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Expert Analysis

Basel Committee Revises Liquidity Coverage Ratio Standards

By
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More than two years ago, I wrote about the new Basel III liquidity standards.[1] One of the new requirements was the imposition of a "liquidity coverage ratio," or LCR, aimed at making sure that banks had sufficient liquid assets for 30 days to cope with a severe liquidity crisis.[2] In January of this year, after protests from the banking industry that the LCR would hamper banks' ability to make loans and adversely affect their bottom lines, the Basel Committee of the Bank for International Settlements revised the standards to allow more time to come into compliance and broadened the categories of assets that would qualify to be considered as liquid assets eligible for the LCR.[3] This month's column will discuss highlights of the revised standards.

A Little History

First, to go back to December 2010, when the final text of the rules was issued by the Basel Committee, a committee of international banking regulators that develops international banking standards, the original purpose was to increase a bank's resilience in the event of a liquidity "stress event."

Under the LCR requirement, a bank is required to maintain unencumbered high quality liquid assets on a continuous basis sufficient to meet at least 100 percent of its estimated net cash outflows on a rolling 30 day calendar day basis during a period of "severe liquidity stress" as determined by banking regulators. In order to maintain the minimum 100 percent LCR, banks will need to over-estimate outflows against which it will need to maintain assets.

Based upon incidents from the most recent economic crisis, the stress scenario against which to test the liquidity ratio includes a material downgrade in a bank's credit rating, loss of a portion of the bank's retail deposits, runoff of certain secured and unsecured fundings, unscheduled draws on the bank's unused credit facilities and increases in market volatilities that impact the quality of collateral or potential future exposure of derivative positions. The stress scenario is a minimum; banks would be expected to be running their own stress tests to determine what additional liquidity they should retain over and above the required minimum.

Eligible liquid assets need to be "high quality" and "unencumbered" and reliable sources of liquidity. The fundamental characteristics of a high quality liquid asset are low credit and market risk, ease and certainty of valuation, low correlation with risky assets, and a sizable active sale or repurchase market. "Unencumbered" means not pledged (whether explicitly or implicitly) to secure, collateralize, or credit-enhance any transaction. A bank can utilize unused assets pledged to a central bank or a public sector entity and assets received in reverse repurchase agreements and secured financing transactions that are held at the bank and meet certain conditions.

The December 2010 rules provided for two levels of assets. Level 1 assets can be counted at 100 percent of their value and are the most liquid—cash, central bank reserves (to the extent that central bank reserves may be tapped by banks during times of stress), certain marketable Basel standard zero risk weight securities and certain sovereign debt securities. In terms of which instruments to classify as high quality liquid assets, the fundamental characteristics would include low credit and market risk, ease and certainty of valuation, low correlation with risky assets, listed on a developed and recognized exchange market for which there is an active and sizable market, and easily convertible to cash.

In January 2013, the Basel Committee of the Bank for International Settlements issued revised liquidity coverage ratio standards.

Level 2 assets can be used for up to 40 percent of the overall liquid asset portfolio, after a minimum 15 percent haircut is made to each asset. Level 2 assets include certain marketable securities assigned a 20 percent risk weight under Basel capital standards and low market risk corporate bonds with a ready valuation.

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As to the cash outflows against which the LCR assets are held, after cash outflow is netted against cash inflow, the total amount of cash inflow can only offset up to 75 percent of the cash outflow even if the amount of cash inflow is greater than that. As a result, a bank would always have to have a portfolio of liquid assets equal to 25 percent of the anticipated outflows at any one time in order to maintain the required 100 percent LCR. Assumptions in calculating the outflow included a certain percentage of run-off of customer deposits and drawdown on customer's credit lines.

Reaction to the Rules

The banking industry criticized the final text and provided data to make its case that as issued, it discounted the real state of liquidity of many of investments held by banks, could result in an immediate significant shortfall in a bank's liquidity, and could hamper mortgage lending that was seen as essential to the recovery of the U.S. housing market.[4] Some critics questioned whether the revisions to the LCR, which some press reports referred to as "huge concessions" to the banking industry or a "watering down" of the rules, would in fact increase lending.[5]

> While a 100 percent LCR remains the standard, the Basel Committee now specifically acknowledges that during a period of financial stress, banks may use all the assets meant for the LCR, which would mean that the ratio could fall below the 100 percent.

Changes by Basel

In January 2013, the Basel Committee issued revised LCR standards. The changes focus on more time to comply, more assets that could be counted for purposes of the LCR and some tweaks to the formula and underlying assumptions.

More Eligible Assets. Level 1 assets remain the same, although the Basel Committee has confirmed that individual countries retain the discretion, in adopting the LCR in their individual jurisdictions, to alter the eligibility of central bank reserves and other deposits as Level 1 assets.

Level 2 assets have been divided into Level 2A and 2B. Level 2A assets are the original Level 2 assets. The new category of Level 2B assets (to be permitted at the option of each implementing jurisdiction), the use of which must meet certain threshold conditions before being eligible such as being issued by unaffiliated parties and being a reliable source of liquidity in the market, are limited to certain corporate debt securities that are rated A+ to BBB–, subject to a 50 percent haircut, certain residential mortgage-backed securities that are rated AA or higher, subject to a 25 percent haircut, and certain common equity securities, also subject to a 50 percent haircut.

Level 2 assets in the aggregate still are restricted to 40 percent of a bank's total assets used to meet the LCR. The aggregate amount of Level 2B assets are limited to 15 percent of all assets used to meet the LCR. Alternative frameworks for calculation of liquid assets have been developed, including ones for banks in jurisdictions that may have an insufficient supply of Level 1 assets in their domestic currencies and for Islamic Shari'ah compliant banks that face religious restrictions on holding certain assets.

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Regarding calculation of cash outflows, some of the assumptions have been changed. The December 2010 standard assumed that many customers would draw down 100 percent of any untapped funds in their credit lines. The revised LCR has lowered that assumption from 100 percent to 30 percent in the case of committed (i.e., irrevocable) "liquidity facilities" for nonfinancial companies, sovereigns and central banks, public sector entities and multilateral development banks. The assumption has been lowered to 40 percent with respect to certain financial institution customers. The Basel Committee has defined a liquidity facility generally as a back-up loan facility that would be utilized to refinance a company's debt when it would be unable to roll over that debt in the financial markets. Loan facilities used for general corporate purposes or working capital would be considered "credit facilities," are addressed separately and are subject to a lower run-off percentage assumption. In addition, the Basel Committee lowered the assumed amount of deposit run-off for a number of categories of customers.

More Time to Comply. The original standard was to require that the minimum LCR be implemented at 100 percent as of January 2015. Instead, the 2015 minimum now will be 60 percent, with a 10 percent increase each year so that the full 100 percent LCR would be fully effective by January 2019.

Update

In last month's column on proposed Federal Reserve Board prudential standards for non-U.S. based banks with banking operations in the United States, I noted that the due date for comments was March 31, 2013.[6] The Federal Reserve Board has now extended the due date for comments to April 30, 2013.[7]

Conclusion

While the Basel Committee has revised the LCR coverage to allow for a longer implementation phase and a broader basket of assets from which to meet the LCR, each country still has to implement the requirements and there is no requirement that a country adopt the revised LCR as written. It could decide to adopt an LCR that more resembles that as originally issued in December 2010. Press reports indicate that at one point, the European Parliament was considering moving up the compliance date for a 100 percent LCR one year to January of 2018.[8] Thus, while banks may think they have won the battle by having the Basel Committee revise the LCR, the war may be yet to come when each country begins the process of enacting those standards into law.

1. "New International Capital and Liquidity Requirements," New York Law Journal, Jan. 12, 2011.
2. "Basel III: International framework for liquidity risk measurement, standards and monitoring," December 2010.
3. "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools," January 2013.
4. See, for example, "The Basel III Liquidity Framework: Impacts and Recommendations," The Clearing House, Nov. 2, 2011.
5. See, for example, Nick Goodway, "No wonder the banks cheer: Basel III is business as usual," London (U.K.) Evening Standard, Jan. 8, 2013; George Hay (Reuters), "Basel U-turn long-term negative," Toronto (Canada) Globe and Mail, Jan. 8, 2013.
6. "Proposed Enhanced Prudential Standards for Non-U.S. Banks," New York Law Journal, Jan. 9, 2013.
7. 78 Fed. Reg. 13294, Feb. 27, 2013.
8. Xana Kakoty, "Report: EU could enforce liquidity coverage ratio ahead of schedule," SNL European Financials Daily, Feb. 13, 2013.