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Basel Oversight Committee Endorses Revised Liquidity Standards and Extends Fully Phased-In Compliance to 2019

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The authors discuss the Basel Committee's recent endorsement of a revised formulation of the new minimum liquidity standard, known as the liquidity coverage ratio—one of two quantitative liquidity measures approved in December 2010 as part of Basel III.

The Group of Central Bank Governors and Heads of Supervision, the oversight body for the Basel Committee on Bank Supervision (the "Basel Committee"), recently endorsed a revised formulation of the new minimum liquidity standard, known as the liquidity coverage ratio ("LCR"),[1] one of two quantitative liquidity measures approved in December 2010 as part of Basel III. Recognizing the need to continue to support the worldwide economic recovery, while ensuring that global banks maintain liquid assets sufficient to meet their short-term cash needs during times of stress, members of this Basel oversight group supported a package with three key modifications and clarifications to the LCR that:

- expand certain categories of assets included as high quality liquid assets ("HQLA"), subject to limitations, and adjusted the assumptions regarding "cash outflows" to better reflect actual reactions to stress;

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- extend the timetable for full phase-in of the LCR from 2015 to 2019, to correspond with the phase-in period for the Basel III capital rules; and
- clarify that banks may use their stock of HQLA in periods of stress, including during the transition period—such that banking organizations would not be expected to maintain 100 percent coverage during such periods—subject to the discretion of home country supervisors to determine appropriate responses.

BACKGROUND

In the wake of the global financial crisis, the Basel Committee, which consists of senior representatives of bank supervisory authorities and central banks from 27 countries, including the United States, observed that many banks, even those with adequate capital levels, lacked sufficient liquidity to withstand short-term economic and financial stress. In response, the Basel Committee formulated a requirement that banks have an adequate stock of unencumbered high quality liquid assets that can be converted "easily and immediately in private markets into cash" to survive a significant stress scenario lasting 30 calendar days. This requirement, which is part of Basel III, is intended to improve the banking sector's ability to absorb shocks, whatever the source, thereby reducing the risk of spillover from the financial sector to the real economy.

Introduced in December 2010, the LCR is the quotient of two components: (a) the value of a banking organization's HQLA in stressed conditions, *divided by* (b) its total expected net cash outflows over the next 30 calendar days under stressed scenarios.[2] The minimum LCR is 100 percent.

Under this standard, HQLA must be unencumbered and should be liquid during a time of stress.[3] The revised standard describes in detail the characteristics that assets must have to be included in HQLA[4] and provides specific examples of the type of assets that have those characteristics. HQLA is composed of two levels of assets: Level 1 assets, which may be held in unlimited amounts, generally include cash, central bank reserves, and certain marketable securities issued or backed by sovereigns and central banks.[5] These assets are typically of the highest quality and the most liquid. Level 2 assets, generally composed of certain government securities,[6] covered bonds

and corporate debt securities,[7] are subject to a 15 percent haircut before inclusion in HQLA and may not in the aggregate account for more than 40 percent of a bank's HQLA.[8]

The denominator of the LCR is the organization's total net cash outflows, which are defined as total expected cash outflows, minus total expected cash inflows, under the specified stress scenario for the subsequent 30 calendar days.[9] Total cash inflows are subject to an aggregate cap of 75 percent of total expected cash outflows, thereby ensuring a minimum level of HQLA holdings at all times.

In addition to defining in detail the components of LCR, the revised standard describes operational requirements designed to ensure HQLA is available when needed. For example, banking organizations (i) should periodically monetize a representative proportion of their HQLA, through sales or repurchase transactions, to demonstrate their liquidity; (ii) must maintain all HQLA stock under the control of the function charged with maintaining the bank's liquidity (generally, the treasury function), and (iii) may be prohibited from including in the consolidated HQLA assets held within operating units (i.e. at the bank level).[10]

MORE ASSETS ELIGIBLE FOR HQLA

Most notably, the revised LCR standards includes as Level 2B assets the following:

- corporate debt securities (including commercial paper) rated A+ to BBB, subject to a 50 percent haircut;
- certain unencumbered equities, subject to a 50 percent haircut; and
- certain residential mortgage-backed securities ("RMBS") rated AA or higher, subject to a 25 percent haircut.[11]

NET CASH OUTFLOWS

The revised standard also makes refinements to the assumed cash inflow and outflow rates, to better reflect actual experience in times of stress. The

Basel Committee reduced the outflow stress levels on certain fully insured deposits, insured and uninsured "non-operational" deposits of non-financial companies, and committed liquidity facilities to non-financial companies, as shown in the Appendix. With regard to derivatives and commitments that are contractually secured by HQLA, the LCR assumes a net cash outflow of 0 percent; however, additional derivatives risk (generally related to collateral substitution or excess collateral that the bank is contractually obligated to return upon request of the counterparty) is fully included in the LCR with a 100 percent outflow assumption. The LCR also introduces a standardized approach for liquidity risk related to market value changes in derivatives positions. These and other changes made by the revised standard are shown in the Appendix.

DELAYED IMPLEMENTATION

The LCR will be subject to phase-in arrangements that align with those that apply to the Basel III capital adequacy requirements. Specifically, the LCR will be introduced as planned on January 1, 2015, but the minimum requirement will begin at 60 percent, rising 10 percentage points each year thereafter to reach 100 percent on January 1, 2019, as shown in the table below.

	2015	**2016**	**2017**	**2018**	**2019**
Minimum LCR requirement	60%	70%	80%	90%	100%

During periods of stress, the revised standard notes, "it would be entirely appropriate for banks to use their stock of HQLA, thereby falling below the minimum."

AREAS OF FURTHER STUDY

As deposits with central banks are one form of liquidity, the interaction

between the LCR and the provision of central bank facilities is expected to be studied in the coming year. In addition, the Basel Committee will continue to develop disclosure requirements for bank liquidity and funding profiles and will continue to explore the use of market-based indicators of liquidity to supplement the existing measures based on asset classes and credit ratings.

RESPONSE OF U.S. REGULATORS

The Federal Reserve has announced that it intends, in conjunction with other federal banking agencies, to implement the Basel III liquidity standards for LCR in the United States through one or more separate rulemakings. The Federal Reserve anticipates that the Basel III liquidity rules will be a central component of the enhanced liquidity requirements required by Sections 165 and 166 of Dodd-Frank. One challenge U.S. regulators will face in adopting this rulemaking will be their inability to use credit ratings as a measure of risk for certain asset classes, like RMBS. While qualified RMBS is defined under the revised standard by reference to credit ratings, Dodd-Frank prohibits regulators from using such credit ratings in their rulemakings.

Under Dodd-Frank, the Federal Reserve issued proposed rules in 2012 that would establish liquidity risk management standards for certain U.S. bank and thrift holding companies and non-banking companies designated as systemically important, as well as the U.S. operations of certain large foreign banking organizations. These proposed rules will subject these organizations to a set of enhanced liquidity risk management standards, including liquidity stress testing, that increase in rigor for larger organizations. The LCR requirements of Basel III are expected to be adopted under separate rulemakings as "quantitative liquidity requirements" that complement the enhanced liquidity risk measures proposed last year.

NEXT STEPS

Having completed work on the LCR, the Basel Committee will be reviewing next the second liquidity metric, the net stable funding ratio ("NSFR"), which supplements the LCR. Designed to promote resilience over a longer time horizon of one year, the NSFR creates incentives for financial institutions to

fund their activities with more stable sources of funding. The Basel Committee intends that the NSFR will become the minimum standard by January 2018.

APPENDIX

Changes to Cash Outflow Calculations

Insured deposits

- Reduce outflow on certain types of fully insured retail deposits from **5% to 3%**.
- Reduce outflow on fully insured non-operational deposits from non-financial corporates, sovereigns, central banks and public sector entities (PSEs) from **40% to 20%**.

Non-financial corporate deposits (not insured)

- Reduce the outflow rate for "non-operational" deposits provided by non-financial corporates, sovereigns, central banks and PSEs from **75% to 40%**.

Committed liquidity facilities to non-financial corporates

- Clarify the definition of liquidity facilities and reduce the drawdown rate on the unused portion of committed liquidity facilities to non-financial corporates, sovereigns, central banks and PSEs from **100% to 30%**.

Committed but unfunded inter-financial liquidity and credit facilities

- Distinguish between interbank and inter-financial credit and liquidity facilities and reduce the outflow rate on the former from **100% to 40%.**

Derivatives

- Additional derivatives risks included in the LCR with a **100%** outflow (relates to collateral substitution, and excess collateral that the bank is contractually obligated to return/provide if required by a counterparty).
- Introduce a standardized approach for liquidity risk related to market value changes in derivatives positions.
- Assume net outflow of **0%** for derivative payments that are contractually secured/collateralized by HQLA, assuming the bank is legally able to re-use the collateral upon payment.

Trade finance

- Include guidance to indicate that a low outflow rate **(0–5%)** is expected to apply.

Equivalence of central bank operations

- Reduce the outflow rate on maturing secured funding transactions with central banks from **25% to 0%**.

Client servicing brokerage

- Clarify the treatment of activities related to client servicing brokerage (which generally lead to an **increase in net outflows**).

NOTES

[1] BCBS, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (Jan. 2013). Available at: http://www.bis.org/publ/bcbs238.htm.

[2] The stress scenario contemplated by the revised standard is a combination of bank-specific and market-wide events, similar to the shocks that occurred in 2007, including: (a) some retail deposits run-off; (b) a partial loss of unsecured

wholesale funding capacity; (c) a partial loss of secured, short-term financing with certain collateral and counterparties; (d) additional contractual outflows that would arise from a downgrade in the bank's public credit rating by up to and including three notches, including collateral posting requirements; (e) increases in market volatilities that impact the quality of collateral or potential future exposure of derivative positions and thus require larger collateral haircuts or additional collateral, or lead to other liquidity needs; (f) unscheduled draws on committed but unused credit and liquidity facilities that the bank has provided to its clients; and (g) the potential need for the bank to buy back debt or honor non-contractual obligations in the interest of mitigating reputational risk.

[3] The revised standard also notes that, ideally, HQLA should also be central bank eligible for intraday liquidity needs and overnight liquidity facilities, although the fact that an asset class is central bank eligible does not necessarily make it HQLA eligible.

[4] All HQLA assets must be traded in large, deep and active repo or cash markets that are characterized by a low level of concentration; and have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions. As to the latter requirement, some asset categories also require that price declines or discounts during historical periods of stress should not have exceeded specific percentages, ranging from 10 percent to 40 percent. Banking organizations will need to be prepared to support the historical performance of certain asset categories under stressed conditions.

[5] Generally, marketable securities issued or guaranteed by sovereigns, central banks, public sector entities, multilateral banks and similar organizations specified in the revised standard must carry a 0 percent risk-weight under Basel II to be included as Level 1 HQLA, in addition to meeting other factors. Banking organizations, however, may hold marketable securities without a 0 percent risk-weight that are issued or guaranteed by sovereigns and central banks of countries in which the liquidity risk is being taken, or in the banks' home countries.

[6] Generally, marketable securities issued or guaranteed by sovereigns, central banks, public sector entities, multilateral banks and similar organizations specified in the revised standard must carry a 20 percent risk-weight under Basel II to be included as Level 2 HQLA, in addition to meeting other factors.

[7] Qualifying corporate debt securities (including commercial paper) include only plain-vanilla assets with readily available valuations based on standard methods that do not depend on private knowledge. These would not include complex structured products or subordinated debt. Qualifying corporate debt securities and covered bonds may not be issued by financial institutions and must either (i) have a long-term credit rating from a recognized external credit assessment institution of at least

AA-, or in the absence of a long-term rating, a short-term rating equivalent in quality to the long-term rating; or (ii) have been internally rated as having a probability of default corresponding to a credit rating of at least AA-.

[8] Home country supervisors may also choose to include within Level 2 assets an additional class of assets (Level 2B), which may not account for more than 15 percent of a bank's total stock of HQLA. The 40 percent cap on all Level 2 assets and the 15 percent cap on Level 2B assets should be determined after the application of required haircuts, and after taking into account the unwind of short-term securities financing transactions and collateral swap transactions maturing within 30 calendar days that involve the exchange of HQLA.

Under the revised standard, Level 2B assets would include certain corporate debt securities (including commercial paper) with external ratings between A+ to BBB-, or equivalent internal ratings (subject to a 50 percent haircut); RMBS externally rated at least AA (subject to a 25 percent haircut); and exchange-traded and centrally-cleared common equity shares, provided the issuer is a constituent of a major stock index in the home jurisdiction where the liquidity risk is taken (subject to a 50 percent haircut).

[9] Total expected cash *outflows* are calculated by multiplying the outstanding balances of various categories or types of liabilities and off balance sheet commitments by the rates at which they are expected to run off or be drawn down. Total expected cash *inflows* are calculated by multiplying the outstanding balances of various categories of contractual receivables by the rates at which they are expected to flow in.

[10] The operating units' net cash outflows must be included in the LCR calculations in order for any liquid assets they hold to be included in the consolidated HQLA. Importantly, any surplus of HQLA held at the operating level could only be included in the consolidated HQLA stock if those assets would also be freely available to the consolidated (parent) entity in times of stress. Under certain conditions, banking regulations may prevent a bank subsidiary from transferring assets to its parent.

[11] The underlying mortgages of eligible RMBS must be "full recourse" loans that have a maximum loan-to-value (LTV) ratio of 80 percent on average at issuance. In addition, the RMBS must be subject to risk retention rules, and the banking organization holding the RMBS as HQLA may not be the issuer, or originator of the underlying mortgages.