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# Liquidity Coverage Ratio: New Basel Measurement Published

On January 6, 2013, the Group of Governors and Heads of Supervision ("GHOS"), which oversees the Basel Committee on Banking Supervision ("BCBS"), approved a significantly revised version of the liquidity coverage ratio ("LCR") that the BCBS has prepared.[1] The LCR was designed to test a banking organization's ability to withstand a liquidity crisis over a 30-day period. The revised LCR modifies certain elements of the original LCR, published in December 2010 as part of the Basel III framework,[2] and extends the deadline for full compliance with the LCR requirements. The inclusion of liquidity measurements in capital standards was a new development and, as originally conceived, generated criticism from the banking community as overly stringent. The BCBS announced in 2011 that it would revisit the LCR; the revised LCR is the result of this study.

The LCR is the ratio of unencumbered high quality liquid assets ("HQLA") to net cash outflows over the next 30 calendar days. Perhaps the most significant change to the original LCR is the addition of assets—residential mortgage-backed securities ("RMBS"), corporate debt, commercial paper, covered bonds, and common equity—to the pool of assets that may be included in HQLA. (As discussed below, these assets comprise a subset of HQLA known as Level 2B.) The effect of this change may be a little bit less than meets the eye for U.S. banking organizations for two reasons:

- RMBS are eligible only if the underlying mortgage loans are full recourse and contain no walk-away clauses or short sale provisions. Several states, among them California and Texas, provide for certain types of walk away clauses, but some of them also provide for deficiency judgments in certain cases. Accordingly, banking organizations holding RMBS may be required to perform a state-by-state review of the loans in each pool.

- A Level 2B asset must have a "proven record" as a source of liquidity during a period of financial stress—typically, that it will fall by no more than 20 percent (40 percent for common equity) in price during such a period. Many of these assets did fall by more than 20 percent during the liquidity crisis in 2008.

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[1] The revised LCR is described in four related documents: a press release dated January 6, 2013, available at http://www.bis.org/press/p130106.pdf; Annex 1 to the press release, which provides a summary description and is available at http://www.bis.org/press/p130106a.pdf; Annex 2 to the press release, which describes the changes made to the December 2010 measure and is available at http://www.bis.org/press/p130106b.pdf; and the final document, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, released on January 7, 2013, available at http://www.bis.org/publ/bcbs238.pdf. Mervyn King, Chairman of GHOS and Governor of the Bank of England, discussed the proposal on January 6; his speaking notes are available at http://www.bis.org/speeches/sp130106.htm.

[2] The original LCR is described in a December 2010 publication, *Basel III: International framework for liquidity risk measurement, standards and monitoring*, available at http://www.bis.org/publ/bcbs188.pdf. The BCBS later issued a set of FAQs on liquidity that is available at http://www.bis.org/publ/bcbs199.pdf. The Basel III liquidity standards also call for a net stable funding ratio (NSFR), which measures the adequacy of a banking organization's liquidity over a one-year horizon. The NSFR as set forth in the December 2010 publication is not affected by the revisions to the LCR.

In any event, U.S. banking organizations should expect to become subject to the new LCR, with some possible adjustments. The proposed enhanced prudential standards for U.S. bank holding companies with $50 billion or more in total consolidated assets and for systemically important nonbank financial institutions ("nonbank SIFIs") include a 30-day liquidity buffer consciously modeled on Basel III; the proposal is sufficiently open-ended to permit the use of either the original or the revised LCR.[3] The comment period on the proposed enhanced prudential standards has expired, but institutions subject to the standards may wish to consider a supplemental comment, if only to urge adoption of the new ratio. Additionally, in the Basel III-based capital proposal released in June 2012, the three federal banking agencies noted that they expected to propose liquidity requirements along the lines of the Basel III standards.[4]

In Europe, the draft Capital Requirements Regulation being negotiated between the European Commission, the Council of the European Union, and the European Parliament does not itself contain provisions for a binding LCR, although it envisions the LCR being introduced in 2015 by a delegated act of the European Commission after an initial observation and review period. European banking organizations can therefore expect to become subject to a modified LCR, under an extended compliance deadline, under the eventual act of the European Commission.

Non-U.S. financial institutions with operations in the United States may also be affected by the response of the Federal Reserve Board (the "Board") to the revised LCR. The Board recently proposed new regulations for certain foreign banking organizations ("FBOs"), as well as for certain foreign nonbank financial companies.[5] The branch and agency network of an FBO with combined U.S. assets of $50 billion or more, and its U.S. intermediate holding company, if any, must maintain liquidity buffers. The elements of the revised LCR are likely to inform the Board's effort to implement the liquidity buffer for branch and agency networks and U.S. intermediate holding companies, and the Board's final rule on this buffer is likely to be more complicated than the requirements for U.S. bank holding companies with $50 billion or more in total consolidated assets and for U.S.-based nonbank SIFIs.

## The Revised LCR

As set forth in the Basel III framework from June 2011, the LCR is designed to "ensure that [over a 30-day horizon] global banks have sufficient unencumbered, high-quality liquid assets to offset the net cash outflows it could encounter under an acute short-term stress scenario." The measure itself is the ratio of qualifying assets to net cash outflows, and should exceed 100 percent. The two components of the LCR—HQLA and net cash outflows—have been revised in important ways.[6] Highlights, but by no means a comprehensive list, of the changes follow.

### *High-quality liquid assets*

The original LCR defined HQLA as including two levels of assets. The first, Level 1, was limited to cash, securities, and other instruments backed by a sovereign government or certain other entities. An institution could include all Level 1 assets in HQLA without restriction. Up to 40 percent of HQLA could consist of Level 2 assets, after certain

[3] The proposal is published in 77 Fed. Reg. 594 (Jan. 5, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.
[4] The Basel III-based proposal was published in 77 Fed. Reg. 52792 (Aug. 30, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-16757.pdf. We discussed this proposal and the related Standardized Approach and Market Risk proposals in *The Banking Agencies' New Regulatory Capital Proposals* (June 2012), available at http://www.mofo.com/files/Uploads/Images/120613-Banking-Agencies-New-Regulatory-Capital-Proposals.pdf.
[5] This proposal is published in 77 Fed. Reg. 76628 (Dec. 28, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.
[6] Two aspects of HQLA have not changed. First, the assets must be unencumbered: "free of legal, regulatory, contractual or other restrictions on the ability of the bank to liquidate, sell, transfer, or assign the asset." Second, the BCBS continues to believe that, ideally, all HQLA (other than Level 2B assets) should be eligible at a central bank for intraday liquidity needs and overnight liquidity facilities. This expectation is not a requirement, however, nor would such eligibility be sufficient for inclusion in HQLA.

haircuts. The revised LCR enlarges the pool of assets eligible for HQLA treatment, subject to strict limitations. The principal vehicle for the changes is the division of Level 2 into Levels 2A and 2B, with Level 2B containing the new components of HQLA. The levels of HQLA are now as follows:

- *Level 1*. Assets eligible for Level 1 remain the same as in the original LCR: cash, central bank reserves (provided the reserves can be drawn down in a period of stress), and certain marketable securities backed by sovereigns and central banks.[7] The same prerequisites apply: a 0 percent risk weight, trading in a large and deep market, a proven record as a reliable source of liquidity, and not issued by a financial institution. The inclusion of debt securities backed by a sovereign or central bank with a risk weight greater than 0 percent that meet certain conditions remains in place as well.

- *Level 2A*. Similarly, the assets that composed Level 2 in the original LCR become the constituents of Level 2A in the revised LCR. These assets include certain government or central bank securities not eligible for Level 1 (i.e., where the assets are risk-weighted at 20 percent rather than 0 percent), covered bonds, and corporate debt securities. Corporate debt and covered bonds were required to meet several conditions that continue to apply. When the U.S. regulators adopt the revised LCR in the capital standards, as we assume they will, one change will be necessary. Both the original and revised LCRs required that corporate debt and covered bonds have an external long-term rating of AA- or better (or certain equivalent ratings). Section 939A of the Dodd-Frank Act prohibits the use of such ratings, and a substitute creditworthiness factor may be necessary. As in the original LCR, all Level 2A assets included in HQLA are haircut by 15 percent.

- *Level 2B*. This level is entirely new and contains perhaps the most important changes to the original LCR. Level 2B includes various assets not previously eligible for Level 2, including certain RMBS, corporate debt securities (including commercial paper), and common equity—all subject to a substantial haircuts. Banking organizations should not overestimate the favorable impact of the new Level 2B. Level 2B assets may not account (after haircuts) for more than 15 percent of HQLA. Additionally, for each category of assets now included in Level 2B, specific restrictions or conditions apply.

    – <u>RMBS</u>. Eligible RMBS cannot have been issued by (or been secured by assets originated by) the bank itself or one of its affiliates, must have a long-term rating of AA or better (or an equivalent short-term rating), must be traded in large, deep, and active repo or cash markets characterized by a low level of concentration and must have a proven record as a reliable source of liquidity during stressed market conditions (i.e., a decline in price of no more than 20 percent during a period of liquidity stress or an increase in haircut of no more than 20 percent over a 30-day period). The "proven record" requirement may preclude the inclusion of some RMBS. Several series of RMBS experienced price declines of more than 20 percent during the financial crisis.

      Other conditions apply to the asset pool and the underlying mortgages. The pool must consist solely of residential mortgages and cannot contain structured products. The mortgages in the pool must, on average, have a loan-to-value ratio at issuance of 80 percent or less, and the mortgages must be full recourse to the mortgage owner (*i.e.*, in the case of foreclosure, the owner remains liable for any shortfall in the sales proceeds). This latter condition may be problematic for many series of RMBS issues in the United States. Several states provide for certain walk-away provisions in mortgage loans, which would render the loans non-full recourse. In addition, the securitizations must be subject to risk retention regulations. RMBS that satisfy these prerequisites are subject to a 25 percent haircut.

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[7] Special rules apply in a jurisdiction with an insufficient supply of Level 1 assets (or Level 1 and all Level 2 assets combined). The United States is not such a jurisdiction. Special rules also apply to *Shari'ah* compliant banks, which are subject to a religious prohibition on holding certain assets that would qualify for Level 1 or Level 2 treatment.

– Corporate debt securities, including commercial paper. These securities must not have been issued by a financial institution or any affiliate of a financial institution and must have either a long-term credit rating between A+ and BBB-, a short-term rating equivalent, or, unrated, an internal rating with a probability of default corresponding to a rating between A+ and BBB-. The securities must be traded in large, deep, and active repo or cash markets characterized by a low level of concentration. Additionally, the securities must have the same proven record as a reliable source of liquidity as do RMBS: a decline in price of no more than 20 percent during a stressed period or a haircut of no more than 20 percent over a 30-day period. As with RMBS, the 20 percent cap would exclude many forms of corporate debt that fell by more than 20 percent in price during the financial crisis. A 50 percent haircut applies to corporate debt securities.

– Common equity. Common equity must not have been issued by a financial institution or any affiliate of a financial institution, must be exchange traded and centrally cleared, must be a constituent of a major stock index in the issuer's home jurisdiction or in the jurisdiction where the liquidity risk is taken, must be denominated in the domestic currency of the banking organization's home jurisdiction or in the currency of the jurisdiction where the organization's liquidity risk is taken, and must be traded in large, deep, and active repo or cash markets characterized by a low level of concentration. A proven record as a source of liquidity during stressed market conditions is also necessary, but with a less stringent quantitative standard than applies to RMBS or corporate debt. The record of the equity's performance must show a price decline of no more than 40 percent during a stressed period or an increase in haircut not exceeding 40 percent over a 30-day period. The haircut on eligible common equity is 50 percent.

Banking institutions should bear in mind that the revised LCR continues the operational requirements of the original LCR. These requirements may affect the includability of certain assets in Level 2B to a greater degree than they may affect Level 1 and Level 2A assets. A banking organization has several duties, including obligations to monetize representative portions of the assets periodically, to ensure that the assets are unencumbered, and to monitor and manage liquidity positions on a timely basis. Other conditions may come into play with respect to the hedging of market risk associated with HQLA, HQLA used to meet statutory liquidity requirements, transferability, and the presence (or not) of large, deep, and active repo markets. A banking organization is also expected to diversify its holdings of HQLA.

### ***Net cash outflows***

Net cash outflows are the difference between total expected cash outflows during the next 30 calendar days in a specified stress scenario, less total expected cash inflows during the same period. Importantly, total cash inflows may not exceed 75 percent of total expected outflows; in other words, net outflows can never be less than 25 percent of total outflows before netting. Outflows are calculated by multiplying various types of liabilities and off-balance sheet commitments by the rates at which they are expected to run off or be drawn down. Inflows are calculated by multiplying the outstanding balances of various contractual receivables by the rates at which they are expected to flow in.

The new LCR revises the net cash outflow calculation in large part by reducing runoff rates on certain deposits and drawdown rates on certain liquidity or credit facilities—thus assuming lesser liquidity risk for such liabilities. In connection with derivative transactions, the LCR assumes in certain cases smaller adverse impact on collateral than did the original LCR. The runoff rates in general are as follows:

- *Retail deposits.* Demand deposits now carry one of three (rather than one of two) outflow rates: 3 percent, if the deposit is "stable" and is insured under a scheme that meets certain requirements;[8] 5

[8] Insurance provided by the Federal Deposit Insurance Corporation meets these requirements.

percent, if the deposit is stable but is not covered by a qualifying insurance program; and 10 percent, if the deposit is not stable. The 3 percent rate is new. A stable deposit is either a deposit from a customer that has other relationships with the banking organization that make withdrawal highly unlikely or a deposit in a transactional account. A stable deposit must also be insured.

Term deposits with a residual maturity greater than 30 days have the same outflow rate as in the original LCR calculation: 0 percent, provided that the depositor has no legal right to withdraw the deposit within a 30-day time horizon, or faces a significant penalty (materially greater than the loss of interest) for an early withdrawal.

- *Wholesale deposits.* Runoff rates on wholesale deposits depend primarily on the nature of the depositor. The rates in the revised LCR are largely the same as they were in the original LCR. There are two changes, largely related to deposit insurance.

  – Operational deposits. Under the original LCR, all deposits by wholesale customers with certain specific operational relationships with the banking organization holding the deposits had a runoff factor of 25 percent if certain conditions were met. In the revised LCR, the factor may be reduced to 5 percent for the portion of stable deposits insured in a qualifying regime.

  – Deposits by nonfinancial corporates, sovereigns, central banks, multilateral development banks, and PSEs have a 20 percent runoff rate if the amount of such a deposit is fully insured by a program that meets certain requirements and a 40 percent runoff rate otherwise. In the original LCR, the outflow rate on deposits from such depositors was 75 percent regardless of deposit insurance.

Otherwise, the rates for deposits by small business customers (5 or 10 percent), cooperative banks in certain institutional networks (25 percent), and all other legal entities (100 percent) remain the same. All unsecured wholesale funding, apart from deposits or as otherwise covered above, is assigned an outflow rate of 100 percent.

- *Secured funding.* The runoff rates for short-term secured funding transactions that mature within the 30-day horizon covered by the LCR—a class of transactions that includes nearly all repos, reverse repos, and securities borrowing and lending transactions—depend largely on the nature of the collateral. The revised LCR makes two adjustments to the approach in the original LCR. First, the revised LCR adjusts the rates to account for assets in the new Level 2B, but the rates otherwise remain the same. Accordingly, for maturing secured funding transactions with counterparties other than central banks or certain government entities, the following rates reflect the different kinds of collateral backing a transaction:

  – Level 1 assets: 0 percent

  – Level 2A assets: 15 percent

  – RMBS eligible for Level 2B: 25 percent

  – All other Level 2B-eligible assets: 50 percent

  – All other assets: 100 percent

Second, standard runoff now rates apply to secured transactions with central banks and certain government entities. All funding transactions with central banks now have a runoff rate of 0 percent, regardless of collateral. Transactions with a banking organization's domestic sovereign, PSEs, and multilateral development banks have a runoff rate of 25%. If the organization backs a transaction with such a counterparty with a Level 1 or Level 2A asset, the runoff rate will be reduced to 0 percent or 15 percent, respectively. The original LCR used runoff rates based strictly on collateral.

- *Derivatives.* The revised LCR maintains the 100 percent outflow rates set forth in the original LCR for net cash outflows on derivative transactions, increased liquidity needs related to either downgrade triggers or the potential for valuation changes on posted collateral, and the loss of funding on structured financing instruments or financing vehicles. The revised LCR also applies the 100 percent rate to collateral that either could be recalled by the posting counterparty or that a counterparty could demand, as well as to HQLA collateral that could be required to replace non-HQLA collateral without the posting bank's consent. Additionally, in the revised LCR, the outflow rate on the collateralization of mark-to-market exposures is the largest absolute net 30-day collateral flow realized during the preceding 24 months.

- *Committed credit and liquidity facilities.* The revised LCR shifts many of the outflow rates on liquidity facilities downward. The full set of runoff rates on credit and liquidity facilities is now as follows:

  - Committed credit and liquidity facilities to retail and small business customers: 5 percent
  - Committed credit facilities to non-financial corporates, sovereigns, central banks, and PSEs, and multilateral development banks: 10 percent
  - Committed liquidity facilities to non-financial corporates, sovereigns, central banks, and PSEs, and multilateral development banks: 30 percent, rather than the original 100 percent
  - Interbank liquidity facilities: 40 percent, reduced from 100 percent in the original LCR
  - Committed credit and liquidity facilities to all other entities: 100 percent. This category includes interfinancial facilities

- *Contractual obligations to extend funds within a 30-day period.* The outflow rate remains at 100 percent. The rate on other contingent funding obligations is at the discretion of national supervisors.

- *Trade finance.* The outflow rate is left to national discretion, but the BCBS expects rates to be set between 0 and 5 percent.

- *Client servicing brokerage.* A 50 percent runoff factor is required for customer short positions covered by other customers' collateral.

- *Central bank funding.* The outflow rate is reduced from 25 percent to 0 percent; that is, a central bank will never revoke funding in a period of financial stress.

With respect to the treatment of net cash inflows, the new LCR follows the standards in the original LCR but makes an addition for secured lending transactions where the collateral is one of the new Level 2B assets. The set of inflow rates accordingly is as follows:

- *Maturing secured lending transactions.* The inflow rate is principally a function of the probability that a maturing reverse repo or securities borrowing transaction will not be rolled over. Both the original and the revised LCRs assume, for example, that all funding transactions secured by Level 1 collateral will be rolled over, and thus the inflow rate is 0 percent. The revised LCR includes the same inflow rates on transactions secured by other collateral: 15 percent for Level 2 collateral and 100 percent for other collateral. The revised LCR also provides new inflow rates reflecting Level 2B assets. The rate on transactions secured by RMBS is 25 percent and on those secured by other Level 2B assets 50 percent. The revised LCR makes one further modification: margin loans backed by collateral not eligible for HQLA have an inflow rate of 50 percent, rather than 100 percent (the default rate in the original LCR).

- *Short positions.* If a banking organization holds a collateralized short position, the inflow rate is 0 percent, regardless of the collateral.

- *Committed facilities.* Both the original and revised LCRs assume that a banking organization will be unable to draw on facilities held at other institutions. Accordingly, the inflow rate is 0 percent.

- *Inflows by counterparty*. For fully performing retail and small business loans, the net inflow rate is 50 percent. The rates on wholesale inflows are 100 percent from financial institution counterparties and 50 percent from all other counterparties, including non-financial corporates, sovereigns, central banks, and PSEs.

- *Other deposits.* Deposits held at other financial institutions for operational purposes (such as clearing, custody, and cash management), and deposits held at the centralized institution in a cooperative banking network, are both assigned an inflow rate of 0 percent.

- *Securities maturing within 30 days and not included in HQLA.* These securities are assigned an inflow percentage of 100 percent. A banking organization may also include in this category inflows from the release of balances held in segregated accounts for the protection of customer trading assets (and as legally required), provided that the balances are maintained in HQLA.

- *Derivatives.* Inflows on derivative transactions are calculated on a net basis, including net of Level 1 and Level 2 collateral. A net receivable receives a 100 percent inflow factor.

### ***Phase-in timetable***

A banking organization is required to maintain an LCR of at least 60 percent beginning in 2015. The standard will be increased by 10 percent in each following year; full compliance with the 100 percent LCR is required in 2019.

## **Concluding Observations**

The revised LCR eases several requirements for the calculations of HQLA and net cash outflows, and the extension of the compliance period will enhance the ability of banking organizations to meet the new requirements. The full impact of the changes remains to be seen. For example, RMBS now may be included (to some extent) in HQLA, but a requirement that the underlying mortgages contain no walk-away clause would exclude any series of U.S. RMBS backed by mortgage loans in a state that requires a walk-away clause. The assets now includable in HQLA also must have a proven record as a source of liquidity; the performance of these assets during the financial crisis may fail to establish the necessary record. Even if these assets pass these tests, the revised LCR allows the assets to comprise no more than 15 percent of HQLA. The revised LCR also imposes substantial haircuts.

In any event, for U.S. banking organizations (and nonbank SIFIs), the revised LCR will have a substantial impact on the liquidity rules required under the Dodd-Frank Act.

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