Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III LCR regulations – Hong Kong SAR

March 2015

BANK FOR INTERNATIONAL SETTLEMENTS

Note that this report refers to the RCAP grades prior to October 2025. The grade 'materially non-compliant (MNC)', ie one notch above the lowest grade, has since been renamed to 'partially non-compliant (PNC)' for greater clarity

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Glossary

AI	Authorized institution
BAO 2012	Banking (Amendment) Ordinance 2012 (Hong Kong)
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BCR	Banking (Capital) Rules (Hong Kong)
BDR	Banking (Disclosure) Rules (Hong Kong)
BDAR 2014	Banking (Disclosure) (Amendment) Rules 2014 (Hong Kong)
BLR	Banking (Liquidity) Rules (Hong Kong)
BIS	Bank for International Settlements
BO	Banking Ordinance (Hong Kong)
C	Compliant (grade)
CFP	Contingency funding plan
CIs	Completion instructions (Hong Kong)
CP	Core Principle (Basel Core Principles)
D-SIB	Domestic systemically important bank
DPS	Deposit Protection Scheme (Hong Kong)
ECAI	External Credit Assessment Institution
FAQ	Frequently asked question
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FX	Foreign exchange
GDP	Gross domestic product
G-SIB	Global systemically important bank
HK	Hong Kong
HKD	Hong Kong Dollar
HKDPB	Hong Kong Deposit Protection Board
HKMA	Hong Kong Monetary Authority
ICAAP	(Internal) Capital Adequacy Assessment Process
IRB	Internal Ratings-Based Approach (credit risk)
LC	Largely compliant (grade)
LCR	Liquidity Coverage Ratio
LERS	Linked Exchange Rate system
LMR	Liquidity Maintenance Ratio (Hong Kong)
MDB	Multilateral development bank
MNC	Materially non-compliant (grade)
N/A	Not applicable
NC	Non-compliant (grade)
RCAP	Regulatory Consistency Assessment Programme
SIG	Supervision and Implementation Group
SPM	Supervisory Policy Manual (Hong Kong)
SRP	Supervisory Review Process (Hong Kong)

Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. Through its Regulatory Consistency Assessment Programme (RCAP) the Basel Committee monitors, assesses, and evaluates its members' implementation of the Basel framework.

The assessments under the RCAP aim to ensure that each member jurisdiction adopts the Basel III framework in a manner consistent with the framework's letter and spirit. The framework's intent is to establish prudential requirements that are based on a sound, transparent and well defined set of regulations that will help strengthen the international banking system, improve market confidence in regulatory ratios, and ensure an international level playing field.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Liquidity Coverage Ratio (LCR) standards in Hong Kong SAR and their consistency with the Basel III framework.[1] Based on the rule-making powers conferred by the Banking Ordinance (BO), the Hong Kong Monetary Authority (HKMA)[2] established the local rules for the LCR in 2014 by (i) issuing a new set of Banking (Liquidity) Rules (BLR) to implement the Basel III LCR framework; and (ii) amending the existing Banking Disclosure Rules (BDR) via the Banking (Disclosure) (Amendment) Rules 2014 (BDAR 2014) to implement the Basel LCR disclosure standards. The BLR came into effect on 1 January 2015 in line with the internationally agreed schedule. As amended by the BDAR 2014 (which completed the legislative process on 5 February 2015 and will take effect from 31 March 2015), the BDR require category 1 institutions (ie authorized institutions (AIs) designated by the HKMA to be subject to the LCR) to make the required LCR disclosures from their first reporting period ending on and after 1 January 2015 (in line with the Basel requirement).[3] The LCR rules are supplemented by a Code of Practice and a set of standard calculation methodology templates, both of which were issued by the HKMA in December 2014 to provide guidance on the calculation and reporting of the LCR. A supervisory circular letter was also published by the HKMA on 6 February 2015 to provide further guidance on the HKMA's approach to applying certain key requirements in the BLR relating to the LCR and to address some identified implementation issues. In the course of the assessment, the HKMA made revisions of the draft rules based on issues identified by and discussed with the Assessment Team.

The Assessment Team was led by Mr Arthur Lindo, Senior Associate Director at the Federal Reserve Board, and comprised two technical experts from Brazil and Switzerland (Annex 1). The main counterpart for the assessment was the HKMA. The overall work was coordinated by the Basel Committee Secretariat with support from Federal Reserve Board staff. The assessment relied upon the data and information provided by the HKMA up to 7 February 2015. The report's findings are based primarily on an understanding of the current processes in Hong Kong as explained by counterpart staff and documents provided to the Assessment Team.

[1] Please also see the accompanying assessment report on Hong Kong's compliance with risk-based capital standards. Other Basel III standards, namely the Net Stable Funding Ratio, the leverage ratio, and the framework for systemically important banks will be assessed as those standards become effective per the internationally agreed phase-in arrangements.

[2] In this report, HKMA refers to "Monetary Authority" (the legal authority under the BO) or "Hong Kong Monetary Authority" (the office of the Monetary Authority), as the context so requires.

[3] In effect, all category 1 institutions will be required to disclose their LCR and related information starting from their first interim financial disclosure in 2015 covering the six-month period ending on 30 June 2015.

The assessment work was carried out in the following three phases (Annex 4): (i) completion of an RCAP questionnaire (a self-assessment) by the HKMA; (ii) an off- and on-site assessment phase by the Assessment Team; and (iii) a post-assessment review phase. The off- and on-site phase included a visit to Hong Kong, during which the Assessment Team held discussions with the HKMA, the seven largest banks in Hong Kong (which were used as the RCAP sample banks for the purpose of impact assessment), three audit firms, and three credit rating agencies. These discussions provided the Assessment Team with a deeper understanding of the implementation of the Basel III regulations and practices in Hong Kong. The third phase consisted of a two-stage technical review of the assessment findings by a separate RCAP review team and a discussion by the Basel Committee's Supervision and Implementation Group (SIG), followed by a review and clearance by the RCAP peer review board. This two-step review process is a key part of the RCAP for substantive quality control and to facilitate the consistency of RCAP assessments.

The scope of the assessment was limited to the consistency and completeness of the domestic regulations in Hong Kong with the Basel framework (see Annex 2 for the related Basel standards). Where domestic regulations and provisions were identified to be inconsistent with the Basel framework, those deviations were evaluated for their current and potential impact on the liquidity ratios for the sample of internationally active banks in Hong Kong. Issues relating to the adequacy of prudential outcomes, liquidity levels of individual banks, or the HKMA's supervisory effectiveness were not in the scope of this RCAP assessment exercise.[4]

This report has the following three sections and a set of annexes: (i) an executive summary including a statement from the HKMA; (ii) the primary set of assessment findings including a description of the assessment, scope and methodology; and (iii) details of the assessment findings along with other assessment related observations.

The Assessment Team sincerely thanks Mr Arthur Yuen, Deputy Chief Executive, Ms Karen Kemp, Executive Director, Ms Rita Yeung (Head, Banking Policy Division), and the staff of the HKMA for the professional and efficient cooperation extended to the Assessment Team throughout the assessment.

4 Some of these issues, including Hong Kong's compliance with the Basel Core Principles for Effective Banking Supervision (BCP) have recently been reviewed under the IMF-World Bank Financial Sector Assessment Program (FSAP) in 2014. See www.imf.org/external/pubs/cat/longres.aspx?sk=41752.0.

Executive summary

The HKMA implemented the Basel III LCR regulations consistently with the internationally agreed timeline, ie by 1 January 2015, and has also applied the transitional arrangements in line with Basel III.

In Hong Kong, the LCR standards apply to 12 banks (10 locally incorporated and two overseas incorporated banks) classified as "category 1 institutions", which account for around 60% of the total banking assets. All other AIs not designated by the HKMA as "category 1 institutions"[5] (ie category 2 institutions) are subject to a local liquidity standard (ie Liquidity Maintenance Ratio – LMR)[6]. The 12 category 1 institutions include all the locally incorporated internationally active banks in Hong Kong. These institutions are required to comply with the international LCR standards as prescribed in the local LCR rules, the subject of this assessment.[7]

The Assessment Team finds the HKMA LCR regulations compliant with the standards prescribed under the Basel framework. Both subcomponents of the LCR, ie the LCR regulation as such and the LCR disclosure standards, are also assessed as being compliant. The team did not identify any deviation from the framework.

The team made one observation related to the LCR outflows. It refers to the expectation of the LCR standards for national authorities to develop additional buckets with higher outflow rates. The HKMA did not make use of this possibility even though the behaviour of foreign currency assets could be different to HKD assets and the behaviour of high-value deposits could (as with the assumed differences between small business customers and larger corporates, for example), be different from non-high-value deposits. The evidence provided to the team suggests that this has not been the case for Hong Kong in the past, but is based on a short time horizon (since 2012). The HKMA signalled that it will keep monitoring the run-off rates for these categories of depositors and might consider future adjustments, where necessary.

While the focus of the RCAP exercise was on the consistency and completeness of regulatory LCR requirements, it became evident from the Hong Kong assessment that effective implementation of LCR standards will require some clarification by the Basel Committee of certain Basel standards that provide members with room for judgment (see Annexes 11 and 14) and thereby open the way for possibly different interpretation. In addition, other elements of the international standards, such as the *Principles for sound liquidity risk management and supervision* and the LCR monitoring tools (Annexes 9 and 10), as well as the Basel Guidance on monitoring tools for intraday liquidity management (Annex 9), are important elements that facilitate the implementation of the LCR, but were subject to self-reporting and not to a formal assessment.

5 See Section 1.1 for more information.

6 The rationale for that distinction is to account for the diversity of AIs in terms of their nature and scale of business as well as operational sophistication and systemic importance to the Hong Kong banking system.

7 The team did not assess the local liquidity standard.

Response from the HKMA

The HKMA welcomes the opportunity for Hong Kong to be among the first two jurisdictions to be assessed under RCAP for their implementation of the Basel III LCR standards, and would like to record its appreciation of the dedication and professionalism with which the Assessment Team, under the leadership of Arthur Lindo, approached the RCAP review of Hong Kong.

The RCAP assessment overlapped in part with the development of the rules and supervisory guidance required to establish the regulatory LCR framework in Hong Kong prior to its implementation on 1 January 2015, and was thus able to provide a valuable source of reference in the development of certain aspects of the regime. The HKMA is pleased that Hong Kong has received an overall compliant rating in relation to its LCR regulations (including LCR disclosure standards).

With respect to the observation raised by the Assessment Team relating to the outflow treatment for less stable retail deposits, the HKMA would offer the following comments and clarifications:

- It should be noted that the outflow treatment for less stable retail deposits varies across BCBS member jurisdictions, largely reflecting the diversity of local circumstances that need to be addressed in different ways. Hong Kong has decided to adopt a standard outflow rate for less stable retail deposits under the LCR. The HKMA studied the stability of different types of less stable retail deposits, based on an analysis of available data (which was regrettably limited and covered only two years), and considered other relevant feedback from industry consultation. Given the lack of reasonably consistent and sufficient data to support a differentiated outflow treatment for less stable retail deposits, the HKMA considered it more appropriate, at least in the initial stage of implementation, to adopt a standard outflow rate for such deposits (which is similar to the approach adopted in a number of other BCBS member jurisdictions), supplemented by an existing power under the Banking Ordinance for the HKMA to increase such rate for individual AIs where this is warranted.
- Adopting a standard outflow rate for such deposits at this time does not preclude the HKMA from revising the approach when there is sufficient evidence to justify a more differentiated treatment for less stable retail deposits. The HKMA will continue to monitor and review relevant information for this purpose.

On the whole, the HKMA considered the RCAP process a very useful exercise, which also served to identify some areas within the Basel liquidity standards that require clarification to ensure their consistent and effective implementation across jurisdictions going forward.

1 Assessment context and main findings

1.1 Context

Status of implementation

The HKMA is the prudential regulator for the banking sector in Hong Kong. The Basel III LCR standards have been in effect from 1 January 2015, in line with the internationally agreed schedule. The LCR rules were implemented via the BLR and the BDR, which are subsidiary legislation under the BO (see Annex 3 for a complete timeline).

In Hong Kong, the LCR standards apply to 12 banks (10 locally incorporated and two foreign incorporated) classified as "category 1" institutions (see Annex 7), which account for around 60% of the total banking assets. All other AIs not designated by the HKMA as "category 1 institutions"[8] (ie category 2 institutions) are subject to a local liquidity standard (ie Liquidity Maintenance Ratio (LMR)). The rationale for that distinction is to account for the diversity of AIs in terms of their nature and scale of business as well as operational sophistication and systemic importance to the Hong Kong banking system. The 12 category 1 institutions include all the locally incorporated internationally active banks in Hong Kong (eight AIs, see Annex 7). These institutions are required to comply with the international LCR standards as prescribed in the local LCR rules, the subject of this assessment.[9]

In addition to the LCR regulations, the HKMA also implemented the BCBS *Principles for sound liquidity risk management and supervision* through the issuance of a statutory guideline under its Supervisory Policy Manual (SPM) in April 2011. Standard reporting templates and associated completion instructions (CIs) for implementation of the liquidity monitoring tools and the intraday liquidity monitoring tools have been developed for implementation beginning June 2015. These requirements are applicable to all AIs (or to all locally incorporated banks and any other AIs with significant intraday liquidity activities that may be designated by the HKMA). A factual description of how each of these frameworks is implemented in Hong Kong is provided in Annexes 9 and 10, respectively.

Regulatory system and model of supervision

With total financial assets of HKD 19.6 trillion (US$2.5 trillion; or 920% of Hong Kong's GDP, Annex 7), the banking system in Hong Kong is one of the largest financial systems in the world. In June 2014, 202

8 In determining whether an AI should be designated as a category 1 institution, the HKMA takes into account a set of relevant criteria and factors, including whether (i) the AI is "internationally active" or significant to the general stability and effective working of the banking system in Hong Kong; (ii) the liquidity risk of the AI is material; or (iii) there is a risk of regulatory arbitrage if a category 2 institution connected to a category 1 institution is not designated as a category 1 institution. To facilitate the HKMA's assessment, quantitative benchmarks are used (re: total asset size, and level of international exposures as measured by the sum of an AI's external claims and liabilities) in conjunction with the review of other relevant "qualitative" factors (such as the nature and complexity of an AI's business operations, its role in the local banking system and financial markets, and the potential impact of its failure on banking stability in Hong Kong). The high-level criteria for designation of AIs as category 1 institutions are set out in Schedule 1 to the BLR. Further guidance and elaboration on the application of such criteria are provided in the HKMA's circular issued on 6 February 2015. The relevant guidance and elaboration will be incorporated into an SPM module in the course of 2015.

9 The team did not assess the local liquidity standard.

AIs operated in Hong Kong (see Annex 7), 57 thereof were locally incorporated AIs, and 145 were branch entities.[10]

The HKMA, established on 1 April 1993, is charged with maintaining monetary and banking stability. The HKMA's monetary policy objective is to maintain currency stability within the framework of the Linked Exchange Rate system (LERS)[11] In its role as Hong Kong's banking regulator, the HKMA is charged with promoting financial stability and the stability and effective working of the banking system, as well as helping to maintain Hong Kong's status as an international financial centre, in part through the maintenance and development of Hong Kong's financial infrastructure.

The most recent assessment of Hong Kong's compliance with the Basel Committee's *Basel Core Principles for Effective Banking Supervision* (BCP) was conducted in 2013 as part of the FSAP, the results of which were published in July 2014.[12] That assessment found a high level of compliance with the BCP[13] and that the HKMA's supervisory practices, standards and approaches were considered well developed, risk-based and of high quality.

1.2 Structure and enforceability of prudential regulations

The liquidity regulations are subject to a well defined legislative process. The same legislative procedures are used as for capital regulations. The relevant hierarchy of prudential rules through which the Basel framework is implemented in Hong Kong consists of the following (see Annex 3):

- Primary and secondary legislation, enacted by the Legislative Council; and
- Different forms of regulatory instruments issued by the HKMA, which clarify legislative and supervisory frameworks, and articulate regulatory and supervisory expectations, including:
    - Codes of practice
    - Statutory guidelines
    - Other guidance

The HKMA's LCR requirements issued before 7 February 2015 in final form meet the RCAP criterion of being enforceable and binding in nature (Annex 6).

1.3 Scope of the LCR assessment

The assessment was made of the LCR requirements as applicable to all category 1 institutions in Hong Kong. In evaluating the materiality of the findings, the quantification was limited to the agreed seven banks subject to the RCAP review (all of which are category 1 institutions).[14] These banks account for

10 See the RCAP report on risk-based capital standards for further information, www.bis.org/bcbs/implementation/l2.htm.

11 See the RCAP report on risk-based capital standards for further information on the HKMA's role with respect to monetary stability, www.bis.org/bcbs/implementation/l2.htm.

12 See www.imf.org/external/pubs/ft/scr/2014/cr14207.pdf.

13 Hong Kong was assessed as compliant on CP 24 and CP 28 (disclosure and transparency related to Pillar 3).

14 Data were collected from the following banks: The Hongkong and Shanghai Banking Corporation Ltd, Bank of China (Hong Kong) Ltd, Standard Chartered Bank (Hong Kong) Ltd, The Bank of East Asia Ltd, Industrial and Commercial Bank of China (Asia) Ltd, China Construction Bank (Asia) Corporation Ltd and DBS Bank (Hong Kong) Ltd.

approximately 57% of Hong Kong's banking sector assets, and the largest bank alone makes up 29% of the sector's total assets.

Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the two components of the Basel LCR framework (LCR and LCR disclosure requirements) and overall assessment of compliance: compliant (C), largely compliant (LC), materially non-compliant (MNC) and non-compliant (NC).[15]

The non-quantifiable aspects of identified observations were discussed and reviewed with the HKMA, in the context of the prevailing regulatory practices and processes.

Ultimately, the assignment of the assessment grades was guided by the collective expert judgment of the Assessment Team. In doing so, the Assessment Team relied on the general principle that the burden of proof rests with the assessed jurisdiction to show that a finding is not material or not potentially material. A summary of the materiality analysis is given in Section 2 and Annex 8.

In a number of areas, the HKMA's liquidity requirements go beyond the minimum Basel standards. Although these elements provide for a more rigorous implementation of the Basel framework in some aspects, they have not been taken into account for the assessment of compliance under the RCAP methodology as per the agreed assessment methodology (see Annex 13 for a listing of areas of super-equivalence).

1.4 Main findings

Overall, the Assessment Team considers the LCR regulation compliant, as are both subcomponents, namely the LCR regulation and the LCR disclosure standards. The grade reflects the fact that the team did not identify any deviations from the framework (Annex 8). This is reflective of the fact that some changes were made by the HKMA (following discussions with the Assessment Team) in finalising the LCR rules (Annex 5).

More details are provided in the main findings section below.

[15] This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of the Basel framework that are not relevant to an individual jurisdiction may be assessed as not applicable (N/A). For further details, see www.bis.org/publ/bcbs264.htm.

Summary assessment grading	Table 2
Key components of the Basel LCR framework	Grade
Overall grade	C
LCR subcomponents (as agreed by the Basel Committee in September)	
Liquidity Coverage Ratio regulation	C
LCR Disclosure Standards	C

Compliance assessment scale (see Section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant).

Main findings by component

Scope of application and transitional arrangements

The Assessment Team did not identify any deviation from the Basel standards. As informed in Section 1.1, the LCR standards apply to 12 *category 1 institutions* in Hong Kong, which include all eight internationally active banks (Annex 7). The other AIs, classified as "category 2 institutions", are required to comply with a domestic liquidity ratio (LMR), which was not assessed herein. LCR implementation follows the phase-in transitional arrangement proposed by Basel, starting with a 60% minimum requirement by January 2015 and reaching 100% in January 2019.

High-quality liquid assets (numerator)

With respect to the HQLA rules, no deviation from the Basel rules was identified. HKMA applies the Alternative Liquidity Approaches (ALA) approach due to an insufficient supply of HKD-denominated HQLA to meet category 1 institutions' potential liquidity needs. The use of ALA was limited to 80% of total net cash outflows and this 20% gap between the minimum LCR and the maximum ALA will be constant during the whole phase-in period.[16]

Outflows (denominator)

The team identified no deviations, but noted the following observation: According to paragraph 79 of the Basel standards, supervisory authorities are expected to develop additional buckets with higher outflow rates for less stable deposits. The HKMA did not make use of this possibility even though the behaviour of foreign currency assets could be different to HKD assets and the behaviour of high value deposits could be different. The evidence provided to the team suggests that this has not been the case for Hong Kong in the past, but is based on a short time horizon (since 2012). The HKMA signalled that it will keep monitoring the run-off rates for these categories of depositors and might consider future adjustments, where necessary.

[16] The maximum level of HKD LCR mismatch that can be covered by foreign currency-denominated HQLA under ALA Option 2 is determined by reference to the 20% minimum holding requirement. That is, if the minimum LCR requirement is 60%, the maximum usage of ALA Option 2 (or foreign currency-denominated HQLA) will be 40% (= 60% – 20%) of HKD-denominated total net cash outflows.

Inflows (denominator)

The Assessment Team did not identify any deviation from the Basel standards.

Disclosure requirements

The Assessment Team did not identify any relevant deviation from the Basel standards. Up to 1 January 2017, HKMA will permit the alternative calculation of the average values proposed by Basel[17] if a category 1 institution faces a practical difficulty in calculating such value using day-end positions.

17 A category 1 institution will be allowed to calculate the "average values" based on the arithmetic mean of the item as at each month-end for each quarter preceding 1 January 2017.

2 Detailed assessment findings

The component-by-component details of the assessment of compliance with the LCR standards of the Basel framework are detailed below. The focus of Sections 2.1 to 2.2 is on findings that were assessed to be deviating from the Basel minimum standards and their materiality. Section 2.3 lists other observations that were identified, but which do not constitute deviations.

2.1 LCR

2.1.1 Scope of application and transitional arrangements

No deviations.

2.1.2 High-quality liquid assets (numerator)

No deviations.

2.1.3 Outflows (denominator)

No deviations.

2.1.4 Inflows (denominator)

No deviations.

2.2 LCR disclosure requirements

No deviations.

2.3 Observations

Basel LCR paragraph no	Paragraphs 55–67: Treatment of jurisdictions with insufficient HQLA
Reference in domestic regulation	BLR §36–38
Findings	HKMA provided us with verbal information about the analysis undertaken to assess the requirement for adoption of an ALA option and assets considered ALA-eligible by the seven RCAP banks (see Annex 7). The assessment team did not undertake an assessment or form any view on Hong Kong's eligibility for ALA, as foreseen by the RCAP. The final decision on Hong Kong's ALA eligibility will be subject to a separate process.
Basel LCR paragraph no	Paragraphs 79–81: Total net cash outflows – Definition of cash outflows: Retails deposit run-off, Less stable deposits
Reference in domestic regulation	BLR §39 (definition of "less stable retail deposit")
Findings	According to paragraph 79 of the Basel standard text, supervisory authorities are expected to develop additional buckets with higher outflow rates for less stable retail deposits. HKMA did not make use of this possibility even though the behaviour of foreign currency assets could be different to HKD assets as is the case for high-value deposits. HKMA provided the team with aggregate data which indicate that there was no different behaviour for such deposits in Hong Kong during the last two years. Based on this assessment, which did not include a period of substantial stress in the markets, though, HKMA dropped its initial proposal of higher outflow rates for high-value deposits during the consultation period. The HKMA signalled, however, that it intends to keep the need for adjustments in this area under review, taking into account future trends and analysis.

Annexes

Annex 1: RCAP Assessment Team and Review Team

Assessment Team Leader:

Mr Arthur Lindo	Federal Reserve Board, United States

Assessment Team Members:

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Mr Michael Pohl	FINMA, Switzerland

Supporting Members:

Mr Page Conkling	Federal Reserve Board, United States
Mr Christian Schmieder	Basel Committee Secretariat

Review Team Members:[18]

Mr Karl Cordewener	Basel Committee Secretariat
Mr Matthias Güldner	SIG member, BaFin, Germany
Mr Sebastijan Hrovatin	SIG member; European Commission, EU
Mr Nkosana Mashiya	SIG member, South Africa Reserve Bank, South Africa

[18] The Review Team is distinct from the Assessment Team, and provides an additional level of quality assurance for the report's findings and conclusions. The Assessment Team has also benefited from the feedback of the RCAP Peer Review Board. The Assessment Team has also coordinated closely with Mr Udaibir Das, Head of Basel III Implementation at the Basel Committee Secretariat.

Annex 2: List of LCR standards under the Basel framework used for the assessment

Basel documents in scope of the assessment

(i) *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013), including the frequently asked questions on Basel III's January 2013 liquidity coverage ratio (April 2014);

(ii) *Liquidity Coverage Ratio disclosure standards* (January 2014);

Basel documents reviewed for information purposes

(iii) *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013) (part on liquidity risk monitoring tools);

(iv) *Monitoring tools for intraday liquidity management* (April 2013); and,

(iv) *Principles for sound liquidity risk management and supervision* (September 2008).

Annex 3: Local regulations issued by the HKMA for implementing Basel LCR standards

Overview of issuance dates of important HKMA liquidity rules — Table 3

Domestic regulations	Name of the document, version and date
Banking Ordinance (BO)	BO (primary legislation) – §97H of the BO (as amended by the Banking (Amendment) Ordinance 2012 (BAO 2012) empowers the HKMA to prescribe liquidity requirements for authorized institutions (AIs), thus providing the legal basis for the BLR. This section and other liquidity-related provisions in the BAO 2012 came into effect on 1 January 2015. The HKMA's power to prescribe liquidity disclosure requirements for AIs in the BDR is derived from §60A of the BO.
Banking (Liquidity) Rules (BLR)	BLR (subsidiary legislation) – this new set of rules, which were made by the HKMA under §97H(1) of the BO to implement, among other things, the Basel III LCR requirements in Hong Kong, came into effect on 1 January 2015.[19]
Banking (Disclosure) Rules (BDR)	BDR (subsidiary legislation) – the HKMA has proposed amendments to the BDR via the Banking (Disclosure) (Amendment) Rules 2014 (BDAR 2014) to implement, among other things, the disclosure requirements relating to the LCR in Hong Kong. The BDAR 2014 were gazetted on 24 December 2014 and completed the negative vetting process by the Legislative Council on 5 February 2015. As amended by the BDAR 2014 (which will commence operation from 31 March 2015), the BDR require category 1 institutions to disclose their LCR and related information from their first reporting period ending on or after 1 January 2015, in line with the BCBS LCR disclosure standards issued in March 2014.[20]

[19] Two minimum liquidity standards were prescribed under the BLR, ie the LCR (to which AIs designated by the HKMA as category 1 institutions are subject) and the liquidity maintenance ratio (LMR), a modified version of the locally developed minimum liquidity ratio in force prior to 1 January 2015, applicable to AIs not subject to the LCR (ie category 2 institutions).

[20] In effect, all category 1 institutions will be required to disclose their LCR and related information starting from their first interim financial disclosure in 2015 covering the six-month period ending on 30 June 2015.

Hierarchy of Hong Kong laws and regulatory instruments Table 4

Level of rules (in legal terms)	Type
Primary legislation	Enacted by the Legislative Council
Subsidiary legislation/rules	Enacted by the Legislative Council
Codes of practice	Issued by HKMA
Statutory guidelines	Issued by HKMA
Other guidance	Issued by HKMA

The regulatory instruments relevant to the HKMA's implementation of the Basel LCR standards include the following:

- Banking (Liquidity Coverage Ratio – Calculation of Total Net Cash Outflows) Code (Code of Practice) – this new Code of Practice has been approved and issued by the HKMA under §97M of the BO for the purposes of providing guidance in relation to the calculation of total net cash outflows under the LCR;
- Supervisory circular on application of minimum liquidity standards – this circular (with an attached guideline) has been issued by the HKMA to provide supplementary guidance on the application of the key aspects of the LCR and LMR requirements. The guidance provided under the circular will form the basis for revising the existing Supervisory Policy Manual (SPM) module LM-1 "Liquidity Risk Management", a statutory guideline issued by the HKMA under §16(10) of the BO. The revised LM-1 will be renamed "Regulatory Framework for Supervision of Liquidity Risk" to provide an overview of the local regulatory liquidity framework (including guidance on the application of LCR and LMR requirements);
- SPM module LM-2 "Sound Systems and Controls for Liquidity Risk Management" – this statutory guideline issued by the HKMA under §16(10) of the BO sets out the liquidity risk management standards for AIs, in line with the 2008 BCBS *Principles for sound liquidity risk management and supervision*. LM-2 complements, and reinforces, the minimum liquidity standards set out in the BLR. (In the recent IMF Financial Sector Assessment Program (FSAP) for Hong Kong (report published on 16 July 2014), the assessors assigned a "compliant" rating to Hong Kong's compliance with Basel Core Principle 24 re liquidity risk);
- Return of Liquidity Position of an Authorized Institution (MA(BS)1E) – this Return, which AIs are required to submit to the HKMA under §63 of the BO, has been revised to incorporate the requirements for the calculation and reporting of the LCR and the LMR. Contained in this Return are standard calculation methodology templates that category 1 institutions must use for the calculation of their LCR (as required under the BLR). The revised Return (and its accompanying completion instructions (CIs)) were finalised before the end of 2014 for implementation from 1 January 2015.
- LCR standard disclosure template – this template is specified by the HKMA as the template that category 1 institutions must use for the purposes of disclosing their LCR and related information as required under the BDR (as amended by the BDAR 2014). The HKMA has developed this template (and its accompanying CIs) in line with the common template and CIs prescribed in the BCBS LCR disclosure standards.

To facilitate the HKMA's supervisory monitoring of AIs' liquidity risk, the following new returns have been developed and will be issued by the HKMA under §63 of the BO for reporting by AIs in 2015:

- Return on Liquidity Monitoring Tools (MA(BS)23) – this Return (with its accompanying CIs) is to implement the BCBS guidance on liquidity monitoring tools contained in the January 2013 Basel III LCR document; and
- Return on Intraday Liquidity Position (MA(BS)22) – this Return (with its accompanying CIs) is to implement the BCBS guidance on intraday liquidity monitoring tools issued in April 2013.

Annex 4: Details of the RCAP assessment process

A. Off-site evaluation

(i) Completion of a self-assessment questionnaire by the HKMA

(ii) Evaluation of the self-assessment by the RCAP Assessment Team

(iii) Independent comparison and evaluation of the domestic regulations issued by the HKMA with the corresponding Basel III standards issued by the BCBS

(iv) Identification of observations

(v) Refinement of the list of observations based on clarifications provided by the HKMA

(vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment

(vii) Forwarding of the list of observations to the HKMA

B. On-site assessment

(viii) Discussion of individual observations with the HKMA

(ix) Meeting with selected Hong Kong banks, accounting firms and a credit ratings agency

(x) Discussion with the HKMA and revision of findings to reflect additional information received

(xi) Assignment of component grades and overall grade

(xii) Submission of the detailed findings to the HKMA with grades

(xiii) Receipt of comments on the detailed findings from the HKMA

C. Review and finalisation of the RCAP report

(xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to the HKMA for comments

(xv) Review of the HKMA's comments by the RCAP Assessment Team

(xvi) Review of the draft report by the RCAP Review Team

(xvii) Review of the draft report by the Peer Review Board

(xviii) Reporting of findings to SIG by the team leader

Annex 5: List of rectifications by the HKMA

The HKMA did not make any changes to its final rules. The changes made by the HKMA while finalising the LCR rules based on discussions with the Assessment Team are not recorded herein – as per the RCAP process.

Annex 6: Assessment of bindingness of regulatory documents

The following table summarises the HKMA's self-assessment of the seven criteria used by the RCAP to determine the eligibility of the HKMA's regulatory instruments for the RCAP. The Assessment Team concluded that the regulatory instruments issued and used by HKMA (as set out in Table 4 of Annex 3) are eligible for the RCAP assessment.

Criterion	Assessment (by HKMA)
(i) The instruments used are part of a well defined, clear and transparent hierarchy and regulatory framework	The Banking Ordinance (BO) provides a comprehensive framework for the setting and enforcing of minimum prudential standards for AIs, including capital, liquidity and disclosure requirements as well as (among other things) ownership, governance, internal controls, provisioning, and large exposures. Specifically in relation to capital, liquidity and disclosure requirements, the BO grants the HKMA the power to issue rules which, without limit to generality, "may give effect to banking supervisory standards … issued by the Basel Committee". The HKMA has used these provisions to issue the Banking (Capital) Rules (BCR), the Banking (Disclosure) Rules (BDR) and the Banking (Liquidity) Rules (BLR) (which took effect from 1 January 2015). These rules have the status of subsidiary legislation. The BO also provides for the HKMA to issue guidance indicating the manner in which the HKMA proposes to exercise its functions under the BO (including the rules made under it) and to issue codes of practice for the purpose of providing guidance in respect of any relevant provisions in the BCR, BDR and BLR. The HKMA's Supervisory Policy Manual (SPM) sets out the HKMA's supervisory policies and practices; minimum standards AIs are expected to attain in order to satisfy the requirements of the BO (which by definition will include the rules made under it); and recommendations on best practices that AIs should aim to achieve. Modules within the SPM fall into three broad categories: • statutory guidelines issued under the BO – these set out the minimum standards with which AIs are expected to comply to satisfy the requirements of the BO. In addition to minimum standards, statutory guidelines may also embody best practices or advisory standards; • non-statutory guidelines issued as guidance notes – these are best practice guides setting out the HKMA's recommendations to AIs in respect of the standards they should aim to achieve, subject to the AIs' size, complexity and scope of activities; and • non-statutory guidelines issued as technical notes – these are usually technical in nature and are for the purpose of clarifying the HKMA's interpretation of regulatory and reporting matters A number of SPM modules complement the application of the BCR and the BDR (and from 1 January 2015 the BLR) and are referred to, where relevant, in the self-evaluation. The power to issue codes of practice is relatively new, having been introduced in 2013. The HKMA has made use of the power to issue a Code of Practice, to supplement the BLR, in relation to the detailed mechanics of calculating total net cash outflows for the LCR. The HKMA is not, however, restricted to issuing guidance in the form of SPM modules or codes of practice and can issue guidance in other forms including supervisory circular letters and frequently asked questions (FAQs). Further, as under the BO, the HKMA can require AIs to submit information to the HKMA in such manner as the HKMA may require, the requirements for AIs to calculate capital and liquidity ratios in accordance with the completion instructions (CIs) accompanying the relevant Banking Returns also has the practical effect of "prescribing" the calculation methodology. The HKMA will monitor AIs' compliance with issued guidance as part of its regular supervision.

(ii)	They are public and freely available	The BO, the BDR and the BLR are available on the website of the Department of Justice (as is all current legislation in Hong Kong). The HKMA publishes SPM modules and other circulars, FAQs and Banking Returns on its website. Codes of practice are required to be gazetted in the Government Gazette and a copy is maintained on the HKMA website.
(iii)	They are viewed as binding by banks as well as by the supervisors	The BO, the BDR and (from 1 January 2015) the BLR, as primary and subsidiary legislation respectively, are binding in Hong Kong and failure to comply may constitute a criminal offence. Any failure to adhere to any of the guidelines issued by the HKMA, whether statutory or non-statutory, may call into question whether the AI concerned continues to satisfy the ongoing authorization criteria under the BO. In addition, where such failure is in respect of any statutory guideline, it may constitute a contravention of the relevant provision or requirement of the BO. Accordingly, severe sanctions may potentially result from failure to adhere to a guideline. In the recent FSAP of Hong Kong the assessors for the Basel Core Principles noted in their report that they had "confirmed with all firms and professionals with whom they met that the SPM, Guidelines and Circulars are perceived and treated as enforceable rules by AIs" (assessment of Core Principle 1 Essential Criterion 3).
(iv)	They would generally be legally upheld if challenged	The BO, the BDR, and (from 1 January 2015) the BLR as primary and subsidiary legislation respectively would be upheld in the courts. The SPM and other guidelines, in setting out minimum standards and the HKMA's interpretation of regulatory requirements and its functions under the BO (including the rules made under it) are tied into the ongoing authorization criteria and the HKMA's powers under the BO, Accordingly (although to date there has been no legal challenge as to the enforceability of the SPM or other guidance) failure to comply may result in use by the HKMA of its powers under the BO and the use of these powers would be binding. Codes of practice are given specific evidentiary value by the BO (§97N). This means that, while failure to observe a provision of a code of practice does not, per se, render the AI liable to civil/criminal proceedings, it is the case that failure to observe the code will, if relevant to something which the HKMA has to prove in order to establish a contravention of a prescribed requirement, be taken as proving that thing unless a Review Tribunal is satisfied that the prescribed requirement was satisfied otherwise than by compliance with the code.
(v)	They are supported by precedents of enforceability	If an AI fails to comply with the BO, the BDR and (from 1 January 2015) the BLR the HKMA has a range of measures which it can deploy. These include, in relation to capital and liquidity shortfalls, issuing a notice requiring the AI to take the remedial action specified in the notice and, if the AI fails to comply, its chief executive, every director and every manager of the AI commits an offence (§97E and §97J BO). (As yet it has not been necessary to initiate any prosecution under these provisions.) Prior to reaching this point, however, the HKMA may also address perceived weaknesses through the Pillar 2 Supervisory Review Process and the CAMEL rating system and through its general risk-based supervisory approach. There are precedent cases, for example, when an AI has received a lower CAMEL rating due to perceived capital/liquidity weaknesses. In addition to the signalling effects to the AI concerned, a CAMEL rating downgrade also increases the level of a locally incorporated AI's contribution to the Deposit Protection Scheme (DPS) in Hong Kong.
(vi)	They are properly communicated and consequences of failure to comply are properly understood and carry a similar practical effect as for the primary law or regulation	Industry consultation will be conducted prior to the gazetting of legislation or prior to the issuance of SPM modules/codes of practice. Thereafter, as noted above, the contents are easily accessible and the HKMA may, if any areas of confusion arise, issue FAQs in short order to clarify. The adverse consequences of failure to comply are understood by the local banking industry as evidenced by the observation of the FSAP assessors referred to under (iii) above.
(vii)	The instrument is expressed in clear language that complies with the Basel provision in substance and	All legislation and regulatory/supervisory instruments are written in clear, precise language and are generally issued in both English and Chinese. While the protocols of legislative drafting may mean that it is not always possible for local laws to track the Basel language exactly, the actual language used is

spirit	designed to reflect the HKMA's understanding of both the substance and the spirit of the Basel standard.

Annex 7: Key liquidity indicators of the Hong Kong banking system

Size of banking sector (HKD millions). Data as of June 2014		
1. Total assets of all authorized institutions (AIs) operating in the jurisdiction[21]	19,587,900	
2. Total assets of all locally incorporated AIs which are internationally active banks[22]	9,812,539	
3. Total assets of locally incorporated AIs to which liquidity standards under Basel framework are applied	10,054,999	
Number of AIs		
4. Number of AIs operating in the jurisdiction (excluding local representative offices)	202	
5. Number of Global Systemically Important Banks (G-SIBs)	0	
6. Number of Domestic Systemically Important Banks (D-SIBs)[23]	N/A	
7. Number of AIs which are internationally active banks	8	
8. Number of AIs required to implement Basel liquidity standards (according to domestic rules)	12	
9. Number of AIs applying an alternative national standard to liquidity (ie Liquidity Maintenance Ratio (LMR))	190	
Breakdown of LCR for seven RCAP sample banks	Unweighted	Weighted
10. Total HQLA	1,679,008	1,627,940
11. Level 1 HQLA	1,525,578	1,525,578
12. Level 2A HQLA	84,769	72,054
13. Level 2B HQLA	68,661	30,308
14. ALA HQLA[24]	0	0
15. Total cash outflows	12,820,320	3,613,850
16. Retail and small business stable deposits	519,174	25,919
17. Retail and small business less stable deposits	3,683,553	325,489
18. Wholesale unsecured operational deposits	401,836	95,329
19. Wholesale unsecured non-operational funding	3,132,772	1,894,275
20. Secured funding	98,844	20,556
21. Debt issued instruments (including credit and liquidity facilities)	546,990	69,740

21 The figure is computed as total assets less provision as reported by AIs in the Return of Assets and Liabilities of an AI, covering the reporting AIs' Hong Kong offices and overseas branches.

22 For this reporting purpose, a locally incorporated AI is regarded as "internationally active" if the amount of its total external claims and liabilities is equal to or exceeds HKD 250 billion (per one of the HKMA assessment criteria for classifying an AI as a category 1 institution (ie an AI subject to the LCR)).

23 Data are not available due to the reason that local framework on D-SIBs is still under development.

24 The QIS data of the seven sample banks (as of June 2014) included in this RCAP assessment did not demonstrate a need for adopting ALA. Nevertheless, the HKMA indicated that some other category 1 institutions not included in this sample did have such a need as demonstrated by their QIS data.

22. Other contractual outflows	1,052,431	1,052,431
23. Contingent funding obligations	3,384,719	130,110
22. Total cash inflows	3,055,344	2,531,461
23. Secured lending	303,905	107,279
24. Retail and small business customers, non-financial corporates, central banks and other entities	594,466	299,287
25. Other cash inflows	2,156,974	2,124,896
26. Liquidity Coverage Ratio		146.1%

Source: HKMA.

Annex 8: A summary of the materiality assessment

There were no deviations in the HK LCR regulation assessment, as shown in Table 5. Consequently, no materiality assessment was performed.

Number of gaps/differences by component

Table 5

Component	Non-material	Material	Potentially material
Scope of application	0	0	0
Transitional arrangements	0	0	0
Definition of HQLA (numerator)	0	0	0
Outflows (denominator)	0	0	0
Inflows (denominator)	0	0	0
LCR disclosure requirements	0	0	0

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps).

Annex 9: Hong Kong's implementation of Basel III liquidity monitoring tools and Basel guidance on monitoring tools for intraday liquidity management

In addition to the minimum standard for the LCR, the LCR framework also outlines metrics to be used as consistent liquidity monitoring tools ("the monitoring tools"). The monitoring tools capture specific information related to a bank's cash flows, balance sheet structure, available unencumbered collateral and certain market indicators. The monitoring tools supplement the LCR standard and are meant to provide the cornerstone of information that aids supervisors in assessing the liquidity risk of a bank. This part of the annex provides a qualitative overview of the implementation of the monitoring tools in Hong Kong.

Basel III Liquidity Monitoring Tools

In addition to the imposition of the minimum liquidity standards (LCR and LMR) from 1 January 2015 on AIs, the HKMA uses various liquidity metrics (eg loan-to-deposit ratio, maturity mismatch ratio, etc) to facilitate its review of the level and trends of AIs' liquidity risk. These metrics provide both AIs and the HKMA with more information about AIs' day-to-day liquidity positions and level of structural liquidity mismatch, which is useful for assessment of resilience under stressed conditions. In the light of the monitoring tools set out in the January 2013 Basel III LCR document, the HKMA developed, and consulted the industry on, a new Return on Liquidity Monitoring Tools (MA(BS)23) and its accompanying CIs) in the course of 2014 in order to implement these tools. The Return will be finalised in the first quarter of 2015 and AIs will begin to report, starting with their end-June 2015 position. AIs are obliged to provide information in the form specified by the HKMA pursuant to §63(2) of the BO.

The Return includes standard reporting templates (and associated CIs) for AIs to report their positions in respect of (i) concentration of funding; (ii) available unencumbered assets; and (iii) LCR by significant currency. The reporting requirements for these monitoring tools are consistent with those specified in the January 2013 Basel III LCR document.

AIs will be required to submit the Return on a monthly basis (except that they will be allowed to submit the Return on a quarterly basis in 2015 as a transitional arrangement). The HKMA will utilise the information received to further enhance its supervisory monitoring of AIs' liquidity risk. As with other liquidity metrics used by the HKMA, the HKMA will discuss with, and require explanations from, individual AIs if their reported positions reveal any concerns or deteriorating trends, or exceed the HKMA's reasonable expectations. Such concerns may include, for example, substantial reliance on some large funding counterparties, significant reduction in the AI's available unencumbered assets, and any potential currency mismatch issues revealed from the LCR by significant currency metric. AIs will also be expected to utilise the new monitoring tools in their liquidity risk management process (eg in their conduct of cash-flow projections or liquidity stress testing).

As regards the monitoring tool on contractual maturity mismatch, AIs are currently required to submit their maturity mismatch positions to the HKMA on a quarterly basis, using the standard maturity mismatch template developed by the HKMA (or their in-house templates if agreed by the HKMA). This metric is used by the HKMA to obtain insight into the extent to which an AI engages in maturity transformation and to identify potential funding gaps that may need to be bridged. The HKMA is modifying the existing standard template, taking into account relevant Basel guidance provided under the Basel III LCR document. In addition, in view of the future implementation of the Basel III Net Stable Funding Ratio, there will be emphasis on longer-term mismatch positions (eg over one year to over five years) to supplement supervisory monitoring of AIs' long-term funding profiles. The HKMA intends to roll out the revised maturity mismatch metric for reporting by AIs in the course of 2015.

As described in the Basel III LCR Document (paragraphs 214 to 219), "market-related monitoring tools" may include a wide range of (i) market-wide information; (ii) information on the financial sector; and (iii) bank-specific information. The HKMA is already using market indicators, institution-specific information and sector-wide information to conduct various types of market surveillance or stress tests for the purposes of identifying and monitoring potential issues that may affect systemic stability or the financial soundness of AIs. For example, there is a high-level committee on macro surveillance within the HKMA, which meets regularly to discuss, among other things, surveillance reports prepared by relevant departments. This committee serves as an effective forum for senior officials of the HKMA to regularly share and update key market information and observe trends in Hong Kong and globally, such as the latest developments in the global economy, major financial markets and asset classes, international fund flows, the banking sector's exposure to key sectors etc.

Moreover, the HKMA regularly publishes its "Half-Yearly Monetary and Financial Stability Report"[25] to present its observations, and where appropriate express its views, on the current state and outlook for economic and financial market developments. This surveillance work and publication are based on analysis of a wide range of economic and financial market indicators. Microprudential Reviews are also prepared from time to time and circulated to senior management internally, with a view to making use of prudential data collected from AIs to assess the stability of the banking sector and identify potential risk drivers for supervisory monitoring purposes.

In addition to the HKMA's use of market-related, sector-wide or institution-specific information for macro- or microprudential surveillance, AIs are also required to establish an early warning mechanism through the use of institution-specific and market-wide information to help identify emerging risks in their liquidity risk positions or potential funding needs (re subsection 3.4 of the SPM module LM-2). Such early warning indicators include, but are not limited to, internal indicators (eg growing concentrations on funding sources, rapid asset growth funded by volatile liabilities etc) and market indicators (eg stock price declines, widening spreads on credit default swaps etc). AIs are required to incorporate their early warning indicators in their "contingency funding plan" (CFP) to facilitate proactive identification, monitoring and reporting of those triggering events that may activate the CFP.

Basel guidance on monitoring tools for intraday liquidity management

The HKMA consulted the industry in 2014 on its proposal to implement in Hong Kong the Basel guidance on monitoring tools for intraday liquidity management issued in April 2013, with a view to enhancing the monitoring of AIs' intraday liquidity risk and their ability to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The proposal entails the development of a new Return on Intraday Liquidity Position (MA(BS)22) (and its accompanying CIs) covering the reporting of intraday liquidity monitoring tools as prescribed in the Basel Guidance. The

[25] The HKMA's Half-Yearly Monetary and Financial Stability Reports are available at: http://www.hkma.gov.hk/eng/publications-and-research/half-yearly-monetary-and-financial-stability-report/.

relevant reporting requirements are expected to be finalised in the first quarter of 2015 for AIs to commence reporting under §63(2) of the BO based on their end-June 2015 position.

In determining the implementation approach, the HKMA has taken local circumstances into account alongside the Basel Guidance. The key elements of implementation are summarised as follows:

(i) Types of AIs covered: In the initial stage of implementation, all licensed banks incorporated in Hong Kong are required to report their intraday liquidity positions in the light of their significant role in the Hong Kong banking sector and participation in the local real-time gross settlement payment systems. Nevertheless, there is flexibility for the HKMA to designate other AIs to report on their intraday liquidity positions where this is warranted;

(ii) Reporting requirements: Recognising the complexity and the large quantity of data involved, AIs are required to report, in the initial stage of implementation, their intraday liquidity positions and related activities of their Hong Kong office in respect of payment and settlement systems. However, AIs may be required to report on a legal entity basis or consolidated basis where necessary. Reporting in respect of AIs' correspondent banking activities will be phased in from 1 January 2017, as provided for in the Basel guidance;

(iii) Intraday liquidity stress testing: AIs will be required to incorporate intraday liquidity stress testing into their overall liquidity stress-testing programme, and undertake stress tests to assess their intraday liquidity requirements during periods of stress.

Annex 10: Hong Kong's implementation of the *Principles for sound liquidity risk management and supervision*

This annex provides a qualitative description of the implementation of the Basel Committee's *Principles for sound liquidity risk management and supervision* (BCBS Liquidity Sound Principles) in the HKMA's regulation. The principles are not part of the formal RCAP assessment and no grade is assigned. This annex serves for information purposes only.

To implement the BCBS Liquidity Sound Principles, the HKMA issued on 1 April 2011 the SPM module LM-2 "Sound Systems and Controls for Liquidity Risk Management"[26] (LM-2) which is a statutory guideline issued under §16(10) of the BO and is applicable to all AIs in Hong Kong.

Locally incorporated AIs are required to apply the liquidity risk management standards set out in LM-2 both on a legal entity basis and on a group basis, while foreign bank branches are expected to apply the standards in respect of their Hong Kong operations. The manner in which the HKMA implements the BCBS Liquidity Sound Principles is briefly described below.

Fundamental principle for the management and supervision of liquidity risk – Principle 1

LM-2 provides a detailed description of the system and control standards for the governance, risk management and disclosure of liquidity risk that AIs are expected to have in place so as to ensure that they have sufficiently robust liquidity risk management systems to withstand severe liquidity shocks. The Board of Directors (the Board) of an AI should be ultimately responsible for the liquidity risk assumed by the AI and the manner in which the risk is managed. Under LM-2, AIs are required to have a sound liquidity risk management framework, which includes the following key elements:

(i) governance of liquidity risk management (§2);

(ii) systems and controls for identification, measurement, monitoring and control of liquidity risk and effective management of cash flows and funding sources. These involve a liquidity risk management process that addresses funding diversification, intragroup liquidity, intraday liquidity, collateral positions, maintenance of liquidity cushion, contingency funding plans (CFPs) and liquidity stress testing (§§3–12); and

(iii) liquidity risk disclosure (§13).

Supervision of the liquidity risk of, and liquidity risk management by, AIs is an ongoing feature of the HKMA's risk-based supervisory framework. If prudential concerns on an AI's liquidity position or liquidity risk management are identified, the HKMA will enter into discussion with the AI proactively to understand the underlying reasons and, where necessary, require the AI to take remedial action to address the concerns within an agreed timeframe. Depending on general market circumstances and

[26] The document can be accessed at the HKMA's website: http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/LM-2.pdf.

institution-specific factors, the HKMA may also intensify its supervisory monitoring of an AI's liquidity position.

Governance of liquidity risk management – Principles 2 to 4

LM-2 §2 sets out the requirements relating to the governance of liquidity risk management, detailing the responsibilities of the Board and senior management of AIs and the role of independent reviews and audits on AIs' liquidity risk management processes. The Board of an AI should determine and articulate clearly the AI's liquidity risk tolerance in order to describe the types and magnitude of liquidity risk that the AI is willing to assume under normal and stressed conditions. The Board is also required to ensure that liquidity risk management forms part of the AI's overall risk management in addition to asset and liability management; establish a liquidity risk governance and management structure; ensure the competence of senior management and appropriate personnel in measuring, monitoring and controlling liquidity risk; approve and review (at least annually) the liquidity risk strategies and other significant liquidity risk management policies and systems (including contingency funding planning); and review regular reports on the AI's liquidity position and maintain awareness of its performance and overall liquidity profile.

Senior management of an AI should be responsible for setting and implementing the AI's liquidity strategy, policies and practices in accordance with the stated risk tolerance, and for ensuring that there is an appropriate internal risk pricing framework to enable liquidity costs, benefits and risks to be properly measured and attributed to relevant business activities so that line management incentives are consistent with, and reinforce, the AI's liquidity risk tolerance and business strategy.

Measurement and management of liquidity risk – Principles 5 to 12

LM-2 provides guidance on the following aspects of AIs' liquidity risk management:

(i) liquidity risk identification, measurement, monitoring and control (§3);

(ii) cash-flow approach to managing liquidity risk (§4);

(iii) liquidity stress testing (§5);

(iv) liquidity risk management in respect of foreign currency (§6), funding diversification and market access (§7), collateral (§11), CFP (§12) and public disclosure (§13);

(v) maintenance of liquidity cushion (§8);

(vi) intragroup liquidity risk management (§9); and

(vii) intraday liquidity risk management (§10).

The following is a summary of the principal requirements underlying an AI's liquidity risk management framework:

(i) An AI should adopt a comprehensive approach to liquidity risk measurement and management, encompassing the full range of liquidity risks to which the AI is exposed across business lines, legal entities and currencies as well as covering assets, liabilities and off-balance sheet exposures (including contingent liquidity risks that may arise from securitisation or other activities).

(ii) An AI should have in place an appropriate funding strategy that provides for effective diversification of the AI's funding sources and a process for regularly gauging the AI's fund-raising capacity from each of the sources;

(iii) An AI should adopt a cash-flow approach to liquidity risk measurement and management. The cash-flow projections should address both contractual and behavioural considerations and be based on well documented and realistic assumptions.

(iv) An AI should actively manage its intraday liquidity risk, taking into account collateral needs and time-critical cash flows resulting in particular from the AI's participation in payment and settlement systems designed to achieve intraday finality.

(v) An AI's stress testing for liquidity risk should adequately capture severe but plausible stress scenarios, including prolonged market-wide disruptions and idiosyncratic shocks, with consideration of "second-round" effects.

(vi) An AI should devise a robust and operational contingency funding plan that takes sufficient account of the AI's stress-testing results and incorporates realistic assumptions about contingency funding sources.

(vii) An AI should maintain an adequate liquidity cushion of unencumbered, high-quality liquid assets that can be swiftly sold or pledged to obtain funds to meet the AI's liquidity needs at all times, even in periods of severe idiosyncratic and market stress.

(viii) An AI's approach to managing its intragroup liquidity risks should recognise and take into account the limitations on the transferability of funding and collateral to the AI from other group entities and (in case of a cross-border banking group) across borders (such as law and regulations, effect of bank resolution regimes or other jurisdiction-specific restrictions).

Public disclosure – Principle 13

An AI should make pertinent disclosure about its liquidity risk management framework and liquidity risk position, which helps reduce market uncertainty concerning the AI's financial condition and enables relevant stakeholders to make an informed judgment of the AI's ability to meet its liquidity needs, both in times of stress and normal circumstances.

The role of supervisors – Principles 14 to 17

The HKMA adopts a risk-based supervisory approach that includes continuous supervision of AIs' liquidity risk through a combination of risk-focused off-site reviews, on-site examinations and prudential meetings with AIs and, where necessary, with the external auditors of AIs.

Off-site monitoring is mainly conducted through regular CAMEL (Capital adequacy, Asset quality, Management, Earnings and Liquidity) rating assessments of AIs and the Supervisory Review Process (for determining the statutory minimum capital adequacy ratio of locally incorporated AIs), regular supervisory top-down liquidity stress testing, day-to-day monitoring of AIs' liquidity profiles and positions through reviewing their statutory Returns reported to the HKMA or their internal MIS reports, and regular prudential meetings with AIs (the HKMA may meet with the Board, committees of the Board, senior management or internal auditors). Where necessary, the HKMA may also hold tripartite meetings with an AI and its external auditors to discuss prudential concerns on the AI's liquidity risk management and related remedial action. In addition, the HKMA generally reviews AIs' liquidity management policies and procedures as well as their contingency funding plan to assess their adequacy and compliance with the requirements set out in LM-2.

On-site examinations of AIs are to ascertain, among other things, whether the risk appetite, and related policies, controls and risk limits in respect of liquidity risk management are properly set, and effectively adhered to, by AIs.

AIs are required to submit regular statutory Returns to the HKMA on their liquidity positions (see Annex 9 for highlights of the HKMA's new prudential liquidity reporting requirements in relation to (i) Basel III liquidity standards and liquidity monitoring tools; and (ii) the Basel Guidance on *Monitoring tools for intraday liquidity management*). Based on information collected from AIs, the HKMA performs supervisory stress tests to assess their resilience to liquidity stress.

In its on- and off-site reviews, the HKMA also regularly collects and reviews necessary information on AIs' liquidity risk management frameworks and controls, including their liquidity risk management policy statement, internal MIS reports, and minutes of meetings of, and the information package provided to, the Board and senior management. Relevant macroprudential information is also available to the HKMA for the surveillance of the liquidity risks faced by the banking sector and to enable the HKMA to assess the aggregate liquidity and funding positions of AIs and the Hong Kong banking sector.

In the event that the HKMA identifies concerns or deficiencies in an AI's liquidity position or liquidity risk management process, the HKMA has a range of supervisory tools or responses to address those concerns or deficiencies, taking account of the level of risk which the concern or deficiency poses to the safety and soundness of the AI concerned or to the wider financial system. In general, the HKMA will enter into discussion with the AI to understand the reasons for concern and, where necessary, require the AI to take remedial action as agreed with the HKMA and within an agreed timeframe. The form of remedial action may include enhanced supervisory requirements imposed on the AI (eg increase of the minimum statutory liquidity ratio applicable to the AI and/or higher frequency of liquidity reporting), requirements to enhance the AI's liquidity risk management systems and controls, restrictions on certain major business activities so as to preserve the AI's liquidity resources, imposition of a higher regulatory capital requirement, and, in more extreme and serious cases, the revocation of the authorization of the AI if this is warranted.

The HKMA maintains regular and ad hoc communication with other banking supervisors, relevant supervisory authorities (eg those of the securities and insurance sectors), central banks, and payment and settlement overseers, in and outside Hong Kong. In many instances, memoranda of understanding have been signed with the relevant authority, which set out the protocol, procedures and channels for exchange of information on issues of mutual supervisory concern, including in crisis situations, and supervisory cooperation to resolve such issues. The HKMA also actively participates in various supervisory colleges for internationally active banks. These arrangements support and facilitate the HKMA's supervision of AIs' liquidity risk and related risk management.

Annex 11: Areas for further guidance from the Basel Committee

The Assessment Team listed the following issue for further guidance from the Basel Committee.

Definition of "stable retail deposit"

The Basel requirement is not explicit in this respect and further clarification could be helpful.

Inflows on operational deposits

Operational deposits: Deposits held at other financial institutions for operational purposes, as outlined in paragraphs 93–103, such as for clearing, custody, and cash management purposes, are assumed to stay at those institutions, and no inflows can be counted for these funds – ie they will receive a 0% inflow rate, as noted in paragraph 98.

Q (in FAQ document): How should a bank determine whether or not a deposit it has placed at another financial institution is an operational deposit?

A (in FAQ document): The same methodology applied in paragraphs 93–104 for operational deposit outflows should also be applied to determine if deposits held at another financial institution are operational deposits and receive a 0% inflow. As a general principle, if the bank receiving the deposit classifies the deposit as operational, the bank placing it should also classify it as an operational deposit.

The response provided in the FAQ does not clarify the issue.

According to paragraphs 96–97, banks are expected to develop internal models to estimate the amount of deposits they may consider as operational. So, a depositing bank only has its own internal model to estimate which amount of its deposits could be considered as operational by (the internal model from) the bank placing it, which would not necessarily meet this bank's estimation.

Prefunding of the deposit insurance

The requirement in the Basel document is very vague as the requirement of the extent of prefunding is not defined.

Annex 12: List of issues for follow-up by future RCAP assessments

The assessment team identified the following issues listed below for follow-up and for future RCAP assessments of Hong Kong.

Treatment of outflow rate for insured deposits

With respect to the outflow rate for insured deposits, the HKMA has hitherto opted for a 5% factor. If the HKMA were to consider allowing for a 3% outflow rate (as foreseen in the consultation paper "Enhancements to the Deposit Protection Scheme" issued by the Hong Kong Deposit Protection Board (HKDPB) in September 2014), the requirement of prefunding should be reconsidered (also see Annex 11). The current level of pre-funding is at 0.25% of the insured deposits. However, the Assessment Team noted that the HKDPB has received a credit facility with a usage limit of HK$120 billion from the Exchange Fund of Hong Kong to ensure effective operation of the DPS.

Annex 13: Areas where Hong Kong's LCR rules are more conservative than the Basel standards

In several areas, the HKMA has adopted a stricter approach than the minimum standards prescribed by Basel. The following list, prepared with input from the HKMA, provides an overview of the areas where the LCR rules in Hong Kong are considered stricter than the Basel minimum standards. These areas have not been taken into account as mitigants for the overall assessment of compliance.

1. Adjustment for 15% and 40% ceilings (ie 15% and 40% caps under LCR text) for calculation of high-quality liquid assets (HQLA)

The HKMA adopts the additional requirement provided in the LCR text (Footnote 64 of Annex 1) whereby category 1 institutions are required to calculate their stock of HQLA taking into account the lower of the institution's HQLA position before and after reversing the relevant securities financing transactions (including securities swap transactions), if any, when applying the 15% and 40% ceilings.

2. Restricted definition of "multilateral development banks" (MDBs)

The Banking (Liquidity) Rules (BLR) adopt the same coverage of MDBs as in the Banking (Capital) Rules (BCR), ie MDBs for capital or liquidity purposes are both confined to those that qualify for a 0% risk weight under the standardised (credit risk) approach in the BCR. Therefore, marketable debt securities issued or guaranteed by non-0% risk-weighted MDBs, as well as expected cash outflows related to such debt securities, will be treated in the same way as those of non-financial corporates without preferential treatment.

3. Treatment of debt securities issued by category 1 institutions and redeemable within the LCR period

No preferential treatment is provided in respect of holders of debt securities who are retail customers (owing to the potential difficulty for AIs of tracking the type of debt holder). Hence, a 100% outflow rate will be applied to all such debt securities (whether or not the holders are retail or wholesale customers).

4. Extension of downgrade triggers embedded in financing transactions, derivative and other contracts

Apart from downgrade triggers up to and including a three-notch downgrade in external ratings, any rating downgrade that will result in a non-investment grade being assigned to the category 1 institution concerned (regardless of the number of notches of downgrade) is also covered.

5. Calculation of expected cash outflows arising from contractual lending obligations under LCR text paras 132 and 133

The LCR text is unclear as to whether the policy intention is to exclude counterparties which are central banks, sovereigns, MDBs and public sector entities (PSEs) from such calculation. To maintain consistency with the inflow treatment set out in LCR text paras 153 and 154, the outflow treatment in the BLR that corresponds with LCR text para 132 is extended to central bank counterparties and the outflow treatment in LCR text para 133 is extended to counterparties which are sovereigns, MDBs, PSEs and other unspecified entities.

Annex 14: Implementation of LCR elements subject to prudential judgment or discretion in Hong Kong

The following tables provide information on elements of LCR implementation that are subject to prudential judgment and national discretion. The information provided helps the Basel Committee to identify implementation issues where clarifications and (additional) FAQs could improve the quality and consistency of implementation. It should also inform the preliminary design of any peer comparison of consistency across the membership that the Committee may decide to do, akin to the studies on risk-weighted asset variation for the capital standards.

Elements requiring judgment (non-comprehensive list) — Table 6

Basel paragraph	Description	Implementation by the HKMA
24 38 50(c) 52(a) and (b) 54(a) to (c)	Treatment of the concept of "large, deep and active markets"	The term "large, deep and active markets" is used in paras 38, 50(c), 52(a) and (b), and 54(a) to (c) of the BCBS LCR Document as a general description of the characteristics of markets in which assets that can be recognised as HQLA should be traded. As a primary consideration, the HKMA will tend to regard an asset as being traded in a "large, deep and active market" if the asset is (i) listed on a recognised exchange; or (ii) traded over-the-counter with multiple recognised dealers or market-makers committed to maintaining market liquidity. In addition, if an asset is recognised by the HKMA as collateral for the provision of intraday or overnight liquidity, the market liquidity of such assets is considered to be more reliable. The HKMA will also take into account other relevant factors, such as the daily market transaction volume of an asset, the level and stability of bid-ask spreads, and the number of market participants engaged in the market transactions involving a particular type of asset, in order to form a view as to whether such assets are traded in a "large, deep and active market". It is, however, recognised that not all market information or data required for assessment may be readily available, especially in markets which are relatively less developed as compared with markets in advanced economies. In such cases, the HKMA will expect AIs to be able to provide additional information demonstrating the market liquidity of the assets concerned. Relevant guidance is provided in the supervisory circular on application of LCR/LMR requirements.
50	Treatment of the concept of "reliable source of liquidity"	The HKMA will adopt the approach described above to consider whether an asset has a proven record as a reliable source of liquidity in the markets (including repo and outright sale markets). Where applicable, special consideration will be given to the market behaviour in respect of that asset in times of financial stress.
52	Treatment of the concept of "relevant period of significant liquidity stress"	While the BCBS LCR standard requires that marketable securities included as level 2A assets should not have experienced a decline of price of more than 10%, or an increase in haircut of more than 10 percentage points

		"over a 30-day period during a relevant period of significant liquidity stress", it is additionally required (in BLR, Schedule 2, Part 3, §4(3), §5(3) and §6(3)) that, in the case that a marketable debt security has not been traded in a relevant period of significant liquidity stress, this price volatility requirement is applicable to any 30-day period since the asset was issued. This is to cater for newly issued debt securities which have not undergone any liquidity stress since they were issued. As regards what constitutes a "relevant period of significant liquidity stress", the HKMA considers that such liquidity stress should be significant enough to disrupt the liquidity conditions and/or effective operation of financial markets in the jurisdiction(s) affected by the stress or crisis. Historical examples of such stress events include the 1997 Asian Financial Crisis and the 2007–08 Global Financial Crisis. Relevant guidance is provided in the supervisory circular on application of LCR/LMR requirements.
74–84	Retail deposits are divided into "stable" and "less stable"	The terms "stable retail deposits" (including related terms such as "other established relationships" and "transactional accounts") and "less stable deposits" are defined in BLR §39. The criteria for recognising that a retail deposit is "stable" have taken into account local circumstances, and are embedded in the relevant definitions, as shown below. "***Stable retail deposit***, *in relation to a category 1 institution, means a retail deposit taken by the 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 either* *(i) the retail customer has at least two other established relationships with the institution, where* *(A) subject to sub-subparagraph (B), at least one of the relationships (but not that of a credit card account) has been established for not less than six months and the account underlying that relationship has not been dormant or inactive in the last six months; and* *(B) the requirement in sub-subparagraph (A) is deemed to be met if the relationship relates to a mortgage loan that charges a penalty for early settlement of the loan within six months from the date on which the loan is drawn down; or* *(ii) the deposit is maintained by the retail customer in a transactional account at the institution."* • In devising the conditions for recognising a relationship as "other established relationship", the HKMA has considered it necessary to cover not only the length of relationship but also the type and nature of relationship. "***Other established relationship***, *in relation to a category 1 institution, means a banking relationship between the institution and a customer of the institution, other than the*

		placing of deposits with the institution, in relation to loans, credit cards, investments or wealth management accounts." "***Transactional account***, *in relation to a category 1 institution, means a deposit account maintained at the institution that is designated by the account-holder to receive funds or make payments on a regular basis.*" "***Less stable retail deposit***, *in relation to a category 1 institution, means a retail deposit taken by the institution that is not a stable retail deposit or retail term deposit.*"
83, 86	Treatment of the possibility of early withdrawal of funding with maturity above 30 days (para 83 – retail deposits; para 86 – wholesale funding)	Pursuant to LCR text para 84, the HKMA has opted to apply generally a non-zero run-off rate (ie a 5% outflow rate) to ***retail term deposits*** (as defined in BLR §39). This is to cater for potential concerns that retail depositors may still seek early withdrawal of their time deposits in crisis situations and the banks concerned may need to repay such deposits for reputation reasons. Any retail time deposits that cannot meet the definitions of "retail term deposit" (eg early withdrawal without significant penalty) and "stable retail deposit" will fall within the category of "less stable retail deposits". To be clear, retail deposits that meet the definition of "retail term deposit" will be subject to a 5% outflow rate; those that do not meet the definition will be subject either to a 5% outflow rate (if they are stable) or a 10% outflow rate (if they are less stable). BLR §41(5) provides that a category 1 institution must include any type of funding (ie not confined to unsecured wholesale funding) in the calculation of its total expected cash outflows if: (i) the funding is callable by the fund provider within the LCR period; (ii) the earliest possible contractual maturity date of the funding falls within the LCR period; and (iii) the funding is either on demand or does not have a specific maturity date. The requirements go beyond LCR text para 86 as the funding concerned is not confined to unsecured wholesale funding. BLR §41(6) specifies further that the funding callable at a category 1 institution's option must also be included in the calculation of its expected cash outflow if there is a market expectation that the institution will exercise that option and thus cause that funding to be repaid before its contractual maturity date.
90–91	Definition of small business customers' exposure is based on nominal EUR amount (EUR 1 million)	As defined in BLR §39, the term "***small business customer***" refers to a corporate (or, if applicable, a group of related corporates) which has provided a category 1 institution with total aggregated funding of less than HKD 10 million (or its equivalent in another currency), and in respect of which (a) if the institution has a credit exposure to the corporate (or the group), the credit exposure meets the criteria for the IRB subclass of small business retail exposures under §144 of the Capital Rules; or (b) if the institution has no credit exposure to the corporate (or the group), that aggregated funding is managed by the institution as if it were a retail deposit. The benchmark of HKD 10 million is approximately equivalent to EUR 1 million.
94–103	Deposits subject to "operational" relationships	The meanings of "operational deposit" and "operational services" are provided in BLR §39, while the qualifying

		requirements for category 1 institutions to determine the amount of operational deposits (after excluding any excess balance that is not regarded as operational deposit) are provided in the Code of Practice (clause 7). Category 1 institutions are further required under clause 7 to conduct their assessment of whether their deposits meet the relevant requirements before they are treated as operational deposits under the LCR, and such assessment should be provided to the HKMA for review upon request. If the HKMA is satisfied that any of the requirements are not met, the category 1 institution concerned will not be allowed to treat the deposits concerned as operational deposits for LCR purposes, and will be required to take remedial measures (eg rectifying deficiencies in identifying excess operational deposits) where necessary. Guidance is provided in the supervisory circular on application of LCR/LMR requirements in respect of the HKMA's approach to treating operational deposits. The HKMA will consider expanding such guidance in due course taking into account implementation experience, industry best practices and any further guidance that may be provided by the BCBS in this regard.
131(f)	Definition of other financial institutions and other legal entities	The term "***financial institution***" is defined in BLR §2(1) to have the meaning given by BCR §157A(3). That is, it refers to "*an entity that* *(a) is a financial sector entity; or* *(b) is engaged predominately in any one or more of the following activities, whether by itself of through any of its subsidiaries* *(i) lending;* *(ii) factoring;* *(iii) provision of credit enhancement;* *(iv) securitisation;* *(v) proprietary trading; or* *(vi) any other financial services activity specified in Part 11 of Schedule 1 of the BCR.*" The HKMA does not envisage a need to define the meaning of "other legal entities" used in LCR text para 131(f). Conceivably this term refers to any other legal entities that have been specified in that paragraph. According to item 2(e) of Table 3 of the Code of Practice, the applicable requirement is that liquidity facilities granted by category 1 institutions to *financial institutions (other than banks) or entities that do not fall within any of paragraphs (a) to (d)* are subject to an outflow rate of 100% on the undrawn portion.

Elements left to national discretion (non-comprehensive list)		Table 7
Basel paragraph	**Description**	**Implementation by HKMA**
8	Use of phase-in options	The HKMA follows the phase-in transitional arrangement proposed by Basel Committee to implement the LCR in Hong Kong starting from 1 January 2015, with a 60% minimum requirement set for the year 2015, followed by increments of 10 percentage points per annum until reaching 100% by 1 January 2019.
18	Use of HQLA by banks during periods of stress	The HKMA has provided in BLR (rules 4, 6, 14 and 16) a framework for allowing category 1 institutions to monetise HQLA under the circumstances specified in rule 6, that is, the institution is undergoing a significant financial stress and its financial circumstances are such that it has no reasonable alternative other than to monetise its HQLA to the extent necessary to meet its obligations. In the circular issued by the HKMA on 6 February 2015, the manner in which the HKMA would respond to such a situation faced by a category 1 institution has been elaborated further.
53, 54, 54(a)[27]	Recognition of level 2B assets as HQLA	The HKMA will only recognise qualifying single A-rated corporate debt securities and, subject to the HKMA's case-by-case approval, qualifying residential mortgage-backed securities (RMBS) as HQLA taking into account the liquidity risk characteristics of the several types of level 2B asset allowed to be recognised as HQLA under the LCR standard. Triple B-rated corporate debt securities and listed common equities are not to be recognised as level 2B assets in Hong Kong because of the higher market liquidity and price volatility risks associated with such assets based on local market circumstances. Moreover, a restricted-use committed liquidity facility will not, at this stage, be regarded as an additional type of "level 2B" liquidity in Hong Kong.
55–67, Annex 2 and Annex 3	Adoption of ALA Option 2	The QIS results for the LCR over the past few years and internal analyses revealed that the supply of HQLA denominated in Hong Kong dollars may not be sufficient to meet category 1 institutions' local liquidity needs for LCR purposes, particularly in catering for situations where the local banking system experiences capital outflows or for the continued business growth of the banking system in future. The insufficiency of HKD-denominated HQLA is caused by various structural factors, including strong fiscal discipline that has resulted in little need for the issuance of

[27] See www.bis.org/publ/bcbs274.htm.

		government debt, the relatively limited size of debt securities markets compared with that of the banking sector in Hong Kong, and constraints in issuing Exchange Fund Bills and Notes (the main source of HKD-denominated HQLA in Hong Kong) under Hong Kong's Currency Board System. Of the three ALA options, the HKMA considers that ALA Option 2 (ie use of foreign currency-denominated HQLA to cover HKD liquidity needs) is most appropriate given the linked exchange rate mechanism between the USD and HKD in Hong Kong.
75	Definitions of "other established relationships" and "transactional accounts" for the purposes of determining "stable retail deposits"	These two definitions are crucial for the determination of a category 1 institution's "stable retail deposits". See the fourth item under Table 6 above for more details about the definitions used by the HKMA for these two terms.
78	Treatment of retail deposits covered by an effective deposit insurance scheme that meets additional requirements	Stable retail deposits covered by the Hong Kong DPS are subject to a 5% outflow rate (instead of 3%), mainly because certain enhancements are under way to ensure the DPS can meet the additional requirements set out in the LCR text footnote 37 (ie depositors can be given access to the protected deposits within seven business days after the deposit insurance scheme is activated). Currently the Hong Kong DPS is conducting a public consultation on various proposals for enhancing the DPS, including possible ways to expedite the distribution of protected deposits to depositors. Nonetheless, it is possible that a category 1 institution's overseas offices may have taken stable retail deposits protected by deposit insurance schemes that can meet the additional criteria. In line with LCR text para 169, if the relevant banking supervisory authority in the overseas jurisdiction concerned applies a 3% outflow rate for such overseas stable retail deposits, this treatment can also be adopted for such deposits when a category 1 institution calculates its LCR covering such deposits. Liquidity Return MA(BS)1E (Part 2, §(I)B, item 2(a) has catered for this possibility.
79	Treatment of "less stable retail deposits"	No additional "less stable" buckets for retail deposits are currently established for LCR purposes, based on the HKMA's consideration of the liquidity risk characteristics of different types of retail deposits in Hong Kong and relevant industry feedback. Nevertheless, the HKMA may exercise the power under §97K of the BO to require a category 1 institution to apply an outflow rate higher than the 10% minimum outflow rate for all or part of the institution's less stable retail deposits (if the HKMA considers that the liquidity risks associated with those deposits are such that it is prudent and reasonable to apply a higher outflow rate to those deposits).
82–84	Treatment of "retail term deposits"	Instead of applying a 0% outflow rate to retail term deposits, as allowed under LCR text para 82, a 5% outflow rate will generally be applied to such deposits having regard to the potential risk of early withdrawal of such deposits in stressed situations, and the

		pressure on AIs to honour those requests for reputation considerations. Nevertheless, term deposits taken by DTCs which are category 1 institutions (or their specified associated entities) may be excluded from the calculation if the deposits are subject to early withdrawal restrictions under §12(3) of the BO.
123	Methodology for calculation of expected cash outflow relating to historical volatility in market value of derivative contracts (and other transactions)	Pursuant to LCR text para 123, which allows supervisors to adjust the treatment flexibly according to circumstances, the HKMA allows a category 1 institution that is unable to use the methodology set out in clause 19 of the Code of Practice (corresponding to LCR text para 123) due to data insufficiency or other reasons to agree an alternative calculation method with the HKMA.
134–140	Outflow treatment for "other contingent funding obligations"	The HKMA assigns outflow rates ranging from 0% to 100% to different types of "other contingent funding obligations" based on their nature and characteristics.
160	Inflow treatment for "other contractual cash inflows" generated from financial institutions	The HKMA adopts the approach of assigning inflow rates that are the same as outflow rates applicable to the same type of counterparty (eg 100% inflow rate for expected cash inflows from financial institutions and central banks).
164–165	Scope of application	The scope of AIs subject to the LCR (ie category 1 institutions) is not confined to internationally active banks but also covers AIs that meet other criteria set out in Part 1 or 2 of Schedule 1 to the BLR (eg those that are significant to the general stability of the Hong Kong banking system).
166	Bases of calculation	Apart from calculating the LCR on a consolidated basis (as required under the BCBS LCR standard), category 1 institutions incorporated in Hong Kong are also required to calculate the LCR on a Hong Kong office basis and an unconsolidated basis (ie legal entity basis). If a category 1 institution is incorporated outside Hong Kong, the institution is required to calculate the LCR on a Hong Kong office basis.
13 (*LCR disclosure standards)*	Exemption of banks from disclosure of LCR based on averages of daily data up to the first reporting period on or after 1 January 2017	This two-year grace period for disclosure of LCR calculated based on averages of daily data will be adopted in Hong Kong in the light of implementation difficulties expressed by the industry (which will necessitate more time for category 1 institutions to adjust their systems and procedures to cater for such disclosure).