HONG KONG MONETARY AUTHORITY 香港金融管理局		
Supervisory Policy Manual		
LM-1	**Regulatory Framework for Supervision of Liquidity Risk**	**V.2 (consultation)**

This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To provide guidance to AIs on the application of the Banking (Liquidity) Rules.

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §7(3)

Previous guidelines superseded

LM-1 "Liquidity Risk Management" (V.1A) dated 01.04.11

Application

To all AIs

Structure

1. Introduction
2. Approach to supervising liquidity risk
3. Statutory liquidity requirements
   - 3.1 Liquidity Coverage Ratio (LCR)
   - 3.2 Liquidity Maintenance Ratio (LMR)
   - 3.3 Implementation of LCR or LMR on Hong Kong office basis, unconsolidated basis and consolidated basis
   - 3.4 Notification of liquidity events and supervisory responses
   - 3.5 Internal targets and limits
4. Determination of category 1 and category 2 institutions

4.1 General

4.2 Designation of category 1 institutions

4.3 Revocation of designation

4.4 Application for designation (or revocation of designation)

4.5 Ongoing review of designation

5. Application of LCR

5.1 Structure of LCR

5.2 High quality liquid assets (HQLA)

5.3 Level 1 assets

5.4 Level 2A assets

5.5 Level 2B assets

5.6 Ceilings on level 2 assets

5.7 Alternative Liquidity Approach (ALA)

5.8 Total net cash outflows

5.9 Monetization of HQLA under financial stress

6. Application of LMR

6.1 Structure of LMR

6.2 Liquefiable assets

6.3 Qualifying liabilities

6.4 Deductions from qualifying liabilities

7. Liquidity disclosure standard

7.1 Disclosure of LCR or LMR information

7.2 Disclosure of information on liquidity risk management

7.3 Other liquidity information

7.4 Disclosure policy

Annex 1: Assets regarded as “free from encumbrances” under LCR or LMR

Annex 2: Guidance on treatment of RMBS under LCR or LMR

1. Introduction

1.1 Liquidity risk is the risk that an authorized institution (AI) may not be able to meet its obligations as they fall due without incurring unacceptable losses. This may be caused by an AI's inability to liquidate assets or to obtain funding to meet its liquidity needs, whether because of institution-specific reasons or market stress.

1.2 Liquidity problems can have an adverse impact on an AI's earnings and capital and, in extreme circumstances, can lead to the collapse of an AI. A liquidity stress besetting individual AIs that play an active or major role in financial activities may have systemic consequences for other AIs and the banking system as a whole. It could also affect the proper functioning of payment systems and other financial markets. Sound liquidity risk management is therefore pivotal to the viability of every AI and the maintenance of overall banking stability.

1.3 To promote the resilience of banks and banking systems to liquidity stress, the Basel Committee on Banking Supervision (BCBS) has issued a set of *Principles for Sound Liquidity Risk Management and Supervision* to strengthen international standards in this area. In addition, two quantitative metrics have been introduced by the BCBS as minimum international standards for liquidity management and supervision:

- the Liquidity Coverage Ratio (LCR), which came into operation from 1 January 2015; and
- the Net Stable Funding Ratio (NSFR), which will commence effect from 1 January 2018. (The local regulations implementing the NSFR will be issued in due course.)

1.4 In Hong Kong, it is one of the ongoing minimum criteria for authorization (provided in paragraph 7 of the Seventh Schedule to the Banking Ordinance (BO)) that the Monetary Authority (MA)[1] should be satisfied that an AI, on and after authorization, maintains adequate liquidity to meet its

[1] In this module, the term "MA" 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.

obligations as they will or may fall due; and complies with the rules[2] made by the MA under §97H(1) of the BO. In this regard, the MA has made the Banking (Liquidity) Rules (BLR) under §97H(1) to prescribe the requirements in respect of –

- the LCR, which is applied to AIs designated by the MA as "category 1 institutions"; and
- the Liquidity Maintenance Ratio (LMR), a local liquidity standard developed by the MA for application to all other AIs that are not designated as category 1 institutions, and which are referred to as "category 2 institutions".

1.5 Moreover, the MA has issued a Code of Practice[3] (the Code) under §97M of the BO to supplement the implementation of the LCR. Standard calculation templates are also included in the Return of Liquidity Position of an Authorized Institution (MA(BS)1E) to facilitate the calculation and reporting of the LCR or LMR by different categories of AIs.

1.6 This module (i) provides an overview of the regulatory framework adopted by the MA for supervising AIs' liquidity risk; and (ii) sets out the approach the MA will take in assessing AIs' compliance with the statutory liquidity requirements provided in the BLR.

1.7 Failure of an AI to adhere to the guidelines in this module may call into question whether the AI continues to satisfy the authorization criterion set out in paragraph 7 of the Seventh Schedule to the BO.

1.8 AIs are also reminded that merely complying with the statutory liquidity requirements in the BLR or meeting the guidelines set out in this module is not of itself sufficient to constitute prudent liquidity risk management. In particular, AIs should adopt additional sound systems and controls tailored to their liquidity risk profiles, having regard to the size, nature and complexity of their businesses and activities. Please refer to the Supervisory Policy Manual (SPM) module LM-2 "*Sound*

[2] Unless otherwise specified, any "rule" cited in this module means a rule included in the BLR.

[3] This refers to the *Banking (Liquidity Coverage Ratio – Calculation of Total Net Cash Outflows) Code*, issued by the MA in December 2014.

Systems and Controls for Liquidity Risk Management" for details.

1.9 This module should be read in conjunction with the BLR, the Code, the Completion Instructions (CIs) for Return MA(BS)1E, SPM module LM-2 and other relevant supervisory documents that may be issued by the MA. The terms used in this module have the meanings used in the BLR or the Code, as the case may be, unless otherwise specified or the context otherwise requires.

2. Approach to supervising liquidity risk

2.1 A key supervisory objective of the MA in respect of liquidity risk is to seek to ensure that AIs can always meet their obligations as and when they fall due, and for this purpose to assess the adequacy of AIs' overall liquidity risk management frameworks and liquidity positions so as to endeavour to reduce the frequency and severity of liquidity problems affecting AIs and to reduce any potential impact on the banking system. To achieve this objective, every AI is required to –

- maintain adequate liquidity in compliance with the minimum LCR or LMR requirement (whichever is applicable); and
- put in place sound systems and controls for the management of liquidity risk.

Furthermore, AIs will be expected to observe any other supervisory requirements as specified by the MA from time to time for the purpose of enhancing AIs' liquidity risk management.

2.2 The MA adopts a risk-based supervisory approach to monitor AIs' liquidity positions and assess the soundness of their liquidity risk management systems and controls through a combination of supervisory actions, including (but not limited to) risk-focused off-site reviews, on-site examinations and prudential meetings. See SPM module SA-1 "*Risk-based Supervisory Approach*" for details of the MA's risk-based supervisory approach.

2.3 In the course of risk-based supervision, the MA conducts off-

site analysis on an AI's liquidity positions. The information required for analysis is primarily obtained via the AI's regular submissions of the following returns:

- Return on Liquidity Position of an Authorized Institution (MA(BS)1E), which reflects an AI's liquidity position as measured by the LCR or LMR;

- Return on Intraday Liquidity Position of an Authorized Institution (MA(BS)22), which reflects an AI's intraday liquidity positions;

- Return on Liquidity Monitoring Tools (MA(BS)23), which reflects an AI's liquidity profiles with respect to (i) the level of concentration of funding sources, (ii) the amount of unencumbered assets that may be used as collateral for funding purposes, (iii) committed facilities granted and received, (iv) maturity mismatch positions, and (v), in the case of a category 1 institution, LCR positions in individual currencies; and

- Return on Selected Data for Liquidity Stress-testing (MA(BS)18), which is used by the MA to collect information from locally incorporated licensed banks to facilitate supervisory stress-testing focusing on their short-term liquidity positions (covering 7 working days)

2.4 Where necessary, the MA may request an AI to provide additional information on the AI's liquidity positions. For example, an AI may be requested to provide its internal cash-flow projections and liquidity stress-testing results, as well as information in respect of the associated methodologies and assumptions, to facilitate supervisory monitoring and review of the AI's liquidity risk profile.

2.5 In addition to conducting offsite reviews, the MA may also conduct on-site examinations to evaluate an AI's liquidity risk management systems and controls. The frequency and scope of coverage of such examinations are determined by the MA on a case-by-case basis, having regard to actual circumstances and the materiality of prudential concerns about a particular AI's liquidity risk profile.

2.6 In the course of liquidity risk supervision, while the MA will

have primary regard to whether an AI complies with the requirements of the BLR and the associated supervisory documents (including the Code, this module, SPM module LM-2, and the CIs for the various liquidity returns), the MA may also take into account the AI's compliance with other relevant guidelines and sound practices, e.g. those set out in SPM modules IC-1 "*General Risk Management Controls*" and IC-5 "*Stress-testing*".

2.7 The results of the MA's offsite review and on-site examination of an AI's liquidity risk position and liquidity risk management systems will be taken into account in determining the AI's CAMEL rating, and in the case of a locally incorporated AI, the regulatory capital requirement under the Supervisory Review Process (see SPM module CA-G-5 "*Supervisory Review Process*"). Where considered necessary, appropriate supervisory measures may also be taken based on such reviews and examinations.

2.8 The MA also seeks to maintain effective communications with AIs' Boards of directors, senior management, auditors, and, where applicable, with overseas supervisory authorities to discuss prudential issues relating to the relevant AIs, including their liquidity positions and risk management controls. Such communications may be undertaken in various forms of prudential meeting or in any other appropriate means to facilitate effective exchange of views and information.

3. Statutory liquidity requirements

3.1 Liquidity Coverage Ratio (LCR)

3.1.1 The LCR is a ratio, expressed as a percentage, of the total weighted amount of a category 1 institution's "high quality liquid assets" (HQLA) to the total weighted amount of its "total net cash outflows" over 30 calendar days (the LCR period):

$$\text{LCR} = \frac{\text{HQLA}}{\text{Total net cash outflows}} \times 100\%$$

3.1.2 A category 1 institution must maintain an LCR of not less than the minimum required levels specified in rule

4(1) and 4(2) as follows:

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

3.1.3 As provided in rule 4(3), failure of a category 1 institution to maintain the minimum required level of LCR will not constitute a contravention of rule 4(1) or 4(2) if, but only if, it is due to the institution's monetization of its HQLA when the institution is undergoing significant financial stress and its financial circumstances are such as described in rule 6.

3.1.4 Specific guidance on the application of the LCR (including the monetization of HQLA by a category 1 institution under rule 6) is provided in section 5 below.

3.2 Liquidity Maintenance Ratio (LMR)

3.2.1 The LMR is a ratio, expressed as a percentage, of the amount of a category 2 institution's "liquefiable assets" to the amount of the institution's "qualifying liabilities" (after deductions) over a calendar month:

$$\text{LMR} = \frac{\text{Liquefiable assets}}{\text{Qualifying liabilities (after deductions)}} \times 100\%$$

3.2.2 As required under rule 7, a category 2 institution must maintain an LMR of not less than 25% on average in each calendar month.

3.2.3 Specific guidance on the application of the LMR is provided in section 6 below.

3.3 Implementation of LCR or LMR on Hong Kong office basis, unconsolidated basis and consolidated basis

3.3.1 §97H(3) of the BO empowers the MA to apply liquidity requirement rules on different bases that may cover all or any part of an AI's business operations.[4] The

[4] Please refer to §97H(3)(d) to (f) of the BO.

manner in which the MA exercises this power is provided specifically in rules 10 to 12.

3.3.2 Under rule 10(1)(a), every AI, irrespective of its place of incorporation, must calculate its LCR or LMR, as the case may require, on the basis that covers all of its business in Hong Kong (Hong Kong office basis).

3.3.3 Rule 10(1)(b) requires further that an AI incorporated in Hong Kong having any overseas branches must calculate its LCR or LMR additionally on an unconsolidated basis covering all of its business in Hong Kong and overseas branches, unless the MA is satisfied that the liquidity risk associated with the business of an AI's overseas branch is immaterial and hence approves, under rule 10(3)(a), the exclusion by the AI of any of its overseas branches from the calculation.

3.3.4 Rule 11(1) provides that a locally incorporated AI having any associated entity (as defined in §97H(4) of the BO) may be required by the MA to calculate its LCR or LMR additionally on a consolidated basis, being the AI's Hong Kong office basis or the unconsolidated basis (where applicable) plus one or more of its associated entities specified by the MA.

3.3.5 Moreover, the MA may, pursuant to rule 12, require a locally incorporated AI to calculate its LCR or LMR additionally on a specially tailored basis covering any part of the AI's business in or outside Hong Kong. The application of rule 12 to a locally incorporated AI is likely to be considered by the MA only in exceptional circumstances, where the MA is of the opinion that the bases of calculation of the LCR or LMR required under rules 10 and 11 would be insufficient to reflect an AI's liquidity risk profile.[5]

[5] For example, if a locally incorporated AI is expanding the operation of an overseas branch or associated entity quickly and the MA is of the opinion that the liquidity risk arising from the operation may not have been reflected clearly in the AI's LCR or LMR calculated on an unconsolidated basis or consolidated basis, the MA may require the AI to calculate its LCR or LMR covering the branch or associated entity on a stand-alone basis .

3.3.6 In determining the consolidated group of a locally incorporated AI for liquidity purposes, the MA may, to the extent practicable, seek to follow the scope of consolidation in respect of the AI for other regulatory purposes (for example, for the regulation of capital adequacy and large exposures). Nevertheless, this does not preclude the possibility that the MA may apply different scopes of consolidation to a locally incorporated AI for different regulatory purposes.[6]

3.3.7 In particular, for liquidity purposes, the consolidated group of a locally incorporated AI may include associated entities which may not be majority owned or controlled by the AI. In determining which associated entities of a locally incorporated AI should be included in the AI's consolidated group for liquidity purposes, the MA will primarily have regard to (i) the respective liquidity risks that the entities concerned pose to the AI and (ii) whether the respective activities of such entities fall within any of the relevant financial activities as defined in rule 11.

3.3.8 As required under rule 13(1), a locally incorporated AI that calculates its LCR or LMR on a consolidated basis must give notice in writing to the MA of any of the matters concerning its associated entities that are specified in rule 13(2)[7] as soon as is practicable after the institution becomes aware of the matter. This will allow the MA to review the scope of consolidation for the application of the LCR or LMR to the AI.

3.3.9 When a category 1 institution calculates its LCR on a basis covering any branch or associated entity operating in a host country where the associated liquidity requirement is different from that in Hong Kong, the institution should apply the requirements set out in

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[6] For example, whilst the MA usually does not require a locally incorporated AI to include its associated entities that are securities or insurance companies (hence subject to distinct capital requirements) in its consolidated group for regulatory capital purposes, the MA may instead require the AI to include such associated entities in the scope of consolidation for liquidity purposes if the MA considers that the liquidity risks posed by these entities to the AI are significant.

[7] These matters basically relate to entities becoming (or ceasing to be) an AI's associated entities and their principal activities (and changes in these activities).

the BLR and the Code for calculating its LCR, unless in the circumstances where rule 22(2) applies to the institution. In this case (i.e. where rule 22(2) applies), the institution should follow the requirements set out by the relevant banking supervisory authority in that host country insofar as the calculation relates to the retail deposits and small business funding of the institution's branch or associated entity operating in that country. (Please refer to paragraphs 5.8.2 to 5.8.19 below for further guidance.)

3.4 Notification of liquidity events and supervisory responses

3.4.1 Under the BO and the BLR, AIs have various obligations to notify the MA of specified matters in respect of their LCR or LMR positions.

3.4.2 Under rule 5, a category 1 institution is obliged to notify the MA as soon as practicable of any anticipated change in its HQLA or total net cash outflows that will cause (or could reasonably be construed as potentially causing) its failure to maintain an LCR as required under rule 4(1) or 4(2) (where applicable). Likewise, every category 2 institution is subject to a similar requirement under rule 8 to report any anticipated change in its liquefiable assets or qualifying liabilities (after deductions) that may make it unable to maintain its LMR at a level not less than 25%. These notification requirements enable the MA to be alerted of any potential liquidity problem anticipated by an AI so that proactive measures can be taken as appropriate.

3.4.3 Moreover, rule 14 provides that, for the purposes of complying with the "prescribed notification requirements" set out in §97I of the BO, an AI must immediately notify the MA of any "relevant liquidity event" prescribed in rule 14(3), and provide the MA with any particulars of the event upon request.[8] Such relevant liquidity events include –

[8] 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 §97I of the BO.

(a) for a category 1 institution:

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

(ii) the institution taking, or being 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;

(iii) the institution having received a notice from the MA setting out the conditions under rule 16(1) to address an event falling within subparagraph (ii) above, but failing to comply with any of the conditions;

(iv) the institution, being a "rule 37 institution"[9], failing to comply with rule 37(d), meaning that the institution fails to maintain an amount of HKD-denominated HQLA (that are level 1 assets) at a level not less than 20% of its HKD-denominated total net cash outflows; and

(b) for a category 2 institution: failing to comply with rule 7 (in respect of the 25% minimum LMR requirement).

3.4.4 In the case of a liquidity event that constitutes a

[9] A "rule 37 institution" refers to a category 1 institution that applies the provisions of rule 37 in the calculation of its LCR. That rule, in conjunction with the other rules provided in Division 4 of Part 7 of the BLR, prescribes the framework of one of the options from amongst the "alternative liquidity approaches" as provided by the BCBS (the ALA option). For further details of this framework, please refer to subsection 5.7 below.

contravention of the BLR (and hence §97H(6) of the BO), the MA may, after holding discussions with the AI, issue a notice to the AI pursuant to §97J of the BO, requiring it to take remedial action as specified in the notice. To the extent practicable, the MA will require the AI concerned to improve its liquidity position and rectify identified liquidity management problems within a reasonable timeframe. Where the circumstances warrant, the MA may take more serious supervisory measures to maintain the general stability of the banking system and protect the interest of depositors (including potential depositors).[10]

3.4.5 The MA's potential supervisory responses to relevant liquidity events falling within the meaning of rule 14(3)(a)(ii) and rule 14(3)(a)(iv) are elaborated upon in subsection 5.9 below.

3.5 Internal targets and limits

3.5.1 As mentioned in paragraph 3.1.2 above, the MA has adopted a phase-in arrangement whereby the minimum LCR requirement will be stepped up steadily until it reaches 100% by 1 January 2019. The phased implementation of the minimum LCR requirement should not, however, be viewed by category 1 institutions as an opportunity to slow down the pace of conformance with the LCR requirements. To guard against this eventuality, the MA expects each category 1 institution to set up an internal target for its LCR position, taking into account the institution's liquidity risk profile and the need to incorporate a sufficient buffer to provide the institution with a "safety cushion" above the regulatory minimum requirements.

3.5.2 A category 1 institution's internal LCR target should be reviewed and approved by the Board (or a Board-level

[10] These measures may include, for example, ring-fencing the institution's business activities (including deposit-taking activities); reviewing the fitness and propriety of any person (including a controller, director, chief executive, or manager) 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.

committee) of the institution[11] at least annually. The review should take into account, among other relevant factors, the annual increments in the minimum requirement during the phase-in period (2015 to 2018) and the historical trend of the institution's LCR positions. For example, if a category 1 institution has maintained an LCR at a relatively low level or has exhibited a volatile trend in its LCR over a considerable period of time (say, during the past 12 months), it may need to provide for a more prudent "safety cushion" in its internal LCR target to ensure ongoing compliance with the regulatory minimum LCR requirement.

3.5.3 If a category 1 institution's LCR has already reached a level that is above the minimum requirement in any of the years during the phase-in period, the institution should set its internal LCR target for the coming year at a level not less than it has already been able to achieve, until its internal LCR target is able to safely ensure full compliance with a 100% LCR requirement.

3.5.4 Similarly, the MA also expects each category 2 institution to set an internal target for its LMR position, taking into account the institution's liquidity risk profile. Such internal target should be reviewed and approved by the Board (or a Board-level committee) of the institution at least annually.

3.5.5 In line with the requirements set out in SPM module LM-2 (sections 4 and 5), each AI should conduct regular projections and stress-testing of its LCR or LMR position as part of its liquidity risk management process, in order to identify risk drivers that may lead to drastic fluctuations in its LCR or LMR. In addition, AIs should formulate prudent metrics and internal limits (e.g. making reference to LCR by currencies, or to cash flows in tenor buckets that are more granular than those required by the LCR/LMR) as supplementary controls to ensure compliance with the LCR or LMR

[11] In the case of a category 1 institution which is incorporated outside Hong Kong, it is acceptable to have the internal LCR target for its Hong Kong branch reviewed and approved by a risk management function at its head office located outside Hong Kong.

requirements and enhance resilience to possible liquidity stress.

3.5.6 In the course of risk-based supervision, the MA 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 necessary, the MA may subject an AI to closer supervisory scrutiny, or expect it to raise its internal liquidity target within a reasonable timeframe, if the MA considers it prudent or reasonable.

4. Determination of category 1 and category 2 institutions

4.1 General

4.1.1 In view of the diversity of AIs in terms of the nature, size and complexity of their business operations, the MA considers it appropriate to tailor proportionate liquidity requirements for different types of AIs taking into account their specific characteristics.

4.1.2 The LCR and the LMR are both designed to promote resilience to short-term funding risks, but there are differences in their respective conceptual frameworks and structures. The characteristics and profiles of AIs designated by the MA as "category 1 institutions" are such that it is considered both appropriate and more prudent for them to be required to observe the more granular and stress-based LCR requirement. Other AIs not designated as "category 1 institutions" are regarded as "category 2 institutions" and are required to observe the LMR requirement.

4.2 Designation of category 1 institutions

4.2.1 Under rule 3(1), the MA may designate an AI as a category 1 institution if he is satisfied that any of the grounds specified in Part 1 of Schedule 1 to the BLR (Specified Grounds) is applicable to the AI. (In the case of an AI that applies for the designation but none of the grounds specified in Part 1 of that Schedule is applicable to the AI, please refer to subsection 4.4 below).

4.2.2 *Ground 1: The AI is internationally active.* In determining whether an AI is internationally active, the MA will assess the level of the AI's international exposure, as measured by the aggregate amount of its external claims and liabilities, against a quantitative benchmark.[12]

4.2.3 *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 MA will assess:

(a) the size of the AI's business operation, as measured by the amount of its total assets (after provisions), against a quantitative benchmark;[13] and

(b) the AI's role (including any special function undertaken) or level of participation in the

[12] The adoption of this measure recognises that an AI with a significant level of external claims and liabilities tends to be more vulnerable to spill-over effects from crises and shocks that may occur in other countries. The MA relies mainly on the data reported by the 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 countries, and thus still pose a degree of cross-border risk to the AI concerned.

For the purpose of initial designation of category 1 institutions to accommodate with the commencement of the LCR requirement from January 2015, the MA, after consulting the local banking sector, set the quantitative benchmark at HK$250 billion in order to assess whether an AI should be regarded as being "internationally active" by reference to the level of its international exposure. This benchmark will be subject to review from time to time, 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.

[13] 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. Having consulted the local banking sector, the MA set this benchmark at HK$250 billion for the initial designation of category 1 institutions. As with the other benchmark for AIs' international exposure, this benchmark on the size of an AI's operation will be subject to periodic review.

In the assessment of a locally incorporated AI without any overseas branch or an overseas incorporated AI, the benchmark is applied to the AI's "total assets (after provisions)" covering its Hong Kong office position, as reported by the AI in the *Return of Assets and Liabilities of an Authorized Institution* (MA(BS)1). In the case of a locally incorporated AI that has overseas branch operation, the benchmark is applied to the AI's "total assets (after provisions)" covering its unconsolidated position (i.e. the combined position of its Hong Kong office and all overseas branches), as reported by the AI in the *Combined Return of Assets and Liabilities of an Authorized Institution* (MA(BS)1B).

local banking system or financial markets[14]. Primary focus is placed on whether the AI may act as a significant conduit for transmitting liquidity problems across AIs, or may have a 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 difficulty or should the relevant financial role or function performed by the AI, or its participation in a particular market activity, be disrupted.[15]

4.2.4 *Ground 3: The liquidity risk associated with the AI is material.* For the purposes of rule 3, the MA 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.[16]

4.2.5 *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) to engage in a degree of regulatory arbitrage (e.g. through intra-group transfers of assets and liabilities) for the purpose of

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

[15] 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, a banknote-issuing function and serving as a clearing and settlement bank for major payment and settlement systems in Hong Kong.

[16] For example, the MA may assess, among other things, whether an 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.

reducing their regulatory liquidity requirements. As a safeguard, if the risk of regulatory arbitrage for such connected AIs is considered high, the MA may decide to designate all of them as category 1 institutions even though they do not all meet one of the other grounds for such designation.

4.2.6 Where there may be a potential risk of regulatory arbitrage for a group of connected AIs, the MA 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.[17]

4.2.7 Whilst the MA expects that in most cases the indicators and benchmarks referred to in paragraphs 4.2.2 to 4.2.6 above will be sufficient for the MA to make the assessment, there may still be cases where an AI's fulfilment of the Specified Grounds can only be observed by reference to other factors. In these cases, the MA will discuss the rationale behind the designation with the AI concerned.

4.2.8 The MA will adopt, as appropriate, a forward-looking approach in assessing AIs relative to 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.

4.2.9 The MA 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,

[17] Concern over regulatory arbitrage relates mainly to those AIs which are connected to the category 1 institution but are not subject to the MA's consolidated supervision in respect of their liquidity positions.

for example, the AIs' business operations in Hong Kong are closely integrated, or there is a specific plan for merging the AIs' business activities.

Restricted licence banks and deposit-taking companies

4.2.10 In general, it is not likely that the MA would designate restricted licence banks (RLB) or deposit-taking companies (DTC) as category 1 institutions in the light of their relatively small, simple and localised operations, which typically render the grounds specified in paragraphs 4.2.2 and 4.2.3 not applicable to these types of AIs. Nonetheless, the MA retains the power to designate an RLB or DTC as a category 1 institution if warranted by exceptional circumstances, in which case the MA will explain the underlying reasons for the designation to the AI concerned.

Consideration of overseas incorporated AIs under rule 3(4)

4.2.11 As provided by rule 3(4), the MA may decide not to designate an AI as a category 1 institution in the circumstances specified in Part 3 of Schedule 1 to the BLR, notwithstanding that the AI may otherwise meet any of the Specified Grounds.

4.2.12 For instance, some overseas incorporated banks operating branches in Hong Kong are affiliated to international banking groups. Their branches in Hong Kong may be covered by their groups' global liquidity management models and the consolidated LCR requirements imposed on their groups by the relevant home supervisors. In these circumstances, the MA considers it reasonable to allow some degree of reliance on the "group" liquidity of overseas incorporated AIs, and may apply rule 3(4) if the circumstances specified in §2 of Part 3 of Schedule 1 to the BLR are met:

(a) the AI is adequately supervised in respect of liquidity risk by the relevant banking supervisory authority of the place of its incorporation – The liquidity requirements and supervisory standards applicable to the AI on

a group basis covering its Hong Kong branch should be comparable to international liquidity standards, including the LCR and the *Principles for Sound Liquidity Risk management and Supervision* set out by the BCBS; and

(b) the AI complies with the liquidity requirements in the place of its incorporation – Upon request by the MA, the AI should be able to demonstrate that its banking group (covering its Hong Kong branch) is able to meet the relevant liquidity requirements in its home country.

4.2.13 The MA may also, in its review of the criteria discussed in paragraph 4.2.12, take into account other related factors, such as –

(a) Global liquidity risk management system – The foreign banking group's global liquidity risk management system should enable its Hong Kong branch to fulfil the MA's liquidity requirements in all major aspects, including the requirements relating to the LMR as set out in the BLR (in case the AI concerned is not designated as a category 1 institution) and other relevant guidelines on liquidity risk management and controls, as specified in SPM module LM-2[18]; and

(b) Effective home-host information sharing arrangements – There should be in place effective communication and information-sharing channels between the MA and the foreign banking group's home supervisor such that the MA is able to obtain supervisory

[18] 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 timely transfer of funds to the Hong Kong branch if necessary. Moreover, the AI should be able to demonstrate that there is no legal or regulatory impediment (such as exchange control or remittance restriction) in the home country that prohibits the foreign bank from transferring liquidity to its Hong Kong branch as and when necessary.

opinions and relevant information from the home supervisor on the foreign banking group's liquidity position on a timely basis.

4.2.14 The MA may utilise any available channels to obtain information for the assessment of the above "group factors" relevant to an overseas incorporated AI. For this purpose, the MA may communicate with the AI's Hong Kong branch or head office, or initiate supervisory dialogues with the AI's home supervisor if necessary. Where appropriate, the MA may draw reference from the report on a country's liquidity supervisory framework that may be issued by the BCBS under its Regulatory Consistency Assessment Programme.

Newly authorized AIs

4.2.15 In the case of new authorizations, the MA will consider whether the applying institution should be designated as a category 1 institution if it is authorized, by reference to the institution's medium-term business plan (usually covering 3 years) and other information provided to the MA for authorization purposes. After authorization, the MA will monitor the institution's actual operation to decide whether the designation should be maintained or changed.

4.3 Revocation of designation

4.3.1 Pursuant to rule 3(5), the MA may revoke the designation of an AI as a category 1 institution if the MA is satisfied that had the designation not been made, he would not now make the designation. Practically, this means that the AI concerned no longer meets any of the Specified Grounds that had originally prompted the MA to designate it as a category 1 institution, or such grounds will not be met in the near future (e.g. due to a permanent change in the institution's financial position, corporate structure or business strategy).[19]

[19] Temporary or sporadic changes are not regarded as sufficient grounds for the MA to designate, or revoke the designation of, an AI as a category 1 institution.

4.4 Application for designation (or revocation of designation)

4.4.1 Decision by the MA under rule 3(1) and (5) may be made upon an application by an AI. Upon receipt of the AI's application for designation as a category 1 institution, the MA will approve the application pursuant to rule 3(1) if –

(a) any of the Specified Grounds is applicable to the AI; or

(b) the MA is satisfied that both the grounds set out in Part 2 of Schedule 1 to the BLR are applicable to the AI. This means that the AI's particular circumstances provide reasonable justification for it to be designated as a category 1 institution;[20] and the AI has the capacity (including systems and resources) to comply with the LCR requirements.

4.4.2 In the case of a category 1 institution that applies for revocation of its designation as such, the institution must demonstrate to the MA's satisfaction that the conditions set out in rule 3(5) (as elaborated in subsection 4.3 above) are no longer applicable to it, or will no longer be applicable to it starting from a specific date. The MA will review critically whether there is any case to revoke the designation of the applying institution.

4.5 Ongoing review of designation

4.5.1 In the course of risk-based supervision, the MA may review whether a category 2 institution should be designated as a category 1 institution, or whether the designation of an AI as a category 1 institution should be revoked, for example, if the MA is aware of a significant change in circumstances in respect of the AI that may affect the MA's decision under rule 3.

[20] For example, an AI, being a part of a foreign banking group which implements the LCR at the group level, may have a case to seek designation by the MA as a category 1 institution for the sake of consistency with its group's liquidity risk management framework.

4.5.2 As required under rule 15, 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 MA as soon as practicable.

4.5.3 If the MA envisages the need to designate, or revoke the designation of, an AI as a category 1 institution, the MA will enter into discussion with the AI concerned to explain the ground for making the change. When the MA's decision is finally issued, the AI will be given a grace period to prepare for implementing the LCR or LMR requirement accordingly.[21] In these circumstances, the AI concerned will be expected to agree with the MA on an implementation plan in order to ensure the institution's prompt compliance with the newly applicable requirement.

5. Application of LCR

5.1 Structure of LCR

5.1.1 The LCR has two components:

(a) The numerator is the total weighted amount of HQLA held by a category 1 institution, including the sum of weighted amounts of level 1 assets, level 2A assets and level 2B assets, net of any adjustments that may be caused by the applications of the ceilings on level 2 assets (see subsection 5.6) and the ALA option (see footnote 9 and subsection 5.7); and

(b) The denominator is the "total net cash outflows", which means a category 1 institution's "total expected cash outflows" after deduction of its "total expected cash inflows", where the amount of deduction shall

[21] The grace period will be specified in the MA's notice to be issued to the AI through the denotation of the effective date of the designation or revocation of designation, as the case may be. Normally, the length of the grace period will not be less than 6 months. A longer grace period may be allowed if the actual circumstances of an individual case so warrant.

not exceed 75% of the total expected cash outflows.

5.2 High quality liquid assets (HQLA)

General

5.2.1 As a basic principle, a category 1 institution should include assets as its HQLA only to the extent that they can be easily and immediately monetizable at all times within the LCR period with little or no loss of value. As provided in rule 25, a category 1 institution must not include an asset in its HQLA unless –

(a) the asset falls within a class of assets specified in Schedule 2 to the BLR and meets the qualifying criteria (if any) specified in that Schedule for that class of assets;

(b) the asset satisfies all the characteristic requirements specified in Schedule 3 to the BLR that are applicable to the asset;

(c) the asset satisfies all the operational requirements specified in Schedule 4 to the BLR that are applicable to the asset; and

(d) the institution satisfies all the operational requirements specified in Schedule 4 to the BLR that are applicable to the institution insofar as those operational requirements relate to the asset.

5.2.2 Category 1 institutions should put in place appropriate systems and procedures to evaluate whether the requirements provided in rule 25 are satisfied in order for a particular asset to be included in an institution's HQLA. This assessment should be conducted periodically by an appropriate function (e.g. risk management or compliance function) within the institution, and proper arrangements should be in place to ensure sufficient checks and balances in the assessment process.

Characteristic requirements

5.2.3 The characteristic requirements set out in Schedule 3 to the BLR are elaborated below:

(a) Low risk – The risks (including, for example, credit risk, interest rate risk, legal or any other types of risk) associated with the asset should be sufficiently low, so that they do not prejudice the asset's ability to be monetizable. For example, high credit standing of the issuer and a low degree of subordination increase an asset's liquidity. Low duration[22], low legal risk, low inflation risk and denomination in a convertible currency with low foreign exchange risk all enhance an asset's liquidity.

(b) Ease and certainty of valuation – The value of the asset should be readily identifiable and measurable, and can be readily agreed on by parties to a transaction involving the asset, whether by reference to the asset's book value or current market price, or a simple valuation method or pricing formula based on publicly available market data.

(c) Simple structure – If the asset is a structured financial instrument, the structure of the instrument should be simple and standardised and it should not inhibit valuation or risk assessment. This implies that most structured financial instruments are usually not recognised as HQLA, except qualifying covered bonds and residential mortgage-backed securities (RMBS).

(d) Low correlation with risky assets – The asset should not have a strong correlation with another asset that carries material risks, nor should it significantly expose the holding

[22] Duration measures the price sensitivity of a fixed income security to changes in interest rate.

institution to specific wrong-way risk or general wrong-way risk. [23] For example, securities issued by financial institutions are usually not qualified for inclusion as HQLA, save for a limited number of exceptions, such as qualifying covered bonds and RMBS, and securities issued by a financial institution which is a public sector entity (PSE).

(e) Active and sizable market with low volatility – If the asset is traded in a secondary market (whether for outright disposal or securities financing transactions), the market should be active and sizable such that the asset can be readily monetized without a substantial discount or haircut to its market price.[24] The historical volatility associated with the trading prices and spreads of the asset should be demonstrably low. In this regard, specific thresholds on price volatility are set out in §4 to §8 of Part 3 of Schedule 2 to the BLR as one of qualifying criteria for the inclusion of specific types of assets as HQLA – please refer to paragraphs 5.4.1(a)(iii) and (b)(iii), 5.5.2(a)(ii) and paragraph 3(d) in Annex 2.

(f) Listed on a developed and recognized exchange – If the asset is listed on an exchange, the exchange should be a

[23] "*Specific wrong-way risk"* has the meaning given in §226A of the BCR. It means the risk that arises when the exposure to a counterparty is positively correlated with the probability of default of the counterparty due to the nature of the transactions with the counterparty.

"General wrong-way risk" has the meaning given in §1(h) of Schedule 2A to the BCR. It means the risk that arises when the probability of default of counterparties is positively correlated with general market risk factors.

[24] In assessing this characteristic requirement in respect of an asset (such as marketable debt securities, covered bonds or RMBS), major factors for consideration include, for example:

- whether the asset is traded publicly in a recognized exchange (as referred to in paragraph 5.2.3(f)), or traded over-the-counter with a considerably large number of market participants;
- the availability of committed market makers to maintain the asset's market liquidity;
- the levels and trends of the asset's market transaction volume and pricing spread; and
- the robustness and efficiency of the clearing and settlement systems in respect of the asset market.

"recognized exchange". Generally, this may include any recognized exchange as defined under §2(1) of the Banking (Capital) Rules (BCR) (which refers to any of those exchanges specified in Part 2 or 3 of Schedule 1 to the Securities and Futures Ordinance).

(g) Denominated in convertible currency – The asset is denominated in Hong Kong dollars (HKD) or in a currency freely convertible into HKD.[25]

5.2.4 In addition to the above characteristic requirements (as set out in Schedule 3 to the BLR), ideally an asset included by a category 1 institution in its stock of HQLA should be capable of being used by the institution as collateral to borrow intraday or overnight funding from the MA (or any overseas central bank). The asset ideally should also have the potential to benefit from a "flight to quality" (meaning that its characteristics are such that it has the potential to attract investors to switch their funds into it) in times of stress.

Operational requirements

5.2.5 In addition to meeting the characteristic requirements stated above, any asset to be included by a category 1 institution as HQLA must be free from any operational restrictions that would prevent timely monetization of that asset during a stress period. The institution must have in place and maintain adequate operational capacity and systems to readily monetize any asset in its HQLA without being constrained by any internal business or risk management strategy.

5.2.6 Specific operational requirements set out in Schedule

[25] If a category 1 institution has a banking operation in an overseas country where the local currency is not convertible into Hong Kong dollar, the HQLA denominated in that local currency held by the banking operation in that country can only be used to cover the liquidity needs arising from the banking operation in that country. Therefore a category 1 institution should treat this portion of HQLA according to rule 23 or 24 (in respect of the treatment of "liquidity transfer restrictions") in calculating its LCR on a consolidated basis or unconsolidated basis covering its overseas banking operation.

4 to the BLR are elaborated below:

(a) Any asset included by a category 1 institution as its HQLA should be –

(i) managed by a liquidity management function[26] designated by the institution for the purpose which has the continuous authority and legal and operational capability to monetize any asset in the institution's HQLA; and

(ii) maintained in a separate pool of assets under the control of the institution's designated liquidity management function with the sole intent of being used as a source of contingency funding, unless it is clear and can be demonstrated to the MA that the designated function as referred to in subparagraph (i) above can monetize any asset in the institution's HQLA (irrespective of where it is maintained within the institution) and the proceeds are available to the designated function without direct conflict with the institution's internal business or risk management strategy, at any time within a period of financial stress that lasts for 30 calendar days.

(b) a category 1 institution should be able to access relevant markets for monetizing assets in its HQLA as necessary. This ability should be tested or verified by periodical monetization of a representative portion of its

[26] Depending on the practical circumstances, the "liquidity management function" of an AI may be performed by a person, a functional department, or a committee. The composition, authorities and responsibilities of that function should be clearly delineated and approved by the institution's Board (or Board-level committee), which assumes the ultimate governance responsibility over that function. The head of the function should be a manager under the meaning of §72B of the BO, or a director or chief executive (or alternate chief executive) approved by the MA under §71 of the BO.

HQLA in the relevant markets, unless this ability can be demonstrated satisfactorily through transactions conducted in the normal course of business operation;

(c) an asset included in HQLA must be free from encumbrances, and, in particular, there must be no legal, regulatory, contractual or other restrictions that inhibit the institution from liquidating, selling, transferring or assigning any asset in its HQLA. (Please refer to Annex 1 for further guidance on the meaning of "free from encumbrances".)

(d) the institution should maintain adequate policies, procedures and systems to enable close monitoring (at least daily) of its HQLA. It should have sufficient knowledge of its HQLA, including the size, composition by types of assets and currency denominations, holding offices, locations, and custodial or other account in which the assets are held. In this regard, daily management reports covering the relevant information in respect of HQLA should be generated to facilitate internal monitoring;

(e) the assets in the institution's HQLA must be freely transferable and available to the institution, whether between its Hong Kong office and any of its overseas branches and specified associated entities (where applicable), and the assets must not be subject to any liquidity transfer restriction.[27]

(f) if an asset is included in the institution's HQLA and it is likely to be monetized through direct sale, there must be no impediments to the sale of the asset and there must be no

[27] If an asset is held by the institution in a legal entity that does not have access to relevant markets for monetizing the asset, the asset is not deemed to be freely transferable unless the asset can be freely transferred to the institution (or to a specified associated entity of the institution) that can monetize the asset.

requirements to hold such asset, including, but not limited to, statutory minimum inventory requirements if the institution is a market maker for assets of that type.

Exclusion of unqualified assets

5.2.7 An asset will cease to qualify as HQLA if it fails to satisfy any condition set out in rule 25 continuously. In these circumstances, a category 1 institution must exclude the asset from its HQLA within 30 calendar days of the assets ceasing to satisfy the condition. If the institution only becomes aware of the cesser after the 30-day period, it should exclude the asset from its HQLA immediately.

5.2.8 On the grounds specified in rule 29 (or rule 30), the MA may require all category 1 institutions (or a particular institution) not to include a particular asset or a class of assets as HQLA. When determining the effective date and any applicable conditions in respect of any such requirement, the MA will normally provide a lead-time of not less than 30 calendar days for the institution(s) concerned to adjust the composition of their HQLA, taking into account the actual circumstances.

Management of foreign exchange risk and concentration risk associated with HQLA

5.2.9 As required under rule 27(2), a category 1 institution must put in place and maintain adequate systems and procedures to manage the foreign exchange risk associated with its HQLA, including –

(a) managing its ability to access relevant foreign exchange markets taking into account the risk that access to such markets may be hindered in times of financial stress;

(b) managing its HQLA so that the HQLA is capable of generating liquidity to meet the institution's total net cash outflows in different currencies; and

(c) managing the composition of its HQLA by currency so that the HQLA is broadly consistent with the distribution of its total net cash outflows by currency.

5.2.10 To ensure compliance with rule 27(2), a category 1 institution should put in place a robust risk management system in line with the guidance set out in section 6 of SPM module LM-2 and, where appropriate, SPM module TA-2 "*Foreign Exchange Risk Management*".

5.2.11 In principle, the above requirements are applicable to each currency in which a category 1 institution has a liquidity need (as measured by total net cash outflows in that currency). The MA will in practice have primary regard to an institution's liquidity positions in HKD, US dollars, major foreign currencies[28] other than the US dollar, renminbi and any currency which is significant[29] to the institution. Moreover, the MA may also look into an institution's liquidity position in any other currency if warranted by the actual circumstances.[30]

5.2.12 With respect to the requirements set out in rule 27(2)(b) and rule 27(2)(c), a category 1 institution is not required to match the currency composition of its HQLA with that of its total net cash outflows fully at all times. This recognises the fact that a certain level of currency mismatch may arise in the normal course of banking operations. However, each category 1 institution should establish internal targets for its LCR in individual currencies having regard to the transferability of liquidity in different currencies. Any position exceeding an institution's internal target

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[28] Under the LCR (which is applicable to category 1 institutions), a "major foreign currency" refers to a foreign currency with global transaction volume exceeding 10% of total global currency market turnover.

[29] A currency is considered to be significant to an AI if the AI's liabilities denominated in that currency account for 5% or more of its total liabilities (including shareholders' funds).

[30] For example, if a category 1 institution is expanding its banking business in an overseas country substantially or swiftly, the MA may have specific regard to the institution's liquidity position in the local currency of that country irrespective of whether the position meets the "5%" significance threshold.

should be reported to the institution's senior management to ensure a prompt management review of the institution's liquidity risk profile. Please also refer to subsection 5.7 below with respect to the use of the ALA option.

Diversification by class of assets in HQLA

5.2.13 Rule 28 requires that a category 1 institution must have in place and maintain adequate policies and limits to control the level of concentration of its HQLA in order to avoid undue exposure to a particular class of asset, type of issue, issuer or currency. In this regard, a category 1 institution should follow the guidance provided in section 7 of SPM module LM-2.

5.3 Level 1 assets

5.3.1 Level 1 assets are confined to –

(a) currency notes and coins;

(b) withdrawable central bank reserves;[31]

(c) marketable debt securities that are issued or guaranteed by a sovereign, central bank, PSE, relevant international organization (IO) or multilateral development bank (MDB), or that are EF debt securities, and –

(i) qualify, in the calculation of credit risk under the standardized (credit risk) approach (STC approach), for a 0% risk-weight;[32]

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[31] The meaning of "withdrawable central bank reserves" is provided in rule 17, supplemented with the elaboration provided in the CIs for item A1(b) in Section (I) of Part 2 of the Return MA(BS)1E.

[32] For the purpose of identifying this class of level 1 assets, the risk-weights of marketable debt securities should be determined under the STC approach pursuant to the following sections under Part 4 of the BCR:

Marketable debt securities issued or guaranteed by:	Applicable provisions in BCR:
• Sovereign or central banks	• §55(2)
• PSE	• §57(2)(b)
• Relevant international organizations	• §56(4)
• Multilateral development banks	• §58

(ii) are traded in large, deep and active markets, characterised by a low level of concentration, and where the debt securities can be monetized through direct sale or repo-style transactions;[33]

(iii) have a proven record as a reliable source of liquidity in those markets even during a period of financial stress; and

(iv) are not an obligation of a financial institution or an associated entity of a financial institution (except that a debt security is issued by a bank which is a PSE);[34]

(d) marketable debt securities that are issued by the sovereign or central bank of a country and denominated in the local currency of that country, or that are EF debt securities[35], and which, under the STC approach, do not qualify for 0% risk-weight under §55(2) of the BCR, or qualify for 0% risk-weight only by virtue of §56(1) or (2) of the BCR, where the category 1 institution is incorporated in that country, or carries on a banking business in that country through a branch or subsidiary;

(e) marketable debt securities that are issued by the sovereign or central bank of a country and denominated in a currency that is not the local currency of that country and which do

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[33] Please refer to footnote 24 for the major factors that should be considered in assessing an asset's compliance with this criterion.

[34] In determining whether a financial institution in another country should be regarded as a PSE or sovereign entity, the MA may, where appropriate, have regard to the categorisation adopted by the banking supervisory authority of the country concerned for LCR purposes.

[35] If EF debt securities no longer qualified for a 0% risk-weight under the BCR, such securities would still be recognised as level 1 assets falling within subcategory (d) (instead of (c)), to the extent that such securities are used by a category 1 institution to cover liquidity needs arising from its operation in Hong Kong.

not, under the STC approach, qualify for a 0% risk-weight under §55(2) of the BCR, subject to the following conditions:

(i) the institution must be incorporated (or carry on a banking business through a branch or subsidiary) in the country in which the issuer of such securities is located; and

(ii) the amount of such securities to be included in this category of level 1 asset must not exceed the amount of total net cash outflows in the currency of the debt securities arising from the institution's banking business in the country in which the debt securities are issued.[36]

5.4 Level 2A assets

5.4.1 Level 2A assets are confined to –

(a) marketable debt securities issued or guaranteed by a sovereign, central bank or PSE, which –

(i) qualify for a 20% risk-weight under the STC approach;[37]

(ii) are traded in large, deep and active markets, characterised by a low level of concentration, and where the debt securities can be monetized through direct sale or repo-style transactions;

[36] For example, if debt securities issued by the sovereign or central bank in Country A are denominated in Currency B which is not the local currency of Country A, a category 1 institution can only recognise such debt securities as level 1 assets under subcategory (e) up to an amount not exceeding the institution's total net cash outflows in Currency B, as generated from the institution's banking business operation in Country A.

[37] The risk-weight as referred to this condition should be determined under §55(2) of the BCR in any case where the security is issued or guaranteed by a sovereign or central bank, or under §57 of the BCR in any case where the security is issued or guaranteed by a PSE.

(iii) have a proven record as a reliable source of liquidity in the markets even during a period of financial stress. As a quantitative criterion, a debt security must not have experienced a decline of more than 10% of its market price, or an increase in haircut of more than 10 percentage points if it is used as collateral in a repo-style transaction, within any period of 30 calendar days during a "relevant period of significant liquidity stress" since the debt security was issued (where applicable), or in the absence of such a "relevant period of significant liquidity stress", any such period of 30 calendar days since the debt security was issued[38]; and

(iv) are not an obligation of a financial institution or an associated entity of a financial institution unless the debt securities are issued by a bank which is a PSE;

(b) marketable debt securities issued by corporates which –

(i) satisfy the requirement set out in §5(1)(a), (b) or (c) of Part 3 of Schedule 2 to the BLR. In other words, the securities must have a long-term ECAI issue specific rating of not lower than AA-, or an equivalent level of short-term ECAI issue specific rating, and hence have a "credit quality

[38] In determining whether a marketable debt security, covered bond or RMBS can be included as HQLA, the price volatility criterion set out in §4(3), §5(3), §6(3), §7(3) and §8(3) of Part 3 of Schedule 2 to the BLR should be applied in such a way that a "relevant period of significant financial stress" means –

- if a debt security was issued on or before 1 January 2007, any period of 30 calendar days since that date; or
- if a debt security was issued after 1 January 2007, any period of 30 calendar days since the issuance date in respect of the security.

grade" of 1 under Part 4 of the BCR;[39]

(ii) are traded in large, deep and active markets, characterised by a low level of concentration, and where the securities can be monetized through direct sale or repo-style transactions;

(iii) have a proven record as a reliable source of liquidity in the markets even during a period of financial stress. (As a quantitative criterion, a debt security must not have experienced a decline of more than 10% of its market price, or an increase in haircut of more than 10 percentage points if it is used as collateral in a repo-style transaction, within any period of 30 calendar days during a "relevant period of significant liquidity stress" since the debt security was issued (where applicable), or in the absence of such a "relevant period of significant liquidity stress", any such period of 30 calendar days since the debt security was issued);

(iv) are not issued by a financial institution or any of its associated entities; and

(v) are not structured financial instruments or subordinated debt securities.

(c) covered bonds which –

[39] If a corporate debt security held by a category 1 institution does not have an ECAI issue specific rating and the institution is approved by the MA (or in the case of an overseas incorporated institution, its home supervisor) to use the internal ratings-based approach for regulatory capital purposes, the institution may include the security in this category of HQLA if the security is internally rated by the institution as having a probability of default corresponding to the required credit quality grade.

This provision can also be applied in lieu of the conditions with respect to ECAI issue specific ratings set out in–

- paragraph 5.4.1(c)(i) for recognising covered bonds as level 2A assets;
- paragraph 5.5.2(a)(i) for recognising corporate debt securities as level 2B assets; and
- paragraph 3(b) in Annex 2 of this module for recognising RMBS as level 2B assets.

(i) have a long-term ECAI issue specific rating of not lower than AA-;[40] and

(ii) satisfy the same criteria set out in subparagraphs (b)(ii) and (iii) above, and

(iii) are not issued by the institution holding the bonds or any of the institution's associated entities.

5.5 Level 2B assets

5.5.1 Under the BCBS LCR standard, certain types of assets can be recognised as level 2B assets under the LCR at the discretion of national authorities. Such assets include (i) corporate debt securities rated A+ to BBB; (ii) listed common equity shares of corporates included in a main index; and (iii) RMBS rated AA or above. Moreover, national authorities may accept committed facilities provided by a central bank as a source of liquidity equivalent to level 2B assets, subject to certain restrictions (RCLF)[41]. National authorities are expected to determine the extent to which level 2B assets (including RCLF) can be recognised as HQLA taking into account the local circumstances.

5.5.2 In light of the risk attributes of these types of asset, including their price volatility and their market liquidity based on historical performance in local markets (especially in time of stress), the MA accepts only the following classes of level 2B assets for LCR purposes:

(a) marketable debt securities issued by corporates, where the securities –

(i) satisfy the requirement set out in §7(1)(a), (b) or (c) of Part 3 of Schedule 2 to the BLR. In other words,

[40] Please refer to footnote 39.

[41] The "restricted-use committed liquidity facility" (RCLF) is provided in paragraph 54a of the BCBS LCR standard, as inserted by the BCBS in January 2014 (www.bis.org/publ/bcbs274.pdf).

the securities must have a long-term ECAI issue specific rating between A+ and A-, or an equivalent level of short-term ECAI issue specific rating;[42]

(ii) have a proven record as a reliable source of liquidity in the markets even during a period of financial stress. (As a quantitative criterion, a debt security must not have experienced a decline of more than 20% of its market price, or an increase in haircut of more than 20 percentage points if it is used as collateral in a repo-style transaction, within any period of 30 calendar days during a "relevant period of significant liquidity stress" since the debt security was issued (where applicable), or in the absence of such a "relevant period of significant liquidity stress", any such period of 30 calendar days since the debt security was issued); and

(iii) satisfy the criteria set out in paragraphs 5.4.1(b)(ii), (iv) and (v) above;

(b) RMBS that comply with §8 and §9 of Part 3 of Schedule 2 to the BLR. In particular, the RMBS must have been approved by the MA to be included as level 2B assets by a category 1 institution. (Further guidance for the treatment of RMBS under the LCR (as well as the LMR) is provided in Annex 2.)

5.5.3 A category 1 institution that includes any level 2B assets in its HQLA must be particularly vigilant to the risks of holding such assets as a stock of liquidity. Appropriate systems and measures should be in place to support the institution's monitoring and control over such risks. For example, an institution should

[42] Please refer to footnote 39.

establish specific limits on the holding of such assets, which should be tracked with regular management reports.

5.6 Ceilings on level 2 assets

5.6.1 To avoid undue concentration on level 2 assets (particularly level 2B assets) included in a category 1 institution's HQLA, two ceilings are imposed as follows:

(a) Pursuant to rule 32(c), the sum of the total weighted amounts of a category 1 institution's level 2A assets and level 2B assets must not exceed 40% of the total weighted amount of the institution's HQLA (40% ceiling); and

(b) Pursuant to rule 32(d), the total weighted amount of the institution's level 2B assets must not exceed 15% of the total weighted amount of the institution's HQLA (15% ceiling).

5.6.2 The application of these two ceilings may be distorted by securities financing transactions which involve exchange of an asset with another asset, where both of these assets are qualified for inclusion as HQLA (or will be qualified upon receipt by a category 1 institution within the LCR period).[43] To avoid such potential distortions, a category 1 institution must determine the total weighted amount of HQLA by taking the following steps:

(a) Step 1 – the institution should follow the provisions of rule 33 and apply the formula it contains (Formula 1) to calculate the total weighted amount of HQLA without reversing any relevant securities financing transaction;

(b) Step 2 – the institution should follow the

[43] For example, by entering into a short-term transaction (i.e. maturing within 30 calendar days) in which a bank transfers out, say, level 2B assets and receives level 1 assets, the bank would be able to include the level 1 assets in its HQLA and have additional capacity for recognising more level 2 assets, hence making the two ceilings less binding upon it, if no adjustment is required.

provisions of rule 34(2)(a) and apply the formula to which it refers (Formula 2) to calculate the total weighted amount of HQLA after reversal of any relevant securities financing transaction and make any necessary adjustment as required by the application of the two ceilings; and

(c) Step 3 – the institution should follow rule 34(2)(b) to take the lower amount between the results as calculated under the first two steps to determine the total weighted amount of HQLA (subject to any other adjustment that may be required if a category 1 institution applies rules 37 and 38 in respect of the ALA option – see subsection 5.7 below).[44]

5.6.3 The mechanics for the calculation of the total weighted amount of HQLA taking into account the 40% ceiling and 15% ceiling are incorporated in the standard templates provided in Part 2 of Return MA(BS)1E. A category 1 institution should put in place effective systems and procedures to identify those securities financing transactions which would need to be reversed under rule 34(2)(a) (as referred to in "Step 2" above), and use the standard templates for the calculation.

5.7 Alternative Liquidity Approach (ALA)

5.7.1 As mentioned in paragraph 5.2.9, a category 1 institution must, pursuant to rule 27(2)(c), manage the composition of its HQLA by currency so that the HQLA is broadly consistent with the distribution of the institution's total net cash outflows by currency.

5.7.2 Recognising however that the supply of HKD-denominated HQLA is not always sufficient to meet the banking sector's aggregate demand for holding such assets for liquidity purposes, one of the options from

[44] To avoid doubt, transactions necessitating exchange of assets which are not both qualified for inclusion as HQLA do not need to be reversed for the purposes of operating the 40% ceiling and 15% ceiling.

amongst the "Alternative Liquidity Approaches" provided by the BCBS, i.e. the use of foreign currency HQLA to cover domestic currency liquidity needs, has been adopted in the local framework (the ALA option).

5.7.3 Pursuant to rule 37, a category 1 institution may use part of its foreign currency-denominated HQLA to cover the institution's "HKD LCR mismatch"[45] in the calculation of the LCR, subject to the conditions and requirements set out in rule 37 and rule 38.

5.7.4 Although a category 1 institution adopting the ALA option is not required to obtain the MA's prior approval for doing so, it must be able to demonstrate, if requested by the MA, its compliance with all of the conditions and requirements set out in rule 37 and rule 38.

5.7.5 In particular, rule 37 provides that –

(a) a "rule 37 institution" must be able to demonstrate to the satisfaction of the MA that it has a genuine need to use foreign currency-denominated HQLA to cover HKD-denominated total net cash outflows in order to maintain its LCR of not less than the minimum requirement set out in rule 4;[46]

(b) the foreign currency-denominated HQLA used under rule 37 must be level 1 assets which have not yet been used by the institution to cover its foreign currency-denominated total net cash outflows. In other

[45] As defined in rule 36, "HKD LCR mismatch", in relation to the calculation by a category 1 institution of its LCR, means that portion of the institution's HKD-denominated total net cash outflows that is not covered by its HKD-denominated HQLA.

[46] 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 HKD (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). This means that a category 1 institution should not make use of the provisions under rule 37 for the sole purpose of seeking profit.

words, an institution running a liquidity shortfall in a specific foreign currency must not use its level 1 assets denominated in that currency for ALA purposes;

(c) in calculating its LCR, the institution must apply the foreign exchange haircuts required under rule 38 on the foreign currency-denominated level 1 assets under rule 37 – please refer to paragraph 5.7.10 below;

(d) the institution must always hold an amount of HKD-denominated level 1 assets that is not less than 20% of the institution's HKD-denominated total net cash outflows – please refer to paragraphs 5.7.6 to 5.7.9 below; and

(e) the institution must be able to demonstrate to the satisfaction of the MA that it has the necessary systems and capacity to manage the level of foreign exchange risk associated with the use of such foreign currency-denominated level 1 assets under rule 37.

5.7.6 Among these conditions as set out in rule 37, it is particularly crucial for a category 1 institution to always maintain an amount of HKD-denominated level 1 assets not less than 20% of its HKD-denominated total net cash outflows. A category 1 institution's failure to meet this condition will result in a "relevant liquidity event" (as specified in rule 14(3)(a)(iv)), in which case the institution must comply with the "prescribed notification requirement" (as provided in §97I of the BO) to notify the MA immediately.

5.7.7 Upon notification of such an event, the MA will enter into discussion with the institution to consider remedial actions. Among other relevant factors, the MA will assess whether the event is caused by any weakness in the institution's internal controls and risk management systems, or by any systemic reasons or special market circumstances which are out of the institution's control.

5.7.8 Depending on the actual circumstances, the MA may consider allowing the institution to continue to adopt the ALA option subject to certain conditions and necessary safeguards, 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 HKD, or both, within an agreed timeframe;

(b) through the exercise of the power under §97K(1) of the BO, setting a range of more prudent foreign exchange haircuts to be applied to the portion of the institution's foreign currency-denominated level 1 assets for rule 37 purposes; and

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

5.7.9 The 20% minimum holding level for HKD-denominated level 1 assets by category 1 institutions is binding at all times, whether during or after the phase-in period. If, for example, the minimum LCR requirement is 100%, the level of foreign currency-denominated level 1 assets that can be used by a category 1 institution under rule shall not exceed 80% (i.e. the difference between 100% and 20%) of the institution's HKD-denominated total net cash outflows. The actual level of usage will be restricted further by the prevailing minimum LCR requirement during the transitional period from 2015 to 2018 and the actual amount of HKD-denominated level 1 assets held by the institution.[47]

[47] For example, if the prevailing minimum LCR requirement is 70% (which is the case for 2016) and a category 1 institution is holding an amount of HKD-denominated level 1 assets covering, say, 30% of its HKD-denominated total net cash outflows, the amount of foreign currency-denominated level 1 assets that can be used by the institution for rule 37 purposes shall not exceed 40% (i.e. 70% less

5.7.10 As set out in rule 38, the foreign exchange haircuts applicable to the foreign currency-denominated level 1 assets used under rule 37 are:

(a) 2%[48] for assets denominated in US dollars (USD);

(b) 8% [49] for assets denominated in Euro, Japanese yen or pound sterling[50]; and

(c) 10% for assets denominated in other foreign currencies that are freely and reliably convertible into HKD.[51]

5.7.11 In line with the BCBS LCR standard, the above foreign exchange haircuts are applicable only to the portion of foreign currency-denominated level 1 assets exceeding the threshold set out in rule 38(2), which is 25% of a rule 37 institution's HKD-denominated total net cash outflows. The application of this threshold is intended to recognise that an institution may incur a certain extent of currency mismatch in the ordinary course of business operation.

5.7.12 The adjustments to a category 1 institution's total weighted amount of HQLA as a result of the application of such foreign exchange haircuts on such foreign currency-denominated level 1 assets can be derived by using the standard templates contained in

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30%). The parameters for the application of rule 37 from 2015 to 2018 (and thereafter) are detailed in Annex 1 to the CIs for Return MA(BS)1E.

[48] The haircut of 2% is derived from the range of the Convertibility Undertaking (i.e. 7.75 to 7.85) under the Linked Exchange Rate System. The calculation is: (7.85 – 7.75) /7.8 ≅ 1.3% (rounded up to 2%).

[49] This level of haircut is in line with the minimum required level (8%) for HQLA denominated in "major currencies" under the ALA option prescribed in the BCBS LCR standard (paragraph 60).

[50] As elaborated in footnote 27 of the BCBS LCR standard, a "major currency" should exhibit significant and active market turnover in the global foreign currency market (e.g. the average market turnover of the currency as a percentage of the global foreign currency market turnover over a ten-year period is not lower than 10%). By reference to the *Triennial Central Bank Survey of foreign exchange and derivatives market activity* published by the Bank for International Settlements (BIS), only the Euro, Japanese yen and pound sterling (other than the USD) can currently meet this criterion. The MA will review the scope of "major currencies" from time to time.

[51] Level 1 assets denominated in renminbi are subject to this level of haircut rate for the purposes of rules 37.

Part 2 of Return MA(BS)1E.

5.7.13 The MA will assess periodically (normally once every five years) whether the adoption of the ALA option in the local framework continues to be necessary.

5.8 Total net cash outflows

5.8.1 A category 1 institution must follow the rules provided in Division 5 of Part 7 of the BLR to calculate its total net cash outflows, the LCR's denominator. Specific guidance on the calculation of individual cash flow items is provided in the Code issued by the MA under §97M of the BO. Standard templates and the associated CIs are provided in Sections B and C of Part 2 of Return MA(BS)1E to facilitate the calculation. Certain items are highlighted below.[52]

Retail deposits

5.8.2 Under the BLR, "retail deposits" taken by a category 1 institution are calibrated into "stable retail deposits", "less stable retail deposits" and "retail term deposits".

5.8.3 Category 1 institutions taking any retail deposits in Hong Kong must follow the MA's requirements in calculating the expected cash outflows arising from such domestic retail deposits.

5.8.4 Pursuant to rule 22(2), if a category 1 institution incorporated in Hong Kong has any overseas banking operation (whether in the form of a branch or associated entity) that takes retail deposits in a host country outside Hong Kong, it must, for the purpose of calculating its LCR on an unconsolidated basis or consolidated basis covering the retail deposits taken by its operation in that country, adopt the requirements set by the relevant banking supervisory authority of the host country for such deposits.

[52] A category 1 institution may exclude "pledged deposits" (as defined in rule 2) from the calculation of its total net cash outflows subject to the conditions set out in rules 41(2), (3) and (4). Please also refer to paragraph 26 to 28 of the CIs for Return MA(BS)1E.

5.8.5 Rule 22(2) does not apply if –

(a) the relevant banking supervisory authority in the host country does not impose any liquidity requirement for the equivalent of an LCR; or

(b) the authority, for the purposes of the calculation of the equivalent of an LCR insofar as the calculation relates to the retail deposits, does not adopt or apply those liquidity requirements to the institution's operation in that country.

5.8.6 Pursuant to rule 22(4), if the MA is of the view that the liquidity requirements in the host country relating to the treatment of retail deposits in the calculation of the LCR are less stringent than the associated requirements in Hong Kong, the MA may require a category 1 institution to apply the relevant requirements in Hong Kong to such deposits for calculating its LCR.

5.8.7 "Stable retail deposit" refers to a retail deposit taken by a category 1 institution from a retail customer and that is payable on demand, or has a remaining term to maturity (or a withdrawal notice period) within the LCR period, where –

(a) the deposit is fully insured by an "effective deposit insurance scheme"; and

(b) the retail customer in respect of that deposit has at least 2 "other established relationships" with the institution, or the deposit is maintained by the retail customer in a "transactional account" at the institution.

5.8.8 As described in clause 3(1) of the Code, the expected cash outflow arising from stable retail deposits is calculated by multiplying the principal amount of such deposits by an outflow rate of 5%.

5.8.9 The outflow rate for stable retail deposits can be lowered to 3% as discussed in clause 3(2) of the Code,

if this level is not inconsistent with the historical run-off behaviour of such deposits during a period of financial stress, and the effective deposit insurance scheme covering such deposits meets specified additional requirements, that is, the effective deposit insurance scheme –

(a) is based on a system of prefunding through periodic collection of levies on the members of the scheme;

(b) has an adequate means of ensuring ready access to additional funding in the event of a large call on its reserves, based on an explicit and legally binding guarantee from the relevant government, a standing authority to borrow from the government, or any other similar arrangement; and

(c) is ordinarily capable of making a payment to depositors in respect of their insured deposits within not more than 7 working days after the scheme is activated.

5.8.10 In Hong Kong, the Deposit Protection Scheme (DPS) is considered by the MA as an "effective deposit insurance scheme". Subject to the satisfaction of certain requirements[53] that may be applicable to a member of the DPS, a category 1 institution may apply an outflow rate of 3% to calculate its expected cash outflows arising from stable retail deposits. This does not, however, preclude the possibility that the MA may require an institution to adopt an outflow rate of 5% pursuant to clause 3(1) for the calculation, if the MA is of the view that the additional requirements in respect of the effective protection scheme described in 5.8.9 above are not met fully by virtue of any deficiency in respect of the institution. It is therefore imperative for a

[53] For example, a category 1 institution (as a member of the DPS) should have the capacity to identify the amount of protected deposits placed by a depositor at the institution, and provide such information promptly to the Deposit Protection Board as and when necessary in order to facilitate the effective operation of the DPS, including a prompt payment to depositors within 7 working days after activation of the Scheme, as mentioned in clause 3(2)(c) of the Code. Otherwise a 5% outflow rate is applied.

category 1 institution to have in place and maintain effective systems and procedures to ensure compliance with all requirements that may need to be fulfilled by it to facilitate the smooth operation of the DPS.

5.8.11 Moreover, the MA may exercise the power under §97K(1) of the BO to vary the level of outflow rate required currently under rule 41(9) (or rule 41(10) as the case may apply) , if he is of the view that the existing level is inconsistent with the historical run-off behaviour of such deposits as observed in the local banking sector or any particular institution(s) during a period of financial stress.

5.8.12 "Retail term deposit" means a retail deposit 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;[54] 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.

5.8.13 The MA expects a category 1 institution to develop its own internal methodology for determining whether a term deposit taken from a retail customer by the institution could be treated as a "retail term deposit" for LCR purposes. Upon request by the MA, the category 1 institution should be able to demonstrate that its policy and practice (including the level of early withdrawal penalty charged by it) can effectively

[54] Pursuant to §12(3) of the BO, a DTC shall not, without the written permission of the MA, repay any deposit within a period of less than three months (as specified in the First Schedule to the BO) from the date on which the deposit was taken by the DTC. If a retail term deposit is taken by a DTC which is a category 1 institution or a member within a category 1 institution's consolidated group, that deposit should be treated according to Annex 4 of the CIs for Return MA(BS)1E for LCR purposes.

reduce the risk of early withdrawal of retail term deposits by its retail customers. Where appropriate, the reasonableness of the institution's policy and practice in respect of the charging of penalties on early withdrawal of term deposits may be assessed by reference to historical data of the institution relating to early withdrawn deposits in normal or stressed situations.

5.8.14 Where appropriate, the MA may compare the level of early withdrawal penalty charged by a category 1 institution with those of other AIs. Depending on the actual circumstances, the MA may use a common benchmark to facilitate comparison of the relevant policies and levels of early withdrawal penalty adopted by different institutions. The level of such a benchmark, if used by the MA, would be determined according to prevailing market circumstances.[55]

5.8.15 Under the BCBS LCR standard, the outflow rate for less stable retail deposits[56] should not be less than 10%. National supervisors are expected to develop as necessary additional buckets of less stable retail deposits to which the application of higher outflow rates may be warranted, taking into account the specific attributes of such deposits.

5.8.16 Currently, less stable retail deposits taken by category 1 institutions are subject to a standard outflow rate of 10% for LCR purposes. The MA will continue to evaluate whether there is sufficient evidence to justify a more differentiated treatment for such deposits. If

[55] In line with the BCBS LCR standard (paragraph 82), the MA may set this benchmark as a certain multiple of the interest accrued on a term deposit, where such accrued interest can be viewed as a "loss" to be borne by the depositor as a result of early withdrawal. The level of the multiplier may be determined from time to time according to the interest rate environment. Under a very low interest rate environment, this multiplier may be set on the high side. For example, a multiplier at 200% would mean that the MA would not normally regard an early withdrawal penalty set by a category 1 institution as "significant" for LCR purposes if the penalty is less than 200% the interest accrued on the term deposits concerned, unless the institution concerned can demonstrate to the MA's satisfaction that there are adequate justifications for the level of penalty otherwise set by the institution.

[56] As defined under rule 39, a less stable retail deposit refers to a retail deposit taken by a category 1 institution that is not a stable retail deposit or retail term deposit.

the MA considers it prudent and reasonable to increase the outflow rate beyond the current level of 10% for such deposits, the MA may do so through exercising the power under §97K(1) of the BO, or by making amendments to the BLR and associated documents (including the Code and Return MA(BS)1E).

Small business funding

5.8.17 Under the LCR, "small business funding" received by a category 1 institution from "small business customers" is treated in a manner akin to retail deposits. The requirements in respect of retail deposits, including the guidelines set out in paragraphs 5.8.2 to 5.8.16 above, are applicable to small business funding.

5.8.18 A category 1 institution should note that, as provided in rule 39, the amount of small business funding received from a single small business customer (or a group of related customers) must be less than HK$10 million (or the equivalent in another currency).

5.8.19 In determining whether the unsecured funding provided by a corporate (or a group of related corporates) can be treated as small business funding, a category 1 institution must ensure that either one of the following criteria is satisfied:

(a) if the institution has a credit exposure to the corporate (or a group of related corporates), the exposure meets the criteria for the IRB subclass of small business retail exposures under §144 of the BCR[57]; or

(b) if the institution has no credit exposure to the corporate (or a group of related corporates), the funding received from the corporate (or a group of related corporates) is managed by

[57] This criterion is applicable irrespective of whether the category 1 institution is adopting the IRB approach for regulatory capital purposes.

the institution as if it were a retail deposit.[58]

Operational deposits

5.8.20 "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. Generally, 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.

(a) As explained in clause 7(1) of the Code, the expected cash outflows arising from operational deposits are calculated by applying –

(i) in the case of that portion of an operational deposit that is fully insured by an effective deposit insurance scheme, the outflow rate that is applicable to stable retail deposits; and

(ii) in any other case, an outflow rate of 25%.

(b) Such preferential treatment is only available to those operational deposits in respect of which the conditions set out in clause 7(2) of the Code are satisfied fully. In particular, subparagraph (h) under that clause refers to

[58] For example, the pricing policy in respect of the funding received from the customer should be comparable to that for general retail customers.

a category 1 institution having an effective methodology for identifying the amount of excess operational deposit maintained in a customer's operational deposit account, having regard to all relevant factors affecting the risk of withdrawal by the customer of the excess operational deposit if the institution were to be in financial stress.

(c) In view of the diversity of business nature and customer profile across category 1 institutions, individual institutions may develop their own internal methodologies for determining the amount of operational deposits and excess operational deposits[59], in accordance with the following guiding principles:

(i) 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.(See clause 7(4) of the Code.) The frequency and level of sophistication of this type of assessment should be commensurate with the institution's liquidity risk profile;[60]

[59] For example, some category 1 institutions may adopt statistical methodologies to assess the stability of deposits in "operational deposit accounts". On top of such statistical approaches, 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.

[60] 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 MA to conduct this type of assessment more frequently as and when necessary.

(ii) 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. The relevant factors may include (but are not limited to) 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);

(iii) 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.[61]

(d) As provided in clause 7(3) of the Code, 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.

(e) The MA 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 MA is of the view that those deposits do not qualify as

[61] Deposits and funding that should not be regarded as operational deposits include (but are not limited to), for example: (i) deposits and funding which are not received in the course of the provision of operational services by a category 1 institution; (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; 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 or benefits normally offered to customers in respect of other deposits which are not regarded as operational deposits.

operational deposits based on any failure to meet any of the conditions set out in clause 7(2) of the Code.

Potential drawdown of undrawn committed facilities

5.8.21 A category 1 institution should calculate the expected cash outflows arising from potential drawdown of loans on undrawn, committed facilities (whether credit facilities or liquidity facilities) within the LCR period according to clause 21 of the Code. The calculation of this expected cash outflow item covers all undrawn portions of committed loan facilities which are "irrevocable" by a category 1 institution.

5.8.22 As a general principle for determining the liquidity requirements (whether under the LCR or LMR) in respect of committed facilities granted by an AI to its customers, the MA expects that an AI should not only have regard to the contractual terms of that facility (in particular, the presence of "protective" clauses to the effect that a facility is "unconditionally revocable") but should assess whether from a customer relationship, reputational, franchise or other perspective it is genuinely and credibly open to the AI, at any time, to revoke the facility unilaterally. In other words, the inclusion of a protective legal clause should not, per se, be regarded as a sufficient ground for an AI to treat its commitment under a facility as a "revocable" commitment requiring no liquidity resource.[62] An AI should therefore calculate its LCR (or LMR) on the basis of a genuine and reasonable assessment of the extent to which drawdown can be refused and undrawn amounts under facilities cancelled or revoked, reflecting not merely that the facilities contain

[62] In practice, unless there are specific issues relating to particular customers (e.g. adverse developments in respect of credit standing or financial strength), it may not generally be feasible for an AI to prohibit its customers, unaffected by such issues, from utilizing their facilities without inducing customer disputes or adverse publicity with negative reputation implications for the AI. Further, given that the granting of facilities has a potential liquidity impact on the AI (whenever the facilities are drawn by the customers concerned), it is reasonable to expect that the AI should reserve a certain level of liquidity to cater for the potential liquidity needs arising from the facilities that have not been drawn. In this regard, the BCBS LCR standard provides (in paragraph 131) that banks should reflect (at certain percentages) "estimated drawdowns from revocable facilities".

protective legal clauses but also other relevant considerations as outlined above.[63]

5.8.23 For calculating the LCR, an outflow rate of 0% can be applied only to those loan facilities (whether credit facilities or liquidity facilities) which are, as assessed by a category 1 institution, uncommitted facilities that can be genuinely and credibly revoked by the institution unconditionally.

5.8.24 Certain types of facility granted by a category 1 institution are not included in the calculation of this expected cash outflow item, including –

(a) facilities that are not loan facilities;[64]

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[63] For instance, after making the necessary assessment, a category 1 institution (or a category 2 institution for LMR purposes) may consider that, say, 20% of the undrawn amounts under a given facility or type of facility cannot be credibly cancelled, notwithstanding the presence of protective legal clauses in the facility documents. It should therefore treat that part of the undrawn facility amounts that may not be cancellable in practice as "committed" for the purposes of the LCR (or LMR). If necessary, the AI may be requested to provide information about the extent to which their facility commitments are assessed by them to be credibly cancellable, and where the circumstances warrant, the MA may through its regular supervisory work review the reasonableness of such assessments. In any case where the reasonableness of the assessment is in doubt, the AI will be expected to enhance the relevant methodology used and recalculate the LCR or LMR accordingly if needed.

[64] For example, some types of facility may only oblige an institution to issue letters of credit or guarantees or to incur other similar types of contingent funding obligations. In these circumstances, the unused portions of such facilities do not need to be included in the calculation of expected cash outflows under clause 21 of the Code. However, if the institution has incurred any contingent funding obligations as a result of the use of such facilities by its customers, such obligations should be included in the calculation of expected cash outflows under clause 23 of the Code. Please refer to paragraphs 5.8.27 and 5.8.28.

In the case of a facility (such as a trade financing facility) granted by a category 1 institution, whereby the facility may impose upon the institution a loan commitment and various types of contingent funding obligations, the expected cash outflows arising from the facility should be calculated in the following manner:

- If the institution's customer can draw loan on the facility up to a certain amount, and the loan commitment is "irrevocable" as reasonably assessed by the institution, the unused portion of the facility should be included in the calculation of expected cash outflows arising from potential drawdown of loan on that facility under clause 21 of the Code.
- If the institution has issued a letter of credit, guarantee or similar document in favour of its customer under the facility, and hence incurred a trade-related contingency or any other contingent funding obligation falling within clause 23 of the Code, the trade-related contingency or contingent funding obligation should be included in the calculation of the expected cash outflows under that clause.

(b) uncommitted facilities which are, as assessed by a category 1 institution on reasonable grounds, genuinely and credibly revocable by the institution unconditionally – This type of facility is subject to an outflow rate of 0% (see item 3 of Table 4 in clause 23 of the Code);

(c) liquidity facilities granted by an institution to support a structured financing transaction, to the extent that the expected cash outflows arising from the structured financing transaction have been included in the calculation of the institution's LCR according to clause 19 or 20 of the Code – please refer to clause 21(7) of the Code; and

(d) facilities which only allow drawing of intraday liquidity (noting that the LCR does not capture intraday liquidity risks).

5.8.25 To avoid doubt, a customer's drawdowns on any committed facilities or uncommitted facilities within the LCR period, if already approved by the institution, should be included in the calculation of expected cash outflows under clause 22 (instead of clause 21) of the Code.

5.8.26 If a committed facility granted by a category 1 institution to its customer is collateralised by an asset that satisfies all the requirements for inclusion in the institution's HQLA but that asset has not been so included, the institution may deduct the fair value of the asset (after applying the required haircut for the particular class of HQLA to which the asset belongs) from the principal amount of the facility commitment.

Contingent funding obligations

5.8.27 Under clause 23 of the Code, a category 1 institution should calculate the expected cash outflows arising

For the calculation of expected cash outflows in these circumstances, please refer to the CIs provided for items B19 to B21 in Part 2 of Return MA(BS)1E, and the illustrative example provided in footnote 36 of the CIs.

from the following types of contingent funding obligations:

(a) trade-related contingencies;

(b) guarantees and letters of credit unrelated to trade-related contingencies

(c) uncommitted facilities; and

(d) non-contractual contingent funding obligations arising from those specific scenarios described in item 4 of Table 4 in clause 23 of the Code.

5.8.28 A category 1 institution should apply the outflow rates with respect to the relevant types of contingent funding obligations as specified in Table 4 under clause 23 of the Code.

5.8.29 In particular, a preferential outflow rate of 3% (as set out in Table 4 of clause 23 of the Code) is applicable to trade-related contingencies exclusively. A category 1 institution should have the required capacity to distinguish between (i) trade-related contingencies and (ii) other guarantees and letters of credit (unrelated to trade-related contingencies) issued by it.

5.8.30 Non-contractual contingent funding obligations will need to be included by a category 1 institution in the calculation of its LCR when there is a reasonable expectation that any of such obligations will materialise within 30 calendar days. In these circumstances, the institution should apply the outflow rates specified in Table 4 under clause 23, or notify the MA as soon as practicable in order to reach an agreement on the methodology for determining the amount of expected cash outflow arising from specific types of such non-contractual funding obligations.

5.9 Monetization of HQLA under financial stress

5.9.1 As mentioned in paragraphs 3.1.2 and 3.1.3, a category 1 institution is required to comply with the

minimum LCR requirement set out in rule 4(1) or (2) at all times, unless the institution is undergoing significant financial stress and its financial circumstances are such as described in rule 6 and hence it may apply rule 4(3) and monetize its HQLA to meet its financial obligations. This provision serves the objective of the BCBS LCR standard that banks should maintain an adequate amount of HQLA which can be monetized in the event of liquidity stress.

5.9.2 The monetization of HQLA by category 1 institutions according to rule 6 is allowed only when –

(a) 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; and

(b) the institution has no reasonable alternative other than to monetize its HQLA in such financial circumstances, notwithstanding that doing this will cause the institution's LCR fall to a level less than as required under rule 4(1) or (2) (where applicable).

5.9.3 As mentioned in paragraph 3.4.3, a category 1 institution which is taking, or is about to take, action to monetize its HQLA under rule 6 must immediately notify the MA of this "relevant liquidity event" (as specified in rule 14(3)(a)(ii)) and provide the MA with relevant information about the event.

5.9.4 Upon receipt of such a notification from a category 1 institution, the MA will assess the situation and enter into discussion with the institution in order to consider appropriate supervisory responses. In determining its supervisory responses, the MA will have regard to the guiding principles set out in paragraph 18 of the BCBS LCR standard as well as the actual circumstances of each case. Major factors for consideration include, but are not limited to –

(a) contributing factors and the seriousness of

the event;

(b) nature of the financial stress (e.g. idiosyncratic or market-wide) which the institution is encountering;

(c) state of affairs of the institution and its risk management systems and profile;

(d) viability of the institution's contingency funding plan, including the availability of contingent funding sources or measures to address the situation; and

(e) potential contagion effects to the financial system and possible implications for the availability of credit and market liquidity.

5.9.5 Depending on the actual circumstances, the MA may require the institution to comply with certain conditions to be determined by the MA pursuant to rule 16(1), so that timely and suitable measures will be taken by the institution to improve its liquidity position within a reasonable timeframe. Such conditions may include (but are not limited to) any or a combination of the following:

(a) maintenance by the institution of an LCR of not less than a level specified by the MA;

(b) submission by the institution to the MA of a plan to restore the institution's LCR to a level normally required under rule 4(1) or (2) within a reasonable period as specified in the notice;

(c) reduction by the institution of its liquidity risk exposures, or adoption of any other measures specified in the MA's notice in order to avoid further deterioration of the institution's liquidity position;

(d) enhanced reporting by the institution to the MA of its LCR position and any other information that may be specified by the MA,

in order to enable close supervisory monitoring of the institution's liquidity situation.

5.9.6 Alternatively, the MA may consider taking the measures mentioned in paragraph 3.4.4 above if the following circumstances are established:

(a) the relevant liquidity event occurring in respect of a category 1 institution is not due to the circumstances specified in rule 6[65];

(b) an event specified in rule 14(3)(a)(iii) has occurred – please refer to paragraph 3.4.3(a)(iii) above; or

(c) the MA is of the view that such actions as are mentioned in paragraph 3.4.4 are necessary to safeguard the general stability of the banking system and the interests of depositors (including potential depositors).

6. Application of LMR

6.1 Structure of LMR

6.1.1 The minimum LMR requirement provided in rule 7 is applicable to a category 2 institution on an average basis covering a calendar month. The average LMR has two components:

(a) The numerator is the sum of net weighted amounts [66] of "liquefiable assets", as determined in accordance with rule 48(3), for each working day of a calendar month.

(b) The denominator is the sum of net weighted amounts of qualifying liabilities (after

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

[66] The net weighted amount of a liquefiable asset, qualifying liability or an item deductible from such asset or liability is calculated by multiplying the principal amount of that asset, liability or deductible item by a "liquidity conversion factor" specified in Schedule 5 to the BLR.

deductions), as determined in accordance with rule 48(4), for each working day of a calendar month. The total net weighted amount of deductible items must not be more than 75% of the total net weighted amount of qualifying liabilities before any deduction.

6.1.2 Pursuant to rule 48(2), the MA may permit a category 2 institution to calculate its average LMR by reference to such days during a month as specified by the MA (instead of covering each working day of a month).[67]

6.1.3 A category 2 institution should use the standard templates provided in Part 3 of Return MA(BS)1E and follow the associated CIs to calculate the net weighted amounts of liquefiable assets and qualifying liabilities (including the deductible items).

6.2 Liquefiable assets

6.2.1 As provided under rule 49, only those types of asset specified in Table A in §2 of Schedule 5 to the BLR can be included by a category 2 institution as liquefiable assets. These assets include:

(a) currency notes and coins;

(b) gold bullion;

(c) claims on, or reserves maintained with, the MA or central banks that are repayable to a category 2 institution on demand or on notice which expires on the first day of the LMR period (i.e. within 24 hours from the date at which the LMR is calculated);

(d) net due from banks, subject to the condition that the weighted amount must not exceed 40% of the total weighted amount of a

[67] Notwithstanding this possible permission, a category 2 institution should manage its liquidity position on a daily basis with a view to maintaining a stable trend in its LMR position in compliance with the minimum requirement. A category 2 institution should avoid bearing undue liquidity risk and "window dressing" it only on such days specified by the MA under rule 48(2).

category 2 institution's qualifying liabilities (before deductions);

(e) Export bills;

(f) Marketable debt securities or prescribed instruments meeting the relevant criteria;

(g) Residential mortgage loans in respect of which The Hong Kong Mortgage Corporation Limited has issued an irrevocable commitment to purchase which is approved by the MA;

6.2.2 A category 2 institution must not include any asset in its stock of liquefiable assets unless the following criteria (as provided in rule 49(2)) are satisfied:

(a) the asset must be readily monetizable, whether by way of outright sale or being used as collateral for secured funding purposes;

(b) the asset must not be overdue or in default;

(c) the asset must be free from encumbrances and there must be no regulatory, legal, contractual or other restrictions that inhibit the category 2 institution from liquidating, selling, transferring or assigning the asset. In this regard, the guidance provided in Annex 1 is also applicable for category 2 institutions to assess whether an asset is "free from encumbrances";

(d) the value of the asset must be readily identifiable and measurable. In this regard, paragraph 5.2.3(b) above is also applicable for the purpose of identifying liquefiable assets under the LMR;

(e) the asset must be freely transferable and available to the category 2 institution and must not be subject to any liquidity transfer

restriction;[68]

(f) the asset must not be a subordinated debt security;

(g) if the asset is a structured financial instrument, the structure of the instrument must be simple and standardised; and

(h) the asset must be denominated in HKD or in a currency freely convertible into HKD. In this regard, footnote 25 is applicable, with all necessary modifications, for the assessment of an asset against this criterion for LMR purposes.

6.2.3 In respect of marketable debt securities, a category 2 institution must not include RMBS in its liquefiable assets unless such inclusion is approved by the MA under rule 49(4). Please refer to the guidance provided in Annex 2 with respect to the consideration of RMBS for LMR purposes.

6.2.4 As set out in Table B of Schedule 5 to the BLR, any debt security or prescribed instrument with a remaining term to maturity of not more than one month issued by a category 2 institution must be deducted from the institution's liquefiable assets, unless otherwise exempted by the MA.

6.2.5 A category 2 institution must have in place and maintain adequate systems and procedures for the on-

[68] In this regard, paragraph 5.2.6(e) is also applicable, with all necessary modifications, for a category 2 institution to assess an asset against this criterion for LMR purposes. This means that the asset concerned must be freely transferable and available to a category 2 institution, whether between its Hong Kong office and any of its overseas branches and specified associated entities (where applicable), and the asset is not subject to any liquidity transfer restriction.

Moreover, as provided in rule 49(3), if one or more assets held by a category 2 institution's consolidated group member are subject to liquidity transfer restriction, such assets must not be included in the institution's liquefiable assets for the calculation of its LMR, except to the extent that the qualifying liabilities (after deductions) of the member are also included in the calculation of the institution's LMR, and the assets so included satisfy all other relevant requirements in rules 49(1) and 49(2). (Please refer to the illustrative example provided in footnote 47 of the CIs for Return MA(BS)1E.)

going assessment and management of its liquefiable assets to ensure compliance with the relevant qualifying criteria. If an asset included in a category 2 institution's liquefiable assets ceases to satisfy any qualifying criterion that is applicable to the asset, the institution must exclude the asset from its stock of liquefiable assets as soon as practicable.[69]

6.2.6 If warranted by the actual circumstances, the MA may exercise the power under rule 51 (or rule 52) to order all category 2 institutions (or individual institutions) not to include an asset or a class of assets as liquefiable assets, with effect from the date or the occurrence of an event specified in a notice issued by the MA under that rule.[70]

6.3 Qualifying liabilities

6.3.1 Qualifying liabilities include all one-month liabilities of a category 2 institution except those liabilities specified in paragraph 6.3.4. As specified in Table C in §2 of Schedule 5 to the BLR, qualifying liabilities are calibrated broadly into the following categories:

(a) total one-month liabilities of a category 2 institution to the MA or central banks;

(b) if a category 2 institution's total one-month liabilities to banks exceed the total one-month liabilities of banks to the institution, the amount of its total one-month liabilities to banks; and

(c) all other one-month liabilities.

6.3.2 As defined in rule 43, "one-month liability", in relation

[69] In practice, any asset that ceases to be eligible for inclusion in a category 2 institution's stock of liquefiable assets should be excluded from the stock starting from the first working day (or, if rule 48(2) applies to the institution, the forthcoming day specified by the MA) immediately following the date of cesser.

[70] Where necessary, the MA will apply rule 51 (or rule 52) for LMR purposes in a manner similar to the modality of applying rule 29 (or rule 30) for LCR purposes. Paragraph 5.2.8 of this module is also applicable, with all necessary modifications, for LMR purposes.

to a category 2 institution or its customer, means –

(a) any liability, other than a contingent liability, the effect of which will or could be to reduce within 1 month the liquefiable assets of the institution or its customer; and

(b) any contingent liability that, in the opinion of the MA, may result in a reduction within 1 month of the liquefiable assets of the institution or its customer.

6.3.3 A category 2 institution's commitment under a facility granted to its customer should be included in the calculation of the institution's qualifying liabilities for LMR purposes, if –

(a) the commitment is "irrevocable" as assessed by the institution on reasonable grounds (please refer to paragraph 5.8.22 which is equally applicable for LMR purposes); and

(b) either one of the following conditions is met –

(i) the date for the institution to fulfil the commitment is known to fall within the LMR period, or

(ii) the commitment must be fulfilled by the institution on demand or subject to a notice period that will expire within the LMR period (unless there is evidence that any condition attached to the institution's commitment will not be realised within the LMR period[71]).

6.3.4 However, a category 2 institution does not need to include the following types of liabilities and obligations for calculating its qualifying liabilities:

(a) pledged deposits;

[71] For example, these conditions may include the execution of security document and the completion of a certain phase of a project.

(b) loan commitments arising from overdraft facilities, credit card facilities and any other facilities granted by a category 2 institution, where such facilities are genuinely and credibly revocable unconditionally by the institution;

(c) trade-related contingencies;

(d) contingent liabilities arising from derivatives contracts;[72] and

(e) non-contractual funding obligations, unless such obligations have materialised and a category 2 institution is liable to make payment under the obligation on demand or within the LMR period.

6.4 Deductions from qualifying liabilities

6.4.1 As set out in Table D in §2 of Schedule 5 to the BLR, the following types of cash inflow can be deducted from a category 2 institution's qualifying liabilities:

(a) total one-month liabilities of the MA or central banks to a category 2 institution (other than the amount included as liquefiable assets);

(b) if a category 2 institution's total one-month liabilities to banks exceed the total one month liabilities of banks to the institution, the amount of the total one-month liabilities of banks to it;

(c) the weighted amount, if any, of a category 2 institution's net due from banks exceeding the 40% cap referred to in rule 48(7); and

(d) eligible loan repayments.

[72] To avoid doubt, this does not include a category 2 institution's contractual liabilities under a derivative contract, where such contractual liabilities have materialised and therefore the institution will need to make a contractual payment within the LMR period.

6.4.2 The deduction of any cash inflow item from the qualifying liabilities of a category 2 institution is subject to the conditions that the cash inflow –

(a) is expected to be received by the institution within 1 month;[73]

(b) arises from assets (whether on-balance sheet assets or off-balance sheet assets) that are fully performing and in respect of which the institution has no reason to expect a default within 1 month; and

(c) the amount and timing for the institution to receive the cash inflow concerned are ascertained, and hence not contingent in nature.

6.4.3 A category 2 institution must have in place and maintain adequate systems and procedures for determining the net weighted amounts of cash inflow items that can be deducted from the institution's qualifying liabilities. If an inflow item does not (or ceases to) satisfy any qualifying criterion set out in paragraph 6.4.2 that is applicable to that item, the institution must not deduct that inflow item from its qualifying liabilities or must cease to do so without undue delay.

7. Liquidity disclosure standard

7.1 Disclosure of LCR or LMR information

7.1.1 Under the Banking (Disclosure) Rules (BDR), an AI, unless otherwise exempted, must include in its interim financial statements and annual financial statements specified liquidity information in respect of its LCR or LMR as the case may require. The relevant

[73] As provided in rule 53(3)(a), for the purpose of this condition, a category 2 institution must assume that a cash inflow is received by the institution at the latest possible date based on contractual rights available to the institution's customers. For example, if the institution's customer has an option to defer a payment to the institution beyond the LMR period, that payment cannot be regarded as an eligible cash inflow item for deduction from the institution's qualifying liabilities.

requirements on disclosure of liquidity information are provided in the following sections of the BDR:

(a) §30A – interim disclosure of LCR information by a locally incorporated category 1 institution;

(b) §30B – interim disclosure of LMR information by a locally incorporated category 2 institution;

(c) §51A – annual disclosure of LCR information by a locally incorporated category 1 institution;

(d) §50B – annual disclosure of LMR information by a locally incorporated category 2 institution;

(e) §103A – disclosure of LCR information by an overseas incorporated category 1 institution; and

(f) §103B – disclosure of LMR information by an overseas incorporated category 2 institution.

7.1.2 An AI should take into account the SPM module CA-D-1 "*Guideline on the application of the Banking (Disclosure) Rules*" in relation to its required liquidity disclosures.

7.2 Disclosure of information on liquidity risk management

7.2.1 Under the BDR, an AI is also required to disclose information relating to its approach to liquidity risk management that is necessary and relevant to the understanding of its liquidity risk position and liquidity management. Such information should include an AI's organization structure, framework and methodology for the management of liquidity risk.

7.2.2 An AI is encouraged to disclose the following information, to the extent practicable:

(a) a statement of the principal objectives of an AI's liquidity risk management framework;

(b) the degree to which liquidity risk management is centralised or decentralised,

with a broad description of the roles and responsibilities of, and interaction among, the relevant committees (e.g. Risk Management Committee and Asset and Liability Committee) and different functional and business units within the group structure with respect to liquidity risk;

(c) the funding strategies (including strategies for the diversification of funding sources) and intragroup lending policies, if applicable, together with a description of the regulatory restrictions on the transfer of liquidity among group entities;

(d) the systems and techniques employed (together with the key assumptions used) for measuring and managing liquidity risks. These may usually include a description of:

(i) major sources of liquidity risk to which the AI is exposed and the techniques used to mitigate liquidity risk;

(ii) the manner of addressing market liquidity risk in the liquidity risk management framework;

(iii) the approach and assumptions used for measuring and managing liquidity risk arising from off-balance sheet exposures and contingent funding obligations (including the provision of financial guarantees, credit protection, liquidity support for ABCP conduits, etc.);

(iv) the management information systems for reporting liquidity positions and risks, including the approach for measuring such positions and risks (and metrics used – see paragraph 7.3.1(a)) as well as the frequency and type of internal liquidity reports;

(v) the stress-testing scenarios adopted and how stress-testing is conducted and the results used;

(vi) an outline of the contingency funding plan and an indication of how the plan relates to the AI's stress-testing and overall business continuity plan; and

(vii) the policies on maintaining the AI's "liquidity cushion" according to section 8 of SPM module LM-2.

7.3 Other liquidity information

7.3.1 As mentioned in SPM module CA-D-1 (paragraph 3.2), the MA encourages AIs to make more extensive voluntary disclosures where it is practical for them to do so. In respect of liquidity information, AIs are encouraged to disclose, where practical, the following additional information:

(a) key internal metrics for measuring and managing liquidity risk, together with relevant explanations to facilitate the understanding of each metric, such as in relation to its objective, the time span covered, key underlying assumptions (including whether it is computed under normal or stressed conditions), and the level within the group (e.g. group, bank or non-bank subsidiary) to which the metric applies;

(b) on-balance sheet and off-balance sheet items broken down into a number of short-term maturity bands and the resultant cumulative liquidity gaps;

(c) the size and composition of the AI's liquidity cushion maintained according to section 8 of SPM module LM-2; and

(d) the extent to which the AI is subject to additional collateral requirements in relevant

contracts as a result of a credit rating downgrade.

7.4 Disclosure policy

7.4.1 Each AI should have a formal disclosure policy to ensure compliance with the applicable statutory disclosure requirements. The policy should set out, among other things:

(a) the methodologies to be adopted by the AI to ensure effective internal controls over the disclosure process;

(b) the procedure for the AI to assess the appropriateness of its disclosures (e.g. in terms of quality, scope, frequency and transparency) and to validate the accuracy of its disclosures; and

(c) the AI's approach to determining what additional information should be disclosed by the AI taking into account the guidance provided in SPM module CA-D-1 and this module.

7.4.2 The AI's disclosure policy should be reviewed and approved periodically by its Board or a Board-level commitment (such as the Audit Committee).[74]

[74] Footnote 11 applies in the case of an AI incorporated outside Hong Kong.

Annex 1 : Assets regarded as "free from encumbrances" under LCR or LMR

1. As required under §2(5) of Schedule 4 to the BLR, each asset included in a category 1 institution's HQLA must be "free from encumbrances" and, in particular, there must be no regulatory, legal, contractual or other restrictions that inhibit the institution from liquidating, selling, transferring or assigning any asset in the institution's HQLA. A similar requirement is also set out in rule 49(2)(c) for liquefiable assets held by category 2 institutions for LMR purposes.

2. The meaning of "free from encumbrances" for HQLA under the LCR is elaborated in §3(2) of Schedule 4 to the BLR. This elaboration is also applicable to liquefiable assets under the LMR (with all necessary modifications).

3. An asset must not be regarded as "free from encumbrances" if it is pledged by an AI (either explicitly or implicitly) to secure, collateralise or provide credit enhancement to any transaction, or the asset is designated by an AI to cover operational expenses (such as rents and salaries).

4. Where an asset is pledged to an AI in a securities financing transaction, the asset may be included as HQLA under the LCR, or liquefiable assets under the LMR, subject to all other qualifying requirements being met, only if –

   (a) the AI has a contractual right to re-hypothecate the asset, but the asset has not been re-hypothecated and is legally and contractually available for use by the AI, to obtain liquidity within the LCR period (or LMR period as the case may be); and

   (b) the AI has no obligation to return the asset to a third party upon demand or at any time within the LCR period (or LMR period);

5. An asset may be included in an AI's HQLA for LCR purposes (or liquefiable assets for LMR purposes), subject to all other qualifying requirements being met, if that asset is pre-positioned or deposited with, or pledged to, the MA, a central bank or PSE for the purpose of obtaining liquidity facilities, to the extent that the AI has not utilised the asset to draw on those facilities.

6. For LCR purposes, if a category 1 institution has pre-positioned or deposited with, or pledged to, the MA, a central bank or PSE a pool of

assets consisting of level 1 assets, level 2A assets, level 2B assets and other assets that do not qualify as HQLA, and no specific assets in the pool have been designated as collateral, the institution may, in determining which assets in the pool will be encumbered as it draws upon the facilities, adopt the following order –

(a) First order of encumbrance: assets not qualified as HQLA;

(b) Second order of encumbrance: level 2B assets;

(c) Third order of encumbrance: level 2A assets; and

(d) Fourth order of encumbrance: level 1 assets.

7. Likewise, for LMR purposes, if a category 2 institution has pre-positioned or deposited with, or pledged to, the MA, a central bank or PSE a pool of assets consisting of liquefiable assets and other assets that do not qualify as liquefiable assets, and no specific assets in the pool have been designated as collateral, the institution may, in determining which assets in the pool will be encumbered as it draws upon the facilities, adopt the following order:

(a) First order of encumbrance: assets not qualified as liquefiable assets;

(b) Second order of encumbrance: liquefiable assets, to be ranked by the ascending order of the respective levels of Liquidity Conversion Factor.

8. If an AI hedges the market risk of an asset included in its stock of HQLA (or liquefiable assets), it must take into account the cash flows that may arise from the hedging arrangement (including any early closure of the hedge when the asset is sold) in the calculation of its LCR or LMR.

Annex 2 : Guidance on treatment of RMBS under LCR or LMR

Recognition of RMBS as level 2B assets under LCR

1. In the light of the fact that RMBS could quickly become illiquid in times of market stress, the MA considers it necessary to exercise a greater degree of scrutiny over the inclusion of RMBS by category 1 institutions as HQLA.

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

   (a) the characteristics and operational requirements set out in Schedules 3 and 4 to the BLR respectively – please refer to paragraphs 5.2.3 to 5.2.6 of this module; and

   (b) all qualifying criteria specified in respect of RMBS under §8 in Part 3 of Schedule 2 to the BLR.

3. The qualifying criteria as referred to in paragraph 2(b) of this Annex require that the RMBS –

   (a) are issued, and their underlying assets are originated, by a person other than the institution holding the RMBS or any of the institution's associated entities. (This means that an institution must not recognise any RMBS as level 2B assets if such RMBS may represent a claim on, or an exposure to, the institution or any of its associated entities);

   (b) have a long-term ECAI issue specific rating of not lower than AA;

   (c) are traded in large, deep and active markets, characterised by a low level of concentration, and where the debt securities can be monetized through direct sale or repo-style transactions;

   (d) have a proven record as a reliable source of liquidity in the markets even during a period of financial stress. Specifically, the RMBS must not have experienced a decline of more than 20% of their market price, or an increase in haircut of more than 20 percentage points if they are used as collateral in a repo-style

transaction, within any period of 30 calendar days during a "relevant period of significant liquidity stress" since the RMBS were issued (where applicable), or in the absence of such a "relevant period of significant liquidity stress", any such period of 30 calendar days since the RMBS were issued;

(e) are backed by a pool of residential mortgage loans that have full recourse to the mortgagor and the weighted average loan-to-value ratio of which does not exceed 80% at the time when the RMBS are issued; and

(f) are subject to regulations which require issuers of the RMBS to retain an interest in the RMBS.

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

Recognition of RMBS as liquefiable assets under LMR

5. To maintain a level playing field between category 1 institutions and category 2 institutions in relation to the treatment of RMBS, the MA applies the same set of qualifying criteria for determining institutions' applications for including RMBS as HQLA under the LCR or as "liquefiable assets" under the LMR. Therefore, paragraphs 2 to 4 of this Annex are similarly applicable for LMR purposes, with all necessary modifications. In other words, no approval will be granted to a category 2 institution for inclusion of RMBS as liquefiable assets for LMR purposes, unless the MA is satisfied that –

(a) the relevant RMBS are able to meet –

(i) the requirements set out in rule 49(2) that are applicable generally to liquefiable assets; and

(ii) qualifying criteria comparable to those applicable to the recognition of RMBS for LCR purposes; and

(b) the applying institution has sufficient capacity to manage the relevant risks associated with its holding of such RMBS.

Application

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

7. Any application for inclusion of RMBS under the LCR or LMR will be carefully assessed by the MA. Where necessary, the MA 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 institution as HQLA (or liquefiable assets), if this is warranted by the circumstances of the case.

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