

Remarks by:

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IILM Roundtable on Liquidity Management “Short Term Financial Instruments”,

Washington DC, United States of America 15-16 April 2015.

BASEL III HQLA REQUIREMENTS AND CONSIDERATIONS IN THE IMPLEMENTATION OF HQLA – SUPERVISORY PERSPECTIVE

Introduction

A very good morning to all of you.

Distinguished Participants,

I would like to thank the International Islamic Liquidity Management Corporation (IILM) for inviting me to this **Roundtable on Liquidity Management “Short Term Financial Instruments”**.

This is indeed a timely event, as we are going through an important phase of the implementation of essential regulatory reforms in the banking sector including liquidity risk management. I see that, **a veritable platform** like this, provides an opportunity for addressing the anticipated liquidity management challenges and issues (including the use of short-term financial instruments for liquidity management purposes) for banks at timely manner.

Following the global financial crisis, Islamic finance with its inclusive proposition, has emerged as a **viable alternative** form of intermediation across the jurisdictions. According to the IFSB Islamic Financial Services Industry Financial Stability Report (2014), total Islamic finance assets grew to an estimated USD1.8 trillion by the end of 2013. So, we can see that one of the most striking characteristic of Islamic finance is its rapid geographical spread in the last three decades and this growth phenomenon has been exemplified by the emergence of Sukūk as one of the most attractive of Sharī'ah compliant assets which can support growth that promotes financial and social stability.

Recently, however, as a result of global regulatory reforms on the liquidity, Islamic banks are faced with, among others, **perennial issues** of short-term Shari'ah-compliant financial instruments that meet the high quality liquid assets and their supervisory treatment under liquidity risk management. **Finding solutions** and discussing possible implications of these issues is integral to improving funding and market liquidity for Islamic banks, and the effective implementation of new liquidity reforms in any jurisdiction.

Before beginning this presentation I would like to commend (the Central Bank of Kuwait being one of the founding members of the IILM) the **pivotal role** and recent efforts of the **IILM in issuing** short-term Shari'ah-compliant financial instruments (i.e. Sukūk) to facilitate and enhance effective cross-border Islamic liquidity management, international linkages and financial stability.

Basel III Reforms on Liquidity – what they hold for us?

Distinguished Participants,

Now let me take you a step back, for a while, to comprehend the Basel III reforms on liquidity and what they hold for us.

The global financial crisis, a popular buzzword for many years, which started in 2007/2008 may be over, considering the current global outlook, but certainly its impacts and repercussion are not yet over as they continue to resonate across the world!

After intense discussion globally, this crisis prompted a series of global financial and regulatory reforms for the banking sector, in particular, reforms introduced by the Basel Committee on Banking Supervision (BCBS) such as capital and liquidity. Specifically, the **Liquidity Coverage Ratio (LCR)** as part of liquidity, formed one of the **key planks of the Basel III reform** package, as liquidity problems faced by banks were a key feature of the crisis and a disruption to liquidity availability is a central element in the origination or amplification of systemic financial crises.¹

A major issue during the crisis was caused by banks being unable to **roll over** short-term financing. Investor confidence plummeted, leading to a liquidity squeeze within some financial institutions. By introducing the new ratios, the BCBS aims to strengthen banks against adverse shocks;

eliminate structural mismatches between assets and liabilities; and encourage more stable sources of funding – medium and long-term rather than short-term options.²

To address above concerns, the BCBS issued **Basel III** in December 2010, which proposed the introduction of new regulatory standards, namely the **LCR** and the Net Stable Funding Ratio (**NSFR**), as a complement to capital adequacy regulations. After the observation phase and further calibration and monitoring of the initial parameters, the BCBS issued final rules for LCR in January 2013 in the document entitled *Basel III: Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*. We should note that this final version of LCR took into account significant adjustments to the components of LCR.

The key objectives of the BCBS's liquidity framework have been: (i) developing a more resilient banking sector and improving banks' liquidity buffers through placing the limits on maturity transformation at the micro level; (ii) reducing the risk of spillover from the financial sector to the real economy; (iii) reducing excessive interconnectedness in the financial system and mitigating systemic liquidity risk at the macro level; and (iv) having adequate stock of unencumbered high-quality liquid assets. All these objectives are applicable to Islamic banks.

While the LCR promotes resilience over a short-time horizon, the NSFR promotes resilience over a longer time horizon. **The LCR consists of two components: HQLA** as the numerator and net cash outflows as the denominator, both in a stress scenario.

In line with the topic, I would like to **confine my discussion to the numerator** (i.e. HQLA) of the LCR of Basel III. I will also provide you in a moment an Islamic finance perspective on the HQLA requirements and main issues and considerations to be understood from a supervisory perspective.

Stock of Sharī ah-compliant HQLA and IFSB Perspective

Distinguished Participants,

The HQLA, according to the BCBS, are the assets that can be easily and immediately converted into cash, with no or little loss of value, covering stressed outflows over next 30 days. It includes **Level 1 assets**³ (deemed to be of highest liquidity) and **Level 2 assets**⁴ (less liquid than Level 1 and subject to haircut for inclusion). The Level 2 is further classified into 2A and

2B. While Level 1 assets can be included without limit, Level 2 assets are considered less liquid and are limited to 40% of the total after haircuts have been applied.

The IFSB, as a global standard setting body for Islamic finance, provides **level playing field** for the Islamic financial services industry in the background of the new global regulatory architecture promulgated by Basel III in the form of capital and liquidity frameworks.

The IFSB has coordinated with the BCBS in raising Islamic banks' concerns on the application of the LCR and these concerns have been reflected by the BCBS. For instance, in the LCR document which was published in January 2013, the BCBS recognised that even in jurisdictions where there is a sufficient supply of HQLA, **Shari'ah-compliant banks** may face "**an insurmountable impediment**" to LCR compliance. We note, in recognising the issues, the BCBS has developed a framework for Alternative Liquidity Arrangements (**ALA**), which provides a way of meeting such requirements till the time HQLA are available in sufficient supply, with deep and active secondary markets. However, jurisdictions that use the ALA are subject to high standards of supervisory monitoring, disclosure and self-assessment.⁵

With respect to the guidance on the Basel III equivalent HQLA requirements, the IFSB, in its recent **Guidance Note⁶ on Quantitative Measures for Liquidity Risk Management in IIFS**, provides framework on the application of global liquidity standards for the Islamic banks with suitable adjustments based on the specific operational characteristics. This framework takes an almost **similar approach of Basel LCR in terms of parameters** but it incorporates a number of additions and adjustments to meet the specificities of IIFS. It has identified a few issues such as i) increased supervisory discretion to cater different jurisdictions; ii) Islamic banks inability of not taking an interest-based loan from the interbank market or other sources; iii) Sharī'ah-compliance and tradability/transferability of debt/instruments; and iv) limitation on the usage of repos and reverse repos at Islamic banks.

According to the IFSB, the assets in Level 1 and 2A, should be traded in a market characterised by a **low level of concentration** and these assets are able to be regarded as a reliable source of **liquidity at all times** (that is, maximum decline of price not exceeding 10% or increase in haircut not

exceeding 10% points over a 30-day period during a relevant period of significant liquidity stress).

The IFSB has also stressed that **regulatory authorities facilitate** to the industry the availability of Sharī'ah-compliant liquidity facilities from central banks, allowing banks to hold HQLA in foreign currencies, and widening HQLA criteria.

Kuwait Experience in LCR and HQLA

Distinguished Participants,

The introduction of the BCBS LCR has prompted regulators to review their existing liquidity regimes. In this respect, we were no exception. We initiated the process of updating our liquidity regulations right after the crisis, and last year in December 2014, we have issued a **comprehensive guidance on the LCR** for both conventional and Islamic banks separately. Our regulations on the HQLA are drawn from, and consistent with, the BCBS and IFSB, so as to provide a level playing field in the industry.

During the preparation of the LCR, **Quantitative Impact Study (QIS)** served as an indicator of the effect such guidelines would have on the Kuwaiti banking sector. In the QIS, we found, high liquidity driven by the Central Bank liquidity requirements of customer deposits, with no constraints of any caps on Level 1 and/or Level 2; nevertheless, Level 1 type assets remain dominant compared to 2A and 2B type assets. Our findings were **consistent with the IFSB⁷ QIS** for IIFS (June 2013) **and recent BCBS findings** (September 2014) which indicated the similar pattern in its QIS results.⁸ According to the BCBS results, the majority of Group 1 and Group 2 banks' holdings, in aggregate, are comprised of Level 1 assets.⁹

While, from certain perspectives, **this is considered a good phenomenon**, to supervisors this demonstrates the need for diversification¹⁰ of the HQLA. The questions are, to what extent this diversification can be achieved in the short-term by banks, and what would be the implications to banks including changing their business models? As we move along on the implementation of the LCR, we will gain more insight into these questions.

Main Issues and Considerations in the implementation of HQLA

Distinguished Participants,

A lack of Shari'ah-compliant HQLA that meet the **stringent** requirements of Level 1 and Level 2 assets is not only problem for Islamic banks but is also being experienced by the conventional banking sector even in those countries with advanced financial services industries.

There are specific issues and considerations on which I will dwell on from Islamic banks' perspective in a moment. We should, however, note that the list of these considerations is not **meant to be exhaustive**, and as we move along on the banks' reporting of the LCR, we might see additional issues coming from the banks. Therefore, at this stage, it is difficult to determine the precise **knock-on effects** of HQLA. In addition, there is also possibility, that new matters will emerge during the implementation phase of the LCR and HQLA.

Now let me present you **certain considerations** that should be given due importance for the HQLA requirements.

First and foremost, is the need for the banks to **develop and implement** procedures, systems and controls to determine the stock of HQLA for LCR purposes.

Second, Level 1 is abundant in Islamic banks compared to Level 2. In Level 1, in some cases, the HQLA are solely composed of two categories, coins and bank notes and central bank liquidity requirement. However, **Level 2** is going to be **a main issue in medium to longer term** as the amount of such instruments in the total composition of HQLA is minimal due to the insufficient and limited supply of *Shari'ah*-compliant instruments (e.g. Sukūk) and, most importantly, the low level of trading in these instruments due to the problem of these instruments normally being held until maturity. A key issue is the absence of secondary markets that provide a "proven record of being a reliable source of liquidity at all times", which are qualifying criteria for any instrument to be considered part of the HQLA.

Third, it would be easy for banks to meet the **fundamental characteristics** (such as low risk, ease and certainty of valuation, low correlation with risky assets, listed on a developed and recognised exchange) compared to the

market-related characteristics (such as active and sizable market, low volatility, and flight to quality) of the HQLA. In addition, let us not forget, only few jurisdictions have an active Islamic money market and capital market; thus, Basel III requirements for the instruments to be traded in a large, active and deep repo market are **effectively difficult, if not impossible**, to meet. This shows each jurisdiction has to identify and provide its own guidance to the banks on the market-related characteristics of the Shari`ah-compliant HQLA that is compatible with its jurisdiction-specific characteristics.

Fourth, the supervisory discretion matters. Both the BCBS and the IFSB have stressed the importance of applying the supervisory discretion on certain elements. For supervisors, this shows having a **subtle balance** between complying with international guidance and catering to local market conditions. In this respect, the question has been, to what extent the jurisdiction can enforce the deviation through its supervisory discretion? For instance, **reciprocal arrangements** of giving preferential treatment (in terms of lower risk weight) to sovereign Sukūk issued by the other jurisdictions, applying **lower haircut** to Sukūk issued in foreign currency and by international institutions (including IILM's Sukūk), and moves by many national supervisors to **'ring fence' branches** and subsidiaries of foreign banks, that is, requiring such branches to have sufficient locally held high quality liquid assets to survive a stress event for 15 days. These are a few examples where supervisory discretion can and will play an important role in setting out HQLA qualifications.

We have discussed the **IILM's Sukūk** as part of the HQLA. However, we note that IILM's Sukūk issuances are not explicitly backed by the member central banks, also there is no clear indication by the IILM that issued Sukūk would be taken back and cashed in through repo style transactions. Based on this, and other considerations, it appears that IILM Sukūk are likely to be treated as Corporate rather than Sovereigns (unless there is clear policy by individual central banks to 'cash-in' IILM Sukūk at the request of Sukūk-holders) in line with the BCBS LCR requirements that the HQLA to be judged based on volume and frequency of trading and price volatility. Keeping this in mind, we have treated it **under 2A in our own LCR framework.**¹¹

Furthermore, **foreign exchange risk** associated with foreign currency HQLA used to cover liquidity needs in the domestic currency; therefore, such liquid assets should be subject to a minimum haircut of certain percentage for major currencies that are active in global foreign exchange markets. The question is what percentage is **appropriate**? Similarly, in the additional use of Level 2 assets with a higher haircut – a supervisory discretion matter.

Fifth, the acceptance of HQLA as collateral. When banks seeking short-term to medium-term *Sharī`ah*-compliant liquidity facilities including LOLR, the acceptance of the HQLA as eligible collateral subject to certain qualifying conditions would certainly enhance the liquidity of the HQLA. Although some *Sharī`ah*-compliant assets may be less risky than many conventional instruments; however, such assets are as **yet untested during stressed** conditions as very few jurisdictions in which Islamic finance has been widely developed have experienced a severe financial crisis in the past decade or so. This indicates the possibility of regular testing the HQLA through sale or *Sharī`ah*-compliant alternatives of repurchase (repo). This is my next point.

Sixth, periodical monetization of assets. Banks will have to ensure that no operational restrictions exist on the availability of HQLA that can prevent timely monetization during a stress period. **Hence**, there is need for periodically monetizing a representative proportion of the assets in the stock of HQLA through sale and *Sharī`ah*-compliant alternatives of repurchase (repo) transactions **to test access to the market and to minimise the risk of negative signalling during times of stress**. It is noted that *Sharī`ah*-compliant alternatives to repos are currently **not widespread due** to a number of operational and *Sharī`ah* compliance issues facing such transactions.

While conventional banks can perform certain activities to create liquid assets to meet the HQLA requirements – for example, **collateralising both financial and non-financial assets**, and undertaking repo transactions to generate liquidity; however, **Islamic banks cannot collateralise financial assets** (with the exception of Sukūk) or **use conventional repo** to generate liquidity. In this respect, if Sukūk/any instrument is not traded in normal market conditions - how the price discovery can be established and is it appropriate to classify as a liquid instrument? These questions are

important to be considered during periods of **severe idiosyncratic** and market stress.

Lastly, home/host cross-border issues in HQLA. Differences in home/host liquidity requirements, and liquidity transfer restrictions (e.g. ring-fencing measures, non-convertibility of local currency, foreign exchange controls, etc.) require a closer cross-border cooperation between the home-host supervisors when it comes to managing the liquidity at the **consolidated level**. The assets in other jurisdictions should be recognised as HQLA only if they are **freely available to the consolidated** entity without any restrictions due to regulatory, legal, tax, accounting or other impediments, both during normal and stressed conditions. Home-host supervisors understanding on how and when liquidity held centrally should be made available to subsidiaries and branches will address among others the treatment of the HQLA and resolution scenario in stressed situations.

Key Prospects and Challenges in the HQLA Requirements

Distinguished Participants,

It is well known that Islamic banking faces challenges in liquidity management. The HQLA requirements highlights both **prospects and challenges** for institutions and their respective supervisory authorities. Let us look at what they are.

While there is plenty of scope for detailed criticism of the HQLA requirements there are key opportunities for us which include i) having robust and stable banking system; ii) effective supervisory oversight with increased list of eligible assets for collateral and LOLR and iii) enhancement and deepening of money market and capital market activities through the issuance of new short-term and long-term liquid instruments under **Shari'ah-compliant securitisation** for HQLA diversification. The minimum requirements of HQLA have set out clear implications for capital market activities. This is a good development, but this will require more coordination with other supervisory authorities on the prudential treatment of such activities.

Besides, for the Islamic finance industry, given its relatively small size, the **question for us is what instruments are available** for Islamic banks to manage their HQLA requirement in this new, more demanding, regime. This

reflects that at least banks longer term investments need nevertheless to be tradable, which is of course the magnetism of securitisation. For all the failures of conventional securitisations in the run-up to the crisis, **Shari'ah-compliant securitisation** in some form is likely to play a significant role in the future.

We should not, however, **undermine the associated challenges** in the implementation of LCR, generally and in particular, HQLA requirements. The key challenges range from data and models, growth strategies of banks, lack of a developed money market, and especially an interbank market, dearth of Level 2 assets with limited capital risk and, ideally, predictable returns, yield curve and price transparency, trading venues and immediacy, issue size and market participation. The impact of these issues is expected to be **proportionate depending on the type and size** of banks whether in small and emerging economies or in larger, more advanced economies.

For many banks, LCR requirements are **'the iceberg below the water'**, and these requirements will necessitate operational, financial and structural change. Hence, there is a danger of **'being squeezed from all sides'**. It is, therefore, important for banks to have a holistic view of the full suite of regulatory changes and the potential impacts on their business in order to manage the challenges ahead.

Conclusion and a way forward

Distinguished Participants,

Let me conclude my remarks. Liquidity is not a “new” issue to central banks, it has been under the **supervisory gaze** for a long time, but certainly its importance has increased as the LCR has broadened the definition of liquidity and has **increased sophistication and threshold in terms liquidity management**.

Moving forward, the availability and implementation of effective HQLA will depend upon, concurrent improvements in, or creation of, other supportive liquidity and legal infrastructures such as: (i) developing **interbank market** – (whether formal or informal); (ii) deepening **funding and market liquidity** through the availability of short-term and long-term liquid instruments issued either by corporates, central banks or sovereign, to address the **paucity** of Islamic debt instruments (iii) establishing **safety nets** – such as Shari'ah-

compliant Deposit Insurance and Shari'ah-compliant Lender of Last Resort arrangements; and (iv) integration of Islamic finance and management of money supply (OMO).

With respect to the dearth of **short-term Sukūk**, the IILM programmatic approach for regular issuance of high quality Sukūk will have a positive impact on Islamic banks by enabling them to compete on a more level playing field with their conventional counterparts in meeting the LCR, and it would gradually build market liquidity of short term *Sukūk*.

Let me put it this way, there is “no quick fix” and “quick wins” for the above issues, it requires a gradual approach to address the gaps for the HQLA requirements, and there is need for enhanced cooperation among different stakeholders including rating agencies, multilateral bodies, corporates, and infrastructure institutions. At the end, it may also appear that **LCR is just a broad-brush liquidity buffer.**¹²

Thank you for your attention.

¹ Daniel C. Hardy and Philipp Hochreiter (2014), *A Simple Macroprudential Liquidity Buffer*, IMF Working Paper, WP/14/235.

² KPMG Liquidity: A Bigger Challenge Than Capital, May 2012.

³ The description of **Level 1 assets** include: (a) coins and banknotes; (b) central bank reserves; (c) *Sukūk* and other *Sharī'ah*-compliant marketable non-equity securities with **0% risk weight** representing claims on or guaranteed by sovereigns, central banks, public sector entities (PSEs), multilateral development banks (MDBs), or relevant international organisations; (d) *Sukūk* and other *Sharī'ah*-compliant marketable non-equity securities with non-0% risk weight but issued in **domestic currencies** by the sovereign or central bank; and (e) *Sukūk* and other *Sharī'ah*-compliant marketable non-equity securities with **non-0% risk weight** but issued by a domestic sovereign or central bank as securities in **foreign currencies**.

⁴ The description of **Level 2 assets** include Level 2A and 2B. **Level 2A:** (a) *Sharī'ah*-compliant marketable securities/*Sukūk* representing claims on or guaranteed by sovereigns, central banks, PSEs, MDBs, or relevant international organisations with **20% risk weight**; (b) *Sharī'ah*-compliant securities and *Sukūk* (including *Sharī'ah*-compliant commercial paper) subject to certain conditions. **Level 2B:** (a) *Sukūk* and other *Sharī'ah*-compliant securities backed by commodity(ies) and other real asset(s) with **25% haircut** subject to certain conditions; (b) *Sukūk* and other *Sharī'ah*-compliant securities not issued by the financial institutions with **50% haircut** subject to certain conditions; and (c) *Sharī'ah*-compliant equity shares with **50% haircut** subject to certain conditions.

⁵ Please see paragraphs 67- 68 of Basel III: *The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*, January 2013.

⁶ IFSB ED of GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions And Islamic Collective Investment Schemes]*.

⁷ Please see Box 2.2 in IFSB *Islamic Financial Services Industry Stability Report*, May 2014.

⁸ Basel III *monitoring report*, September 2014, <http://www.bis.org/publ/bcbs289.pdf>.

⁹ A total of 101 Group 1 and 115 Group 2 banks participated in the LCR monitoring exercise for the end-December 2013 reference period. The average LCR was 119% for Group 1 banks and 132% for Group 2 banks, which compare to average LCRs of 114% and 132% for Group 1 banks and Group 2 banks, respectively, as of June 2013.

Within Level 1 assets, 0% risk-weighted securities issued or guaranteed by sovereigns, central banks and public sector entities, and cash and central bank reserves comprise the most significant portions of the qualifying pool. By comparison, within the Level 2A asset class, the majority of holdings comprise 20% risk-weighted securities issued or guaranteed by sovereigns, central banks or public sector entities. Eligible non-financial common equity shares comprise the majority of holdings of Level 2B assets.

¹⁰ Apart from the paucity of Islamic debt instruments, Islamic banks hold predominantly common equity Tier 1 capital - in part this reflects Islamic banks' tendency to hold more equity than debt resulting less consideration to debt instruments, and making the diversification more difficult.

¹¹ According to the IILM, five IILM Member regulators (Malaysia, Mauritius, Nigeria, Qatar, and Turkey) recognise the IILM Sukūk as Level 2A or better assets for liquidity purposes.

¹² More recently, in a IMF working paper, Daniel and Philipp (2014), have called for a set of "systemically liquid assets" (SLAs), consisting of assets, the value of which is not correlated with the state of the financial system, and which even in a crisis situation can be used as payment, quickly sold without loss, or readily be used as high-quality collateral. Note that these assets may be claims on a foreign investment-grade sovereign, say, but not claims on the own commercial banking system.