewhat more straightforward than applying the criteria to foreign banks (where additional considerations inevitably need to be taken into account). The HKMA expects that local banks meeting the quantitative benchmarks for size of business operation (HK\$200 billion) or level of international exposure (HK\$100 billion) will be classified as Category 1 AIs. Whether any of a local bank's

subsidiaries, which are themselves AIs, should likewise be classified as Category 1 AIs will be considered on a case-by-case basis.

Application to foreign banks

22. Currently, the majority of AIs are foreign banks operating in branch form⁵. Their business size and risk profiles are even more diverse than those of local banks. Therefore, operating on a similar premise to that described above in respect of local banks, the HKMA would not intend to subject all foreign bank branches to the Basel III liquidity standards. The HKMA would propose instead to adopt an approach based upon assessment of their significance to the Hong Kong banking system in order to determine which foreign banks should be classified as Category 1 AIs.
23. On this basis, it is envisaged that while the majority of foreign banks would be subject to the MLR, some foreign banks may be classified as Category 1 AIs because of their sizable operations (including retail operations) and sophisticated business activities (with some being major players in derivatives or other traded markets) in Hong Kong. Moreover, the MLR, being a somewhat more broad-brush liquidity measure, may not be a suitable liquidity standard for foreign bank branches engaged in complex financial products and activities.
24. The HKMA is however not inclined to rely wholly on foreign banks' compliance with the LCR at the group level. As an internationally recognised principle, both the home and host supervisors of cross-border banking groups have the right and obligation to supervise the liquidity risks of such groups that may affect the banking systems in which they operate. Hence, it has been a longstanding practice for home supervisors to supervise the liquidity risks of their banking groups on a consolidated basis, while host supervisors supervise the liquidity risks of those groups operating in their jurisdictions to ensure that sufficient liquidity is maintained by foreign bank branches to support their local operations. This is the approach currently practised by the HKMA. Nevertheless, for foreign banks that may potentially be Category 1 AIs, the HKMA is prepared to seek confirmations and assurances from their home supervisors in assessing the extent of reliance that may be placed on the banks' consolidated LCR (see second bullet under paragraph 26 below for more details).
25. In the case of the NSFR, which principally regulates the overall funding structure of a banking group, the HKMA is aware of the potential challenges for foreign banks to meet this standard at the branch level, given that foreign bank branches do not have branch capital as a major source of available funding and most of the foreign bank branches in Hong Kong do not have ready access to retail deposits. There may therefore be some basis for considering whether to exempt foreign

⁵ As of 30 April 2012, there were a total of 199 AIs operating in Hong Kong (including 154 licensed banks). Among them, 139 were incorporated overseas (including 131 foreign banks).

banks under Category 1 from compliance with the NSFR at the branch level, on the condition that the foreign banks concerned comply with the NSFR implemented in their home jurisdictions. The HKMA will reach a final decision on this issue after consulting the industry on the NSFR at a later stage. However, the HKMA's current leaning is towards relying on foreign banks' compliance with the NSFR on a group basis.

26. The HKMA's current intention would be to largely follow the criteria set out in paragraph 15 above in classifying foreign banks as Category 1 AIs. In addition to assessing individual foreign banks' positions against appropriate benchmarks, more focus would likely be placed on the other less quantifiable assessment factors included in paragraph 15. Importance would be attached to some aspects that are particularly relevant to foreign bank branches, such as –

- Group-specific factors – Issues to be considered include whether a foreign bank branch (i) has any major role within its banking group (e.g. in respect of trading or funding management); and (ii) is closely linked to, or potentially affected by, other connected AIs or non-AI financial entities operating in Hong Kong or elsewhere. These factors may have a bearing on the assessment of both potential impact on the local banking sector / markets and whether any connected AIs of foreign banks under Category 1 should also be classified as Category 1 AIs; and
- Home supervision / assurance of liquidity – Given that host liquidity regulations will have cross-border implications for international banking groups and in line with the spirit of home-host supervisory cooperation, the HKMA intends to seek confirmation from the home supervisor of a potential Category 1 foreign bank (and the relevant head office if necessary) on how liquidity is being managed / regulated at the home level, with a view to assessing whether there are sufficient arrangements and safeguards (e.g. collateral arrangements) or whether sufficient comfort can be obtained to provide adequate assurance of the sufficiency, availability and transferability of funds for meeting the liquidity needs of the Hong Kong branch in a timely manner should there be a group liquidity crisis. In cases where sufficient assurance can be obtained (although the hurdle will likely be high), the HKMA may allow the foreign bank concerned to be classified under Category 2 (thereby not requiring the foreign bank to be subject to the LCR at the branch level on the strength of its consolidated LCR).

27. The HKMA would welcome the industry's feedback on the proposed approach re foreign bank branches and any operational issues that might be prompted by it.

Classification of Category 2 AIs

28. A Category 2 AI will be any AI that is not a Category 1 AI. A Category 2 AI will be subject to the MLR, but may opt for inclusion under Category 1 provided that the HKMA's consent is obtained.
29. Category 2 AIs are expected generally to include RLBs, DTCs and licensed banks (including local and foreign banks) that do not fall within Category 1 based on the proposed classification criteria.
30. While Category 2 banks will be subject to the MLR as a regulatory standard, the HKMA may for supervisory monitoring purposes require some of these banks to report their LCR / NSFR ratios to the HKMA as a monitoring tool (not as a binding standard). This approach is prompted by the need for a closer degree of supervisory scrutiny of the liquidity positions of Category 2 banks in some cases. Banks likely to be subject to this requirement would include those that (i) are marginal cases not included under Category 1; (ii) are likely to become potential Category 1 AIs in the near to medium term; and/or (iii) require closer monitoring of their liquidity positions for risk assessment purposes.
31. As a monitoring tool, this should provide the HKMA with useful and more granular information for analysing selected banks' liquidity / cash-flow positions and balance sheet structure. The focus would be on identifying any negative trend from the metrics and any indication of current or potential liquidity issues requiring discussion with the bank concerned, rather than on the absolute value of the metrics.

Section 2

Process & Procedures for Classification Framework

Initial determination of classification

32. After the proposed classification framework is finalised (taking into account the industry's comments), the HKMA proposes to conduct an assessment exercise to determine a potential list of Category 1 and Category 2 AIs and notify individual AIs of the category to which they may potentially belong (and the reasons for their classification) based on latest available information. Individual AIs may discuss with, or seek clarification from, the HKMA if they have comments or questions regarding the classification. The plan is to complete this process as soon as practicable within this year.
33. Based on the potential list of Category 1 and Category 2 AIs, the HKMA will devise, for implementation monitoring purposes, the LCR / NSFR reporting requirements to be observed by Category 1 AIs during the observation period⁶. This implementation monitoring exercise will replace the local QIS reporting exercise for the LCR / NSFR currently in place. Category 2 AIs may also be required to report their MLR for implementation monitoring purposes during the observation period (albeit probably on a less regular basis).
34. If there are circumstances that an AI considers will or may affect its classification (under Category 1 or 2) prior to the implementation of the LCR and MLR in January 2015, the AI should discuss these circumstances with the HKMA at the earliest opportunity. Any Category 2 AI that wishes to opt for inclusion under Category 1 should also seek the consent of the HKMA as soon as possible.
35. During the observation period, the HKMA proposes to monitor any change in circumstances that may result in a need to revise the classification of individual AIs. The HKMA will also collect information from individual AIs to facilitate bilateral discussion regarding the basis of calculation and scope of consolidation of the relevant liquidity standards (see Section 4 for more details).
36. Prior to the implementation of the LCR and MLR on 1 January 2015, the HKMA will formally notify individual AIs of the category (i.e. Category 1 or Category 2) to which they belong for the purposes of complying with the liquidity standard applicable to them.

⁶ The observation period will last until the end of 2014 (for the LCR) and the end of 2017 (for the NSFR).

Ongoing review and change of classification

37. The HKMA proposes to review the classification of Category 1 and Category 2 AIs annually (or whenever the HKMA is aware of a significant change in circumstances in respect of an individual AI that may affect its classification). This would be done as part of the HKMA's ongoing risk-based supervision. If the indication is that a Category 2 AI may fulfil the specified criteria for Category 1, the HKMA would propose to inform the AI concerned of its assessment and invite the AI's comments. When eligibility for Category 1 is confirmed, the HKMA would propose to give the AI a grace period to comply with the LCR (and the NSFR where applicable). The HKMA's current thinking is that a grace period of six months should be appropriate but the period could be subject to extension or curtailment if circumstances so warrant. Similar procedures would apply if the assessment relates to a Category 1 AI and the indication is that the AI may no longer meet the relevant Category 1 criteria. However, such a change (i.e. from Category 1 to Category 2) would only be initiated where there is strong supporting evidence from the AI concerned (see also paragraph 39 below).
38. Where a Category 2 AI foresees changes in its business plan or circumstances that may result in it satisfying the Category 1 criteria, the HKMA would propose that the AI be obliged to inform the HKMA in writing of such changes as soon as practicable. The HKMA would then assess whether a change in classification is justifiable.
39. The HKMA would propose that a Category 1 AI should be entitled to apply in writing to the HKMA for a change in its status to Category 2 if it can demonstrate to the HKMA's satisfaction that it no longer meets the criteria specified by the HKMA, or there is reason to expect that the criteria will not be met in the near future (e.g. due to a major change in its business plan or strategy). In such circumstances, the HKMA would likely require the AI to provide any such information or documentary evidence as is deemed necessary in the circumstances of the case. The HKMA would consider each case based on its own merits, taking into account the information provided by the AI to justify its request. The request would not be considered if the circumstances affecting the AI's classification are temporary or sporadic in nature (e.g. due to short-term fluctuations in the AI's total asset size).

Newly authorized AIs

40. The HKMA would propose to assess whether a newly authorized AI should be classified under Category 1 or 2 based on supervisory judgement, by reference to the AI's three-year business plan and other information provided to the HKMA for authorization purposes. After authorization, the HKMA would monitor the AI's actual operation to decide whether a change of classification is necessary.

Section 3

Parallel Reporting of MLR as Monitoring Tool

Floor requirement for HQLA

41. As proposed in the Consultation Paper (L1), a Category 1 AI, in complying with the LCR, would have been required to observe a floor amount of HQLA equivalent to 25% of the AI's 1-month qualifying liabilities (net of deductions) as calculated under the MLR.
42. This "floor" requirement on HQLA was prompted by an anomaly observed in the HKMA's analysis of the interplay between the LCR and MLR in comparing the results of applying the two ratios to banks with different business or liquidity risk profiles (see paragraph 15 of L1). Although, as expected, the analysis indicated that banks with significant retail portfolios tend to perform better than those with significant wholesale portfolios under the LCR, there were also cases where a bank's liquidity requirement under the LCR was lower than that under the MLR if the amount of its retail deposits due or repayable within one month is larger than that of its wholesale deposits due or repayable within one month. While the definition of liquefiable assets under the MLR will be wider than that for HQLA under the LCR, banks in the above situation will still be advantaged as they can hold a lower quantity of liquid assets if they are required to observe the LCR standard instead of the MLR standard.
43. Therefore, applying the LCR to Category 1 AIs may not in all circumstances result in a higher liquidity requirement compared to application of the MLR and this would arguably defeat the primary objective of subjecting Category 1 AIs (which are more critical to the operation of the Hong Kong banking system) to the Basel III liquidity standards. The "floor" level of HQLA, calculated by reference to the MLR, was devised and proposed to address this issue and ensure that Category 1 AIs will always be subject to the higher of the liquidity requirements under the LCR and MLR.

Replacement by MLR parallel reporting requirement

44. The anomaly described in paragraph 42 above would appear to be confined only to banks of a certain specific profile and it is difficult to predict whether the anomaly will persist as banks' behaviour adjusts to the implementation of the LCR. In light of this and noting the industry's concern about overlap between the LCR and MLR, the HKMA is minded to replace the "floor" requirement by a parallel reporting arrangement to be applied only to a limited number of Category 1 AIs that are considered to be prone to the identified anomaly. Under this arrangement, when the LCR is implemented in 2015, selected Category 1 AIs would be required (in addition to complying with the LCR as the binding statutory liquidity requirement) to adopt the MLR as a monitoring tool (no

minimum level would be set) and report the ratio to the HKMA for a 3-year transitional period.

45. During the 3-year transitional period, the HKMA will monitor and compare the positions of those AIs, subject to the parallel reporting requirement, under the LCR and MLR to determine if there is any cause for concern. (For example, if an AI's liquidity requirement under the LCR is persistently and materially below that under the MLR, there may be a case for assessing whether the LCR requirement is sufficient in respect of that AI's liquidity risk profile.) Towards the end of the transitional period, the HKMA would review the implementation experience in respect of the LCR and MLR to determine if the parallel reporting requirement for those AIs can be discontinued.
46. This monitoring metric approach is conceptually simpler and with the removal of the "floor" requirement, the LCR standard to which Category 1 AIs will be subject will not be more stringent than the Basel III requirement. The proposal would however still enable the HKMA to monitor, identify and address cases where there may be potential concern about the adequacy of liquidity requirements maintained by the Category 1 AIs concerned under the LCR.

Section 4

Basis of Calculation & Scope of Consolidation of Liquidity Standards

Basis of calculation

Background

47. Under Basel III, the liquidity standards and monitoring tools should be applied on a consolidated basis. However, national supervisors may also apply the standards and monitoring tools to individual banks or any subset of banks within a group⁷.
48. Pursuant to section 102 of the BO, the HKMA applies the LR on the following bases of calculation:
- Unconsolidated basis (i.e. Hong Kong office position) – This applies to all AIs (whether locally or overseas incorporated). Essentially, an AI is required under section 102(3) to calculate the LR on an unconsolidated basis, the scope of which is limited to the AI's business in Hong Kong, hence excluding all its subsidiaries or overseas branches; and
 - Consolidated basis – This applies to locally incorporated AIs only. Under section 102(3A), the Monetary Authority (MA) may require a locally incorporated AI to calculate the LR on a consolidated basis, either in lieu of or in addition to, the requirement for the LR to be calculated on unconsolidated basis (re section 102(3)).

For an AI to calculate the LR on a consolidated basis, the MA may under section 102(3B) require the calculation to be made only in respect of certain subsidiaries or overseas branches of the AI.

Proposal

49. To further enhance regulatory oversight and enable a more comprehensive analysis of AIs' positions under the liquidity standards (i.e. LCR / NSFR / MLR), the HKMA proposes to adopt, pursuant to section 97H(3)(d) to (f) of the Banking (Amendment) Ordinance 2012, the following bases of calculation:
- Hong Kong office basis – As with the existing requirement under section 102(3), all AIs, regardless of their place of incorporation, will be required to

⁷ See *Basel III: International framework for liquidity risk measurement, standards and monitoring*, paragraphs 187 and 188.

calculate the liquidity standards applicable to them in respect of their business in Hong Kong⁸;

- Unconsolidated basis⁹ (i.e. legal entity or solo basis) – All locally incorporated AIs will be required to calculate the standards on a legal entity basis (or solo basis) covering their overseas branches (if any). This will be a new basis of calculation when the standards are implemented; and
- Consolidated basis – Similar to the existing requirement under section 102(3A), the MA will require locally incorporated AIs to apply the standards on a consolidated basis. The main difference from the existing practice is that pursuant to section 97H(3)(e) of the Banking (Amendment) Ordinance 2012, such consolidation may cover not only an AI's subsidiaries but also any other associated entity¹⁰ (in which the AI may not necessarily have a controlling stake) as specified by the MA. This proposed extension to associated entities is intended to address some lessons learned from the recent Global Financial Crisis¹¹, and the HKMA envisages that the inclusion of such entities in the calculation of the standards will only apply in limited circumstances.

50. Thus, the HKMA may require locally incorporated AIs to apply the standards on three bases (i.e. Hong Kong office, unconsolidated (legal entity or solo), and consolidated) or on a combination of these bases. This will provide the HKMA with more relevant and comprehensive information for assessing AIs' liquidity positions as well as the distribution of their available liquidity in and outside Hong Kong. As a general principle, the HKMA would propose to require AIs to apply the standards on all three bases, unless an AI can provide adequate justifications to the HKMA that any of the bases is not applicable or necessary in its case (e.g. the AI has no (i) subsidiary or SPV-like associated entity; and/or (ii) overseas operation).

51. In the case of overseas incorporated AIs, only the "Hong Kong office basis" will be applicable. This is in line with the international practice that host supervisors supervise the liquidity risks of foreign banks operating in their jurisdictions

⁸ Under section 97H(3)(d) of the Banking (Amendment) Ordinance 2012, the MA has the discretion to require a locally incorporated AI to apply the standards on the basis that the AI's business includes all or any part of its business in or outside Hong Kong (i.e. not only in respect of the Hong Kong office). This discretion will only be exercised where necessary. For example, if an AI's Hong Kong operation deploys a significant amount of liquidity to the AI's branches in an overseas jurisdiction, the HKMA may consider requiring separate monitoring of the liquidity position of its Hong Kong office and branches in that jurisdiction. As for overseas incorporated AIs, section 97H(3)(f) provides the MA with the power to require such AIs to apply the standards only to their business in Hong Kong.

⁹ The term "unconsolidated basis" referred to here differs from that under section 102 of the BO in that the latter excludes any subsidiaries or overseas branches of the AI by virtue of section 102(3C).

¹⁰ See section 97H(4) of the Banking (Amendment) Ordinance 2012 for definition of "associated entity".

¹¹ Cases became apparent in the crisis where special purpose vehicles (SPVs) established by banks for securitization purposes posed significant liquidity risk to the banks concerned in spite of their lack of a controlling stake in those SPVs.

while the home supervisors of those banks supervise their liquidity risks on a consolidated basis.

Scope of consolidation

52. The Basel III liquidity requirements indicate that the application of the liquidity standards will follow the existing scope of application set out in the Basel II framework¹². At present, when requiring an AI to calculate the LR on a consolidated basis, the HKMA will select relevant subsidiaries and overseas branches of the AI for consolidation purposes. There are also some existing guidelines (i.e. the modules “Liquidity Risk Management” (LM-1) and “Sound Systems and Controls for Liquidity Risk Management” (LM-2) under the Supervisory Policy Manual)¹³ providing relevant principles and examples that may be considered by the HKMA in determining the scope of consolidation.
53. In determining which of the subsidiaries (or associated entities where appropriate) of a locally incorporated AI should be included in the consolidated calculation of the new liquidity standards, the HKMA will have principal regard to the level of liquidity risk of the AI’s associated entities (including subsidiaries). The aim is to capture those entities that pose a material liquidity risk to the banking group concerned. In general, consistent with the scope of application under the Basel II framework, such entities will normally include those engaged in banking activities, or in other activities that may subject the group to material liquidity risk exposures¹⁴.

Determination for individual AIs

54. As part of the process for implementing the liquidity standards, the HKMA will enter into discussions with individual AIs after the classification framework for Category 1 and Category 2 AIs is finalised for the purpose of determining for each AI (i) the bases of calculation of the liquidity standards applicable to an AI; and (ii) if the AI is to apply the standards on a consolidated basis, which of its associated entities (including subsidiaries) should be included in the consolidation.

¹² See paragraph 187 of *Basel III: International framework for liquidity risk measurement, standards and monitoring*.

¹³ See para. 4.1.6 of LM-1 and para. 1.3.3 of LM-2.

¹⁴ AIs may have regard to the activities within the definition of “financial entities” under the Basel II framework, which include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking, although this should not be regarded as an exhaustive list.