FS Regulatory Brief

Basel III liquidity regime — More practical but not yet workable

January 2013

On January 7th, the Basel Committee on Banking Supervision ("BCBS") issued a finalized standard ("Standard") on the Liquidity Coverage Ratio ("LCR"), a short-term liquidity measure that considers a 30-day period of liquidity stress. The LCR forms one of the key components of the Basel III reform package, which also includes:

(i) Revised capital standards, which have been largely defined (further changes are expected to the trading book framework and the leverage ratio).

(ii) The Net Stable Funding Ratio ("NSFR"), a longer-term liquidity measure designed to restrain the amount of wholesale borrowing and encourage stable funding over a one year time horizon.

The recent BCBS action only covers the LCR. The NSFR (proposed with the LCR in December 2010) remains a work-in-progress, and the BCBS indicated it would be focusing on it for the next two years. However, given that it took over two years to finalize the LCR, achieving a two-year target date for the NSFR may be a challenge as the NSFR is more complicated and enjoys less global consensus than the LCR did.

This **FS Regulatory Brief** summarizes the key changes to the LCR from the original BCBS proposal, and provides an early assessment of its US implementation and impact on financial institutions.

Key LCR changes

BCBS had proposed the LCR with the understanding that the LCR could change given its implications on global lending and economic growth. The recently released Standard delivers on that expectation, with the BCBS explicitly noting the importance of "ongoing strains in some banking systems" when setting the Standard – a reference to continued financial market challenges in Europe.

As a consequence, the Standard delays full implementation of the LCR until January 1, 2019. On the originally proposed start date of January 1, 2015, banks need only meet 60% of the Standard. They will need to meet 100% of the Standard by 2019 (rising in increments of 10 percentage points per year).

The Standard provides an exemption to this timetable for countries receiving financial support for macroeconomic and structural reform. Such countries may choose a different implementation schedule, in recognition of the reality that their banking systems have not recovered sufficiently to comply.

Aside from this timetable change, the Standard differs from the original proposal in the following two key ways:

- The types of High Quality Liquid Assets ("HQLA") that can be held as part of the LCR *(in the numerator)* have been expanded.
- The assumed 30-day cash outflow and cash inflow rates that make up Net Cash Outflow *(the denominator of the LCR)* have been modified to essentially slow the assumed rate of Net Cash Outflow.

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It was expected that the types of assets eligible to be held as part of HQLA would be broadened because of the continued market difficulties in Europe. Without the change, the LCR may have led to the perverse result of increasing bank exposure to sovereigns at a time when doing so would be risky given the eurozone crisis. Contradictorily, however, by leaving sovereign debt in the Standard as a Level 1 HQLA (with no discount factor), the BCBS is implying that the distressed debt of some European countries is as liquid as the debt in financially stronger sovereigns – an assumption that is not supported by recent evidence.

The Standard also differs from the original proposal by clarifying that banks are allowed to fall below a 100% LCR during times of stress, subject to their supervisor's discretion (i.e., banks are not required to hold an additional buffer on top of the LCR buffer).

The Standard otherwise remains largely consistent with the original proposal by requiring that banks assess potential Net Cash Outflow using supervisory assumptions (not banks' internal models) and by requiring at least monthly reporting on a consolidated level (as well as on a subsidiary or foreign-branch level where relevant).

As is customary with BCBS standards, the LCR Standard is regarded as a global minimum. It will be up to each national supervisor to implement the Standard, and they may implement stricter or modified requirements.

High quality liquid assets

The most significant change with respect to HQLA is the establishment of a new class of eligible assets, designated as Level 2B. The previous Level 1 and Level 2 asset classifications continue as originally proposed, as does the limitation that Level 2 assets cannot make up more than 40% of HQLA. The new Level 2B class is subject to a similar 15% limitation.

The new Level 2B assets are subject to a discount factor (or "haircut") that reduces the extent to which they can count towards HQLA. The Level 2B assets, summarized below, are the following:

- *Residential mortgage-backed securities ("RMBS") rated AA or higher* are subject to a 25% haircut. Such RMBS must meet very strict criteria including only being comprised of "full recourse" underlying loans, never having fallen in value by over 20%, and having originated with a loan-to-value ratio of 80%. The RMBS must also be traded in deep and liquid markets and not have been issued by the bank or its affiliates.
- *Corporate debt securities rated between A+ and BBB-* are subject to a 50% haircut. These must have never fallen in value by over 20%.
- *Common equities, which are exchange traded and part of a major market index,* are subject to a 50% haircut. These must be denominated in the same currency as the deposits giving rise to the liquidity stress, and must have never fallen in value by over 40%.

The most important point about these newly added assets is that although the BCBS now includes them as part of HQLA, the conditions are so restrictive, particularly with respect to RMBS, that such assets are of limited practical utility. Beyond the several explicit conditions within the Standard related to RMBS, all three types of assets are separately subject to high capital charges (risk-weighted at 100% for debt securities and common equity).

Net cash outflows

The assumed 30-day cash outflow and cash inflow rates that make up Net Cash Outflow *(the denominator of the LCR)* have been modified to generally soften the assumed rate of Net Cash Outflow during a liquidity crunch relative to the original BCBS proposal.

With respect to the outflow of retail deposits, a very important change is that the assumed outflow rate has been reduced from 5% to 3% over the 30-day period *if the retail deposits are insured under a pre-funded structure*. If not, the assumed outflow rate for retail deposits remains at 5% as originally proposed. This change is clearly beneficial to banks in the US which insures deposits in a pre-funded structure, unlike the practice of many other countries.

Other changes with respect to cash outflows for various types of liabilities include the following and are listed in **Appendix A**.

- The assumed outflow rate for *wholesale unsecured funding provided by non-financial corporations and sovereigns* (including central banks and public sector entities) has been reduced from 75% to 40%, and can be as low as 20% if the deposits are covered by an effective deposit guarantee or public guarantee.
- The category of *maturing secured funding transactions* now includes those transactions backed by the new category of Level 2B assets. Specifically, the assumed outflow rate for transactions backed by RMBS is 25% and the rate when backed by other Level 2B assets is 50%. Secured funding transactions with central banks benefit from a run-off rate of 0%.
- The category of *retail fixed term deposits* has been removed and subsumed within the "retail deposits" category as "stable" or "unstable"; however, the basic rule remains the same – deposits which cannot be withdrawn within the 30-day period (or which would be subject to significant penalties if withdrawn) remain excluded from the LCR.
- The category of *unsecured wholesale funding with operational relationships* has been more strictly and explicitly defined and changed to "operational deposits"; however, the 25% outflow assumption remains unchanged.

The Standard also includes an "Other" category with respect to cash outflows, which includes items such as derivatives-related outflows. They include the following and are also listed in **Appendix A.**

- The assumed drawdown on committed *credit and liquidity facilities to non-financial entities* has been reduced from 100% to 30% over the 30-day period.
- The assumed drawdown on committed *credit and liquidity facilities to financial institutions* has been reduced from 100% to 40%. This definition originally only applied to facilities provided to banks subject to prudential supervision, but it has been broadened under the Standard to include other financial institutions (i.e., securities firms and insurance companies) and distinguishes between credit facilities (with an assumed drawdown rate of 40%) and liquidity facilities (with an assumed drawdown rate of 100%) to these other institutions.
- For *derivatives*, a new requirement was introduced for establishing the collateral outflow assumption for each particular derivatives asset. The requirement assumes collateral outflow to be the largest absolute net outflow over a 30-day period during the preceding 24 months.
- A 0% outflow is assumed for *derivatives* and *commitments* secured by HQLA.

With respect to cash inflows, the constraints on offsetting inflows against outflows to derive Net Cash Outflow remain unchanged: inflows have to be contractual, default must not be expected, and inflows cannot exceed 75% of outflows. The assumed rollover rate of reverse-repo and similar transactions are also broadly unchanged by the Standard, with the following exceptions:

- New inflow rates have been assumed for the newly added Level 2B category of HQLA assets: 25% inflow for eligible RMBS and 50% inflow for other Level 2B assets.
- The assumed inflow rate for margin lending backed by all other collateral has been defined as 50%.

How will LCR be applied in the US?

BCBS's revised LCR comes during a period of regulatory uncertainty in the US as banks continue to wait for final liquidity requirements by the Federal Reserve as part of a package of Enhanced Prudential Standards ("EPS"). These EPS proposals are currently open for public comment in the US and affect bank holding companies with over $50 billion in assets (proposed January 2012), nonbank financial companies designated as systemically important (proposed January 2012), and foreign banking organizations operating in the US (proposed December 2012).

Now that BCBS has issued the Standard, US regulators will propose rules implementing LCR in the US. As important, the Standard will have to be incorporated into outstanding EPS proposals, which explicitly indicate the central importance of the BCBS's liquidity proposal. Expect the US implementation process to be multi-staged and for the final EPS rules to incorporate strong liquidity risk management and quantitative liquidity requirements, based on the LCR. Furthermore, expect further delay in the three EPS proposals as the LCR is incorporated, particularly as a result of establishing quantitative liquidity requirements.

US EPS liquidity rules are likely to require more of banks than the LCR does. In particular, under the EPS, the US liquidity buffer must cover Net Cash Outflows for 30 days *over a range of liquidity stress scenarios,* unlike the LCR which only entails a single scenario. This range must at a minimum include three separate scenarios: market stress, idiosyncratic stress, and a combined market and idiosyncratic stress scenario.

Furthermore, the LCR is a minimum supervisory liquidity requirement whereas the EPS liquidity buffer determined by banks will need to be assessed relative to associated stress tests and account for the covered company's capital structure, risk profile, complexity, activities, size and other risk factors.

The Standard's pool of eligible HQLA generally corresponds to similarly defined assets in the EPS, but the following exceptions are important:

- The eligibility of *RMBS securities* under the EPS is likely to be more expansive than under the Standard. The EPS as proposed explicitly deems eligible securities issued or guaranteed by US government-sponsored agencies. Although the Standard also includes RMBS (as part of Level 2B HQLA), the Standard in reality disqualifies most US RMBS by requiring, for example, that all underlying loans be "full recourse" in addition to several other requirements discussed above.
- Credit rating agency-related criteria for certain Level 2 assets under the Standard will not be a part of the EPS because Dodd-Frank requires that US regulators not rely on the credit ratings of external agencies. Consequently, US regulators will have to clarify a different standard in the final EPS.
- The Standard's specified haircuts for HQLA are likely to be utilized under EPS requirements as the discount to the fair market value of assets included in the EPS liquidity buffer.
- Eligible securities under the proposed EPS are likely to ultimately conform with those securities delineated under Level 2 of the Standard (with similar outflow rate assumptions).

For foreign banking organizations covered by EPS, the LCR regime will likely present additional challenges because eligible assets under the EPS may differ from those defined by their home country supervisors. In particular, problems may exist if the buffer assets supporting the branch network for the prescribed stress test horizon between days 15 to 30 are held outside of the US.

For EPS-covered US firms that fall outside of the large internationally active banking sector targeted by the Standard, they do not appear to face compliance challenges. Relying on the most recent BCBS Quantitative Impact Study ("QIS") published in September 2012 (using December 2011 data) as a proxy, the majority of Group 2 Banks (those with less than €3 billion in Tier 1 capital) performed satisfactorily in relation to the LCR target. However, challenges may still remain for enhancing the monitoring and reporting of LCR data for these non-internationally active US banks.

Finally, the Standard takes reporting one step further than EPS by requiring that data be provided to supervisors on at least a monthly basis. This requirement, if implemented in the US, would greatly increase the level of regulatory reporting for covered firms and present operational challenges.

LCR's impact on financial institutions

The relaxation of the Standard's implementation timetable will have a muted beneficial impact on large internationally active banks, the majority of which are moving closer to compliance with the LCR requirement after significant shortfalls at December 2011 as shown in the September 2012 BCBS QIS. We do not expect to see institutions down-size liquidity portfolios to take advantage of the 60% compliance threshold as of January 1, 2015, given the slow lending environment and continuing regulatory scrutiny of liquidity risk by national supervisors.

The addition of the Level 2B asset category to HQLA will provide modest relief to yield-starved bank liquidity portfolios, establishing firmer regulatory ground for the many banks seeking to diversify portfolios with a more balanced approach to the yield and liquidity trade-off. However, this flexibility is accompanied by increased capital requirements as discussed above and increased reporting requirements. Banks will also have to establish a qualification process for Level 2B assets, including a fact-based assessment of liquidity characteristics. We expect national supervisors will go further to ensure a robust risk management framework is in place to address the heightened counterparty and market risk associated with these riskier asset classes. Banks accustomed to accommodating only the highest quality instruments in their investment portfolios, may go further yet by enhancing their risk management capabilities.

The roll-back of the assumed outflow rate of non-operational, non-financial corporate deposits from 75% to 40% will come as a tremendous relief to corporate business lines, which would otherwise face punitive cash buffer charges with drastically reduced profitability. Nevertheless, with the run-off assumption of these deposits still significantly higher than the operational category of 25%, banks will still need to develop a robust deposit behavioral framework to isolate excess from operational deposits and minimize the need for excessively conservative assumptions. Indeed, banks that currently classify a large portion of their corporate deposits as operational may see an overall increase in the corporate deposit buffer due to the more stringent requirements for operational characterization contained in the LCR.

The reduction of the outflow assumption for trade finance in particular resolves what was feared to be a significant impact to this line of business. Additionally, the reduced drawdown assumption for committed corporate liquidity facilities from 100% to 30% helps address a major pricing and credit availability concern shared by both corporate banking business lines and corporate treasurers.

Finally, how the Standard will be adopted in specific jurisdictions remains to be seen and may impact financial institutions in unique ways. Important areas, such as the inclusion of central bank reserves, are subject to national discretion.

In conclusion, the transitional arrangement for LCR, while providing breathing room for the minority of banks requiring additional time to meet the Standard, is simply a deferral of the eventual full impact and does not lessen the urgency for tackling the many challenges of the Basel III liquidity requirements.

What should banks be doing now?

- Prepare to report LCR to supervisors as of January 1, 2015 by having the infrastructure in place well ahead of time in order to be able to react to surprises. The level of detail, in particular the need to report on individual legal entities and overseas branches where required, should not be underestimated.
- Assess expected conformance with the LCR by gathering data and assessing assumptions about currently held HQLA and Net Cash Outflow (including capital costs and other calculations associated with Level 2 assets). US-regulated institutions will have to make this assessment under multiple scenarios in order to conform with expected Federal Reserve requirements.

- EPS-covered firms should be prepared to widen operating plans beyond the outstanding EPS proposals in order to factor in changes made in the final rules accommodating the LCR.
- Expect less than full harmonization of the Standard's quantitative measure, thus requiring multiple exposure monitoring and reporting models across legal entities and jurisdictions.
- Requirements to demonstrate how liquidity buffers cover capital structure, risk profile, complexity, activities, size, and other risk factors will require extensive documentation and internal assessments of measurement models and reporting frameworks.
- Prepare to comment on the Federal Reserve's upcoming proposal implementing LCR as the comment period window may provide insufficient time to perform a meaningful analysis.

Appendix A: Changes to HQLA haircut and cash flows assumptions

Changes to HQLA haircuts and cash outflow/inflow rates under the Standard are listed below.

		New Factor	Old Factor
HQLA			
Level 2B Assets			
	Qualifying RMBS rated AA or higher	25%	N/A
	Qualifying corporate debt securities rated between A+ and BBB-	50%	N/A
	Qualifying common equity shares	50%	N/A
Cash Outflows			
A.	Retail Deposits		
	Certain stable deposits (deposit insurance scheme meets additional criteria)	3%	5%
B.	Unsecured Wholesale Funding		
	Fully insured non-operational deposits from non-financial corporates, sovereigns, central banks and public sector entities (PSEs)	20%	40%
	Non-financial corporates, sovereigns, central banks, multilateral development banks, and PSEs	40%	75%
C.	Secured Funding		
	Secured funding transactions with central banks	0%	Varies by asset type, 0-25%
	Backed by RMBS eligible for inclusion in Level 2B	25%	N/A
	Backed by other Level 2B assets	50%	N/A
D.	Additional Requirements		
	Increased liquidity needs related to market valuation changes on derivative or other transactions	Largest absolute net 30-day collateral flow realized during the preceding 24 months	National discretion
	Excess collateral held by a bank related to derivative transactions that could contractually be called at any time by its counterparty	100%	N/A
	Liquidity needs related to collateral contractually due from the reporting bank on derivatives transactions	100%	N/A
	Increased liquidity needs related to derivative transactions that allow collateral substitution to non-HQLA assets	100%	N/A
	Derivatives (and commitments) that are contractually secured/collateralized by HQLA	0%	N/A
	Currently undrawn committed credit and liquidity facilities provided to:		
	- non-financial corporates, sovereigns and central banks, multilateral development banks, and PSEs	10% for credit 30% for liquidity	10% for credit 100% for liquidity
	- banks subject to prudential supervision	40%	100%
	- other financial institutions (include securities firms, insurance companies)	40% for credit 100% for liquidity	100%
	Other contingent funding liabilities (such as guarantees, letters of credit, revocable credit and liquidity facilities, etc)	National discretion	National discretion
	- Trade finance	0-5%	N/A
	- Customer short positions covered by other customers' collateral	50%	N/A
Cash Inflows			
	Maturing secured lending transactions backed by the following collateral:		
	- Level 2B assets (Eligible RMBS)	25%	N/A
	- Level 2B assets (Other assets)	50%	N/A
	- Margin lending backed by all other collateral	50%	N/A

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
Financial Services Regulatory Practice Marketing Leader
646 471 0588
alison.gilmore@us.pwc.com

Contributors: Stephen Baird, Kevin J. Clarke, Chi Lai, and Shyam Venkat.

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