Liquidity Coverage Ratio

Aims to ensure banks maintain adequate levels of unencumbered high quality assets (numerator) against net cash outflows (denominator) over a 30 day significant stress period.

- **High quality assets should comprise:**
  - at least 60% ‘Level 1’ assets - essentially cash, central bank reserves and sovereign debt qualifying for a 0% risk weight under the Basel II standardised approach for credit risk; and,
  - no more than 40% ‘Level 2’ assets – sovereign debt qualifying for a 20% risk weight under the Basel II standardised approach for credit risk and corporate bonds and covered bonds of at least AA-rating.

- **Operational requirements apply to the management of the ‘high quality assets’ including the conditions that they should be managed with the sole intent for use as a source of contingent funds and should not be comingled with or used as hedges on trading positions.

- **Net cash outflows are defined as the total expected cash outflows minus total expected cash inflows during the 30 day stress period. Cash outflows are subject to prescribed ‘run-off’ rates while cash inflows are subject to prescribed ‘inflow factors’, resulting in a severe stressed ‘net cash outflow scenario’.”

1. **Why it matters**
   1.1 It is important that banks maintain sufficient levels of liquidity, both in terms of quantity and quality, to be able to navigate plausible and sufficiently severe market-wide and firm specific liquidity shocks. The quantification of liquid asset requirements and the formulation of qualitative requirements needs to be undertaken with reference to:

   i) experience and observed trends in the value and marketability of assets under stressed conditions; and,

   ii) the expected and observed behaviours of the inflows and outflows associated with particular types of assets and liabilities during periods of unexpected volatility and crisis.

   1.2 It is particularly important that new standards are appropriately calibrated and that their effects are modelled comprehensively to mitigate the risks of causing unintended consequences such as pricing and market distortions,
and/or driving the funding of some types of activities away from the banking sector.

2. **Summary of AFME Position**

2.1 Clarification is needed on the methods for calculating the ratio, and the implications of the non-inclusion of some classes of assets as Level 1 or Level 2 needs to be reviewed. Wider market disclosure of the new ratio on a firm specific basis should only occur after full implementation.

3. **Regulatory Context**

3.1 One of the five building blocks of the Basel III and CRD 4 proposals is the need to improve the management of liquidity. The Basel Committee has developed two new standards for use in the supervision of liquidity risk. The Liquidity Coverage Ratio (LCR) is the first of these new measures and aims to promote the short-term resilience of the liquidity profile of banks to survive a significant stress over a period of 30 calendar days. This is seen as a minimum level of liquidity required for internationally active banks.

4. **Overview of the LCR**

**a Over-arching LCR Calculation**

4.1 The LCR requires banks to continuously maintain a stock of ‘high quality unencumbered liquid assets’ that is sufficient to cover net cash outflows for a 30 calendar day period under a prescribed significantly severe stress scenario (combined idiosyncratic and market-wide).

4.2 The formula used is:

\[
\frac{\text{Unencumbered stock of high quality liquid assets}}{\text{total net cash outflows over a 30 day time period}} \geq 100\%
\]

4.3 Banks and supervisors are also expected to be aware of any potential mismatches within the 30-day period and ensure that sufficient liquid assets are available to meet any cashflow gaps throughout the period. This prescribed stress should be viewed as a minimum supervisory requirement for banks. Banks are expected to conduct their own stress tests to assess the level of liquidity they should hold beyond this minimum.

**b Stock of high quality liquid assets / buffer**

4.4 The test of whether liquid assets are of ‘high-quality’ is that their liquidity generating capacity, through sale or secured borrowing, is assumed to remain stable even in periods of severe idiosyncratic and market stress, and should be easily and immediately converted to cash at little or no loss of value. High quality assets should also ideally be eligible at central banks for intraday liquidity needs and overnight liquidity facilities.

4.5 The buffer of high-quality liquid assets comprises Level 1 and Level 2 assets. Level 1 assets can be included without limit. Level 2 assets are considered less liquid and are limited to 40% of the total after haircuts have been applied.
4.6 Level 1 Assets are included in the buffer at market value and include:

- Cash;
- Central bank reserves able to be drawn down in times of stress;
- Liquid, marketable securities issued by or guaranteed by sovereigns, central banks and certain international organisations and which qualify for a 0% risk-weight under the Basel II standardised approach for credit risk; and,
- Certain non-0% risk weighted assets may also be included where these match an institution’s jurisdictional currency liquidity needs or operational requirements.

4.7 Level 2 Assets – these can be included subject to a minimum 15% supervisory haircut to their market value and are capped at 40% (post haircut) of the total buffer.

4.8 They include:

- Liquid, marketable securities issued by or guaranteed by sovereigns, central banks, and certain international organisations and which qualify for a 20% risk-weight under the Basel II standardised approach for credit risk;
- Certain corporate bonds (senior status, vanilla) of at least an AA-rating or equivalent; and,
- Covered bonds of at least an AA-rating or equivalent.

4.9 Level 1 and Level 2 assets must be traded in deep active markets with low levels of concentration and proven liquidity.

4.10 For very few jurisdictions there may be an insufficient supply of Level 1 assets and a limited supply of Level 2 assets. Alternative treatments may be available subject to strict criteria for their use. Options currently under consideration are the use of central bank secured liquidity facilities (for a fee), holdings of liquid assets in non-domestic currencies and use of additional Level 2 assets which are subject to a higher haircut. Options will be finalised during the observation period.

c Operational requirements

4.11 Buffer assets must be unencumbered and readily convertible into cash. They should not be co-mingled with or used as hedges on trading positions or applied / designated elsewhere. Liquid assets should be managed with the sole intent for use as a source of contingent funds and should be under the control of the specific function charged with managing the liquidity risk of the bank.
4.12 Assets received in reverse repo and securities financing transactions that are held at the bank which have not been rehypothecated, and which are legally and contractually available for the bank's use can be considered as part of the stock. In addition, assets which qualify for the stock of high-quality liquid assets that have been pledged to the central bank or a public sector entity (PSE) but are not used may be included in the stock.

4.13 Buffer assets must be monetised periodically to test access to the market and to minimise the risk of negative signalling during times of stress. Should an eligible buffer asset become ineligible, institutions may continue to hold the asset for a further 30 days, providing time to replace the buffer asset or adjust stock accordingly.

4.14 Institutions are also required to monitor the LCR in significant currencies (a currency is considered "significant" if the aggregate liabilities denominated in that currency amount to 5% or more of the bank’s total liabilities).

4.15 Intraday liquidity needs are not covered by the LCR and will be subject to further consideration by the Basel Committee.

d Calculation of net cash outflows
4.16 Net cash outflows are defined as the total expected cash outflows minus total expected cash inflows during the 30 day stress period. Cash outflows are subject to prescribed ‘run-off’ rates while cash inflows are subject to prescribed ‘inflow factors’, resulting in a severe stressed ‘net cash outflow’ scenario.

4.17 Run-off rates are assigned to each source of funding during the 30 day stress period and are calibrated according to expected stability ("stickiness"). Particular attention is paid to retail and unsecured wholesale funding from small business customers.

4.18 Stability considers factors such as protection offered by government or public guarantee schemes, length of client / other relationships with the bank, purpose of the account e.g. transactional/savings. Deposits which are viewed as less stable include those which do not benefit from government / public protection schemes, high-value deposits, deposits from sophisticated or high net worth individuals, deposits which may be withdrawn quickly e.g. internet and foreign currency deposits.

4.19 Net derivative payables and reporting institution downgrade trigger (3 notch) events are also considered in addition to committed facilities provided and commitments to off-balance sheet vehicles.

4.20 Run-off rates range from 5% to 100%, depending on the source and nature of the funding. The less stable funding is perceived to be, the higher the run-off rate.

4.21 Cash Inflows are included on assets which are expected to continue to perform during the 30 day stress period. Inflow factors range from 0% to
100% dependent on inflow source and whether secured or unsecured. No inflow 'allowance' is given for committed credit or liquidity facilities received by the reporting institution.

4.22 Cash inflows are subtracted from expected cash outflows to arrive at 'net cash outflows'. Cash inflows are capped at 75% of cash outflows, resulting in the requirement to hold at least 25% of cash outflows in the high-quality asset buffer.

5. Commentary/analysis of the LCR

5.1 Below is a link to the Table of Issues that AFME has sent to BCBS on behalf of its members.

Table of Issues

5.2 A summary of the areas of primary concern can be presented as follows.

Recognising the marketability of assets

5.3 A key concern for AFME is a) the relatively narrow definition of level 1 liquid assets; b) the continuing uncertainty of the definition of level 2 assets; and c) the potential economic impact on those asset classes not recognised as either level 1 or level 2 assets.

a) The narrow definition of level 1 assets could result in an over concentration in such assets and, in a market wide crisis, result in all banks attempting to monetise the same assets at the same time, thereby exacerbating the system wide liquidity problems.

b) The current proposals for defining the level 2 assets remain under scrutiny. It may be that the only way in which such assets can be identified is for the authorities to maintain a list of eligible assets centrally.

c) The current approach implies that for all assets outside the narrow liquidity buffer, as currently defined, it is not possible to generate any liquidity value within a 30 day time horizon, and that any associated financing requirements (e.g. equity repo) would have to be fully covered by liquidity buffer eligible assets. As currently designed, the LCR might drive the funding of such assets outside the banking sector and may reduce market liquidity in these asset classes.

Operational requirements

5.4 Confirmation is sought that the stock of high quality liquid assets in the LCR, provided that they are unencumbered and could be monetized in a crisis scenario should be eligible for the buffer (whether they are held in the
trading or the banking book, or whatever their accounting classification). Whether an asset is a trading position, a hedge to a trading position, or sourced via other means is irrelevant once it is in a central clearance account, determined to be unencumbered, determined able to be monetised and under the control of the treasury function.

Committed credit and liquidity facilities

5.5 Confirmation is sought on the definition of a liquidity facility and in particular where committed facilities are provided to cover a number of business purposes. The run-off factor applied to liquidity facilities to non-retail or small business customers is defined as 100%. This will impact the availability of facilities meeting this definition and the industry is concerned the assumed drawdown is in excess of experience through periods of financial stress. Clarity of the definition will aid the Basel III QIS exercise and the conclusions able to be drawn from the results gathered.

6. Transitional regime

6.1 Given these concerns about impact and other questions relating to the computation of the LCR, AFME will be pressing both the BCBS and the EU (through the EBA) to use the monitoring period to engage fully with the industry and examine the impact of the current design of the LCR, specifically addressing any unintended consequences.

6.2 Reporting processes will be implemented in 2011 which will enable supervisors to monitor aspects of the LCR for an observation period through to end December 2014. During this time supervisors will determine if revisions or recalibration of the LCR are necessary. The LCR, including revisions, will be introduced on 1 January 2015.

Disclosure

6.3 The disclosure requirements for the LCR are currently unclear and we recommend that public disclosure occurs only after full implementation.

7. Case Studies

7.1 Based on our interpretation of BCBS188 we have constructed a series of examples that look at the computation of the LCR. We have used a building block approach to help to illustrate the calculations that require confirmation and questions that arise.

[Note: Attach link to Annex 2 of 4 Feb letter]

7.2 AFME has also developed a case study which examines the interplay of the LCR, NSFR and LR using a stylised balance sheet. The study highlights that:

- The ratios must be managed together, but their design makes steering difficult;
The cures associated with a breach in one of the ratios may result in responses that cannot effectively address the underlying 'capital or liquidity issues'.

A breach in, for example, the NSFR can result in a cure that has the bank raising capital in response to a funding problem that cannot be addressed by longer term funding invested in high quality liquid assets owing to constraints presented by the leverage ratio.

Interplay Case Study