PRIVATE SECTOR CONSULTATION

Basel III Framework: Rules and Guidelines on Liquidity Risk Management for Banks

A. Introduction

1. Section 34(1)(a) of the Monetary Authority Act (2020 Revision) ("MAA") states that:

   After private sector consultation and consultation with the Minister charged with responsibility for Financial Services, the Authority may -

   (a) issue or amend rules or statements of principle or guidance concerning the conduct of licensees and their officers and employees, and any other persons to whom and to the extent that the regulatory laws may apply;

2. Requirements specific to the private sector consultation are prescribed in section 4(1) of the MAA as follows:

   When this Law requires private sector consultation in relation to a proposed measure –

   (a) the Authority shall give to each private sector association a draft of the proposed measure, together with –

   i. an explanation of the purpose of the proposed measure;
   ii. an explanation of the Authority's reasons for believing that the proposed measure is compatible with the Authority's functions and duties under section 6;
   iii. an explanation of the extent to which a corresponding measure has been adopted in a country or territory outside the Islands;
   iv. an estimate of any significant costs of the proposed measure, together with an analysis of the benefits that will arise if the proposed measure is adopted; and
   v. notice that representations about the proposed measure may be made to the Authority within a period specified in the notice (not being less than thirty days or such shorter period as may be permitted by subsection (3)); and

   (b) before proceeding with the proposed measure, the Authority shall have regard to any representations made by the private sector associations, and shall give a written response, which shall be copied to all the private sector associations.

3. The Cayman Islands Monetary Authority ("the Authority") seeks consultation and comment from the private sector associations concerning the proposed revised *Basel III Framework: Rules and Guidelines on Liquidity Risk Management* (the "Liquidity Rules") (Appendix 1).

B. Background

4. The Authority's Liquidity Rules issued in November 2018 (effective from June 2019) included Liquidity Coverage Ratio ("LCR") requirements applicable to the Category A Retail Banks (the "Retail Banks") regulated by the Authority.

5. As per the Basel Committee on Banking Supervision's ("BCBS") Basel Framework ("Basel Framework"), the objective of the LCR is to promote the

short-term resilience of the liquidity risk profile of internationally active banks. It does so by ensuring that banks have an adequate stock of unencumbered high-quality liquid assets ("HQLA") that can be converted easily and immediately in private markets into cash to meet the banks' liquidity needs for a 30 calendar days liquidity stress scenario. The LCR seeks to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spill-over from the financial sector. Retail banks are required to maintain a minimum LCR of 100%.

6. As part of the implementation of the liquidity framework, the Authority implemented the LCR for Retail Banks and the Minimum Liquidity Ratio ("MLR") for all other banks. However, the Authority did note challenges with the implementation of the LCR. Notwithstanding, with the issuance of the Liquidity Rules in November 2018, the Authority planned to observe how retail banks adjusted their business models to be in compliance with the LCR framework and if the noted challenges still existed after implementation, the expectation was that a review of the Liquidity Rules would be in order to ensure that the measure was meeting the intended purpose.

7. Subsequently, the Cayman Islands Bankers' Association ("CIBA") submitted formal correspondences on behalf of the banking industry detailing the CIBA members' challenges in implementing the LCR along with the proposed actions to address the challenges. The Authority's review of CIBA correspondences and assessment of the Retail Banks' LCR reporting in 2020 highlighted industry proposals and liquidity reporting areas which warranted further review.

8. As a result, the Authority completed a comprehensive review of LCR reporting for all retail banks and, where necessary, held bilateral discussions around liquidity risk management, the individual banks' business models and liquidity reporting. Revised LCR returns for December 2020, information from bilateral discussions, and a detailed review of the Liquidity Rules conducted by the Authority was used to evaluate and determine the appropriate regulatory responses as proposed.

C. <u>International Standards</u>

9. The liquidity standards are a core component of the Basel Framework, namely the *Basel III: International Regulatory Framework for Banks*. The importance of liquidity is further evidenced in the BCBS Core Principles for Effective Banking Supervision ("BCP").

10. BCP 24 states *"The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards."*.

11. Further, as the Authority proposes changes to the Liquidity Rules which reflect appropriate regulatory/supervisory flexibility, both the BCPs and Basel Framework include principles in line with the concepts of proportionality and use of national discretion.

    (1) Criteria 2 of BCP 24 states *"the prescribed liquidity requirements reflect the liquidity risk profile of banks (including on- and off-balance sheet risks) in the context of the markets and macroeconomic conditions in which they operate".*

    (2) The BCBS LCR and liquidity risk monitoring tools framework states "*These two standards are comprised mainly of specific parameters which are internationally "harmonised" with prescribed values. Certain parameters, however, <u>contain elements of national discretion</u> <u>to reflect jurisdiction-specific conditions</u>. In these cases, the parameters should be transparent and clearly outlined in the regulations of each jurisdiction to provide clarity both within the jurisdiction and internationally*".

D. <u>Purpose of Proposed Revisions to Measure and Consistency with the Authority's Functions</u>

12. Section 6(1) of the MAA outlines the principal responsibilities of the Authority, which includes its regulatory functions, *inter alia*, "to regulate and supervise financial services business carried on in or from within the Islands".

13. Section 6(3) of the MAA provides that in performing its regulatory functions, the Authority shall, *inter alia*:

    (a) endeavour to promote and enhance market confidence and the reputation of the Islands as a financial centre;
    (…)
    (c) recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the Islands, vis a vis both consumers and suppliers of financial services, while conforming to internationally applied standards insofar as they are relevant and appropriate to the circumstances of the Islands;
    (d) recognise the principle that a burden or restriction which is imposed on a person or activity should be proportionate to the benefits, considered in general terms;
    (…)
    (f) recognise the need for transparency and fairness on the part of the Authority.

14. Based on its comprehensive assessment of relevant liquidity considerations and the Liquidity Rules, the Authority proposes to amend the prescribed BCBS definition of HQLA to include a provision that allows the Authority to recognise additional assets as HQLA on a case-by-case basis. The standard BCBS LCR framework does not contain such a provision, but the Authority considers such application of national discretion as necessary to address current liquidity challenges within the financial sector and provide greater regulatory/supervisory flexibility in applying the LCR framework in consideration of proportionality.

E. Jurisdictional Comparison

15. This section highlights various approaches adopted by some jurisdictions to address challenges in implementing the LCR. The comparison is mainly focused on the treatment of HQLA for comparable institutions in other countries that have adopted the LCR.

Table 1: Summary of Jurisdictional Comparison

Jurisdiction	Summary of the Approach Adopted
Bermuda *Bermuda Monetary Authority*	1. Like the Cayman Islands, Bermuda does not have a central bank. Relevant highlights from Bermuda's LCR implementation include: (1) use of national discretion to widen Level 1 asset eligibility by allowing US dollar assets, qualifying under Basel III as Level 1 assets, to be fully eligible as Level 1 assets in Bermuda; (2) allowing banks to include certain US dollar balances held in its qualifying correspondent bank to be included as a Level 1 asset to offset the fact that this jurisdiction does not have a central bank. This inclusion of qualifying correspondent bank balances is subject to a 25% of HQLA Level 1 limit and a demonstration to the bank's Board that the credit quality of the correspondent bank is satisfactory; and (3) requesting all Bermudian banks to continue to work with their existing correspondent banks to identify conduits for bank funds to be placed at the US Federal Reserve, in a pass-through account or into a secured funding vehicle such as a reverse repurchase facility, backed with HQLA Level 1 assets.
Jersey *Jersey Financial Services Commission*	1. Jersey has implemented the LCR and Liquidity Mismatch Ratio ("LMR") which stipulates that deposit takers are required to adhere to the LCR unless approval has been given to use the LMR. The Minimum LCR and LMR is 100%. 2. The LMR allows qualifying inflows from group banks to be treated similarly to HQLA whereas in the LCR, inflows are limited in effect as they are only considered in determining the net cashflows. The formula for LMR is: $\text{LMR} = \dfrac{\text{HQLA + inflows}}{\text{Outflows}}$

Jurisdiction	Summary of the Approach Adopted
	3. Jersey's level 1 assets, level 2A assets and level 2B assets are consistent with the asset types adopted by the Authority and the BCBS. However, the LMR provides an alternative to institutions that may face challenges in adopting the LCR.
Guernsey *Guernsey Financial Services Commission*	1. Guernsey has implemented the LCR and Liquidity Mismatch Ratio ("LMR") which stipulates that all Guernsey incorporated banks must comply with LCR unless approval has been given to use the LMR. The Minimum LCR and LMR is 100% and the formula for LMR is: $\text{LMR} = \dfrac{\text{HQLA + qualifying inflows + other inflows}}{\text{Outflows}}$ 2. Guernsey's level 1 assets, level 2A assets and level 2B assets are consistent with the asset types adopted by the Authority and the BCBS. However, the LMR provides an alternative to institutions that may face challenges in adopting the LCR.
Switzerland *Swiss Financial Market Supervisory Authority*	1. Switzerland has elected to adopt options 2 & 3 of the BCBS' Alternative Liquidity Approaches ("ALA") given the insufficient supply of HQLA in local currency.

16. The jurisdictional comparison above confirms that the insufficiency of HQLA is a common issue in several jurisdictions, including large and developed economies such as Switzerland. The Authority leveraged on the above comparison and considered the pros and cons of different approaches.

F. <u>Cost and Benefit Analysis</u>

17. The following table shows the significant costs and benefits associated with the issuance of the proposed revised measures.

Table 2: Costs and Benefits of Issuing the Revised Liquidity Rules

	Costs	Benefits
CIMA	1. The Authority will incur the usual administrative costs associated with conducting industry consultation, publication and amending supervisory manuals and reporting forms. These costs are not deemed to be overly burdensome and represent	1. The Authority will be able to solve the lack of sufficient level 1 HQLA in a reasonable manner while maintaining the financial soundness of the Cayman Islands through improved compliance with international standards and increased bank resilience.

	Costs	Benefits
	typical costs of the Authority carrying out its mandate. 2. Additionally, as banks may be allowed to rely on "lower quality" liquid assets (e.g., recognising placements held with a centralized group treasury unit as HQLA), the Authority may face increased resourcing costs to supervise banks liquidity more closely.	
Cayman Islands	1. There are no immediate foreseen costs to the jurisdiction as a whole with the implementation of these requirements. However, in the event of a liquidity crisis, deviation from the prescribed BCBS definition of HQLA, and related reliance on "lower quality" liquid assets by banks, may result in costs to the jurisdiction, including those related to possible need for an expedited resolution regime if banks fail.	1. The amendments will promote the achievement of a more proportionate application of Basel III regulation/supervision which supports the Cayman Islands in achieving a more level playing field relative to other jurisdictions with central banks, deposit insurance schemes or adopted national discretion for the expansion of the standard stock of HQLA. 2. Additionally, the proposed amendments, which will be applied on a case by case and cautious basis, will continue to support the resilience of the Cayman Islands' financial sector to possible liquidity shocks.
Retail Banks	1. The Retail Banks are expected to incur minimal costs to update the reporting systems and train their staff to implement the amendments as the information/data required is readily available from the banks' systems.	1. The amendment will ensure that the Retail Banks are not disadvantaged with regard to the perceived and actual risk of having lower liquidity ratios relative to comparable banks in the jurisdictions that have expanded the standard stock of HQLA. 2. Further, the proposed amendment will enable the Retail Banks to

	Costs	Benefits
		meet the minimum LCR requirements without significant exposures to price volatility while maintaining a sound liquidity framework that is consistent with international practices.
Summary	Consequent on the above, it is determined that the benefits outweigh the costs, and the issuance of the revised Liquidity Rules should be pursued by the Authority.	

G. Consultation Feedback and Comments

18. Before proceeding with the proposed revised measure, the Authority shall have regard to any representations made by the private sector associations only. Feedback submitted by individuals, entities, or other bodies, unless acting on behalf of private sector associations, will not be accepted by the Authority. Representations from private sector associations must be submitted as a consolidated document, and a listing of the entities which provided feedback should be included. Private sector associations should ensure that conflicting positions are resolved prior to submission to the Authority. Where positions conflict within or across associations, the Authority will consider all available information in taking a decision, which will be at its sole discretion.

19. To ensure that all responses are given due consideration, it is important that private sector associations make clear reference to the sections of the measure being commented on, and that responses are unambiguous, clearly articulated and based on fact. The consultation process is not designed to address complaints or grievances. Feedback of this nature should be submitted through the established complaints process.

20. In cases where the feedback proposes to change a policy position of the Authority or substantially amend any requirement of the draft measure, information to support the position of the association must be provided. The table below provides an example of the Authority's expectation with regard to feedback for the proposed measure.

Reference	Example of a Helpful Comment	Examples of Comments needing more Support
Rule 4.2[1]	In Rule 4.2 the current text omits the fair value measurement of liabilities. Also, as defined it is not asymmetrical with the Market Price definition and thus scenarios exists that fall into neither category.	× This is not what is done in other jurisdictions. × I don't think we should do this. × CIMA is not considering the position of the experts.

[1] This example is not reflective of the content of the proposed measure(s).

	Suggested wording: *Hard-to-Value Securities means an asset* *or liability* *for which* *there is no Market Price which is required to be measured at fair value pursuant to 5.2*	

21. All feedback submitted by private sector associations will be given due consideration, nevertheless, the decision to adopt any feedback provided into a proposed measure will be at the sole discretion of the Authority.

H. Notice of Representations

22. The Authority seeks consultation through written comments and representations from the private sector associations concerning the proposed revised regulatory *Basel III Framework: Rules and Guidelines on Liquidity Risk Management*.

23. The Authority must receive representations by 1700hrs on **Wednesday, November 10, 2021**. Representations received after this deadline may not be considered and will not form part of the collated written response provided to private sector associations.

24. Comments and representations must be addressed to:

The Managing Director
Cayman Islands Monetary Authority
P.O. Box 10052
SIX, Cricket Square
Grand Cayman KY1-1001
Cayman Islands
Tel: 345-949-7089
Fax: 345-946-5611
Email:
Consultation@cimoney.com.ky
and copied to PaulMcAllister@cima.ky.

25. The Authority shall have due regard to any representation made by the private sector associations and industry stakeholders. The Authority shall provide a written response collating the feedback received and the Authority's position on this feedback. This response shall be copied to all relevant private sector associations only.

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