Basel III and beyond:
Making the right calls on LCR

The finalised Basel III standard on the Liquidity Coverage Ratio (LCR) was unveiled in January 2013, ready for what will now be a phased introduction from January 2015. But a significant number of grey areas remain, many of which are unlikely to be ironed out by 2015. The January announcement has also created a number of new operational demands. It's therefore vital that your business takes the initiative by coming up with solutions that reflect the liquidity risk management strategy within the business, can be clearly articulated to frontline teams and can be fully justified to your supervisors.

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Banks are already evaluating and reporting their LCR. But as a far-reaching survey recently carried out by PwC highlighted, banks face a lack of clarity over definitions and wide scope for interpretation in how the LCR is measured and communicated. The required judgement calls are leading to considerable inconsistencies between banks across a number of key areas of the LCR including prime brokerage, the netting of derivative cash flows and the amount of permitted fungibility between regulated entities. This is both an operational and business challenge. Frontline teams do not like uncertainty. They want to be clear about how the LCR rules will affect the business and pricing decisions.

The Basel Committee on Banking Supervision's (BCBS) finalised standard has eased some of the financial impact by lowering the bar that has been set. Key developments include broadening the eligibility criteria for assets that can meet the liquidity buffer. The BCBS has also relaxed some of the run-off assumptions for net cash outflows to better reflect experiences in times of stress. Assuming the EU and the UK adopt the gradual phasing in, your bank will only need (from a regulatory perspective) to maintain a 60% LCR in the first year and then add a further 10% every year up until full implementation in 2019.

Nonetheless, considerable uncertainty remains. And there remains a lot of room for local discretion, so there are likely to be significant inconsistencies in application between the US Federal Reserve, the European Banking Authority, particular countries within the EU and other jurisdictions around the world. This includes discretion over what qualifies as a 'high quality' liquid asset and what doesn't.

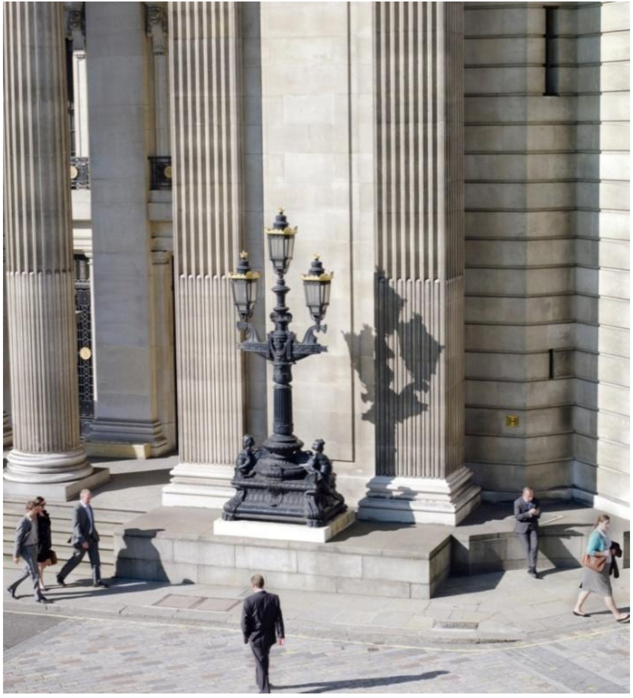
Further clarity from supervisors may be limited ahead of 2015 as they too are still working out how to implement the rules. They may also want to wait to see how their banking markets and wider economies are faring in the years ahead before making any hard and fast judgements on application in 2015 and beyond.

New data and systems requirements

The revised rules announced in January will require your bank to source data that may not have been collected before. Examples include data for the new 'standardised' approach for derivatives. While this new approach aims to simplify data demands, you will need a two-year run of daily data to be able to meet the requirement. Daily information may not be currently available and even if it is, the quality may be patchy. More broadly, regulators will expect that all the new data is sourced in an effective and well-controlled way, which is going to be challenging, especially early on.

Solutions needed now

So how can your bank get its LCR management on track? First, you can't afford to wait for clarity over the details. It's important to devise solutions now, even if this requires judgement calls that may later need to be refined or revised. It's also important to make sure the solutions are sufficiently agile and flexible to deal with further changes ahead.



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The starting point is an appraisal on what the business does and the liquidity management implications from both a business and regulatory perspective. You can then work out what works best for your business rather than simply defaulting to regulatory demands that may be unclear or inappropriate. Ideally, this appraisal should include an LCR impact analysis by business line, both to assess the impact on product costs/prices and the specific data demands for each operation.

A key part of this proactive approach is being able to articulate the complications within your business created by the new rules, for example, in relation to securities financing transactions. This will allow you to articulate the implications to business teams so that they can make the necessary plans and adjustments. You can also get on the front foot by conveying the judgements required and the proposed solutions to your supervisor. Making sure your approach is clear, well-defined and well-documented will make it easier to justify the reasoning to your supervisors. It will also make it easier to make any adjustments that may be necessary if interpretations change.

Most banks are developing strategic solutions to liquidity risk management, but are still relying on tactical approaches while these are being put in place. Speeding up development is going to be important as the tactical fixes are proving to be a significant drain on limited resources. The additional demands of Basel III are going to heighten the demands.

Business engagement is also crucial in making sure the necessary data is available and aligning LCR management with business realities. This can be difficult if the LCR does not correspond with the way liquidity risk is managed within the business – the variations between the 'standardised' and in-house approaches for derivatives that we touched on earlier may be an example of this. Most banks also face a major task in internal communication and need to invest time to ensure that managers really understand the LCR and its practical implications.

Giving you the edge

PwC is helping a range of banking and capital markets businesses to get to grips with the practicalities of Basel III. If you would to know more about the LCR provisions and how they will affect your business, please call your usual PwC contact or one of the Basel team leaders listed here:

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