Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Revised Basel Liquidity Framework*

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January, 2013

On November 12, 2010, the leaders of the world's most important economic countries met in Seoul, South Korea, and agreed to address the problem of liquidity risk through a new liquidity standard that would be applied to banking organizations around the globe. This agreement is not self-executing, and in the United States, implementing regulations must be issued by the federal banking agencies. However, implementation was delayed due to concerns that the liquidity standard was so stringent that it would impede economic recovery in the United States and Europe.

On January 6, 2013, the Basel Committee on Bank Supervision announced major revisions to the 2010 liquidity standard, and, in particular, to the liquidity coverage ratio (LCR). The LCR requires banking organizations to maintain sufficient amounts of high quality, liquid assets to withstand a 30-day run on the institution following severe economic stress. To test the sufficiency of the liquidity reserve, the LCR specifies a "stress test" with stipulated deposit outflows and other liquidity demands. The LCR test requires that a bank have sufficient high quality liquid assets to withstand a 30-day period during which the resources of the institution will be subject to the stressed environment. Among other changes, the latest revision to the LCR broadens somewhat the assets that may be considered high quality liquid assets. Also, the revised agreement allows for a four year phase-in of the liquidity requirement beginning in 2015.

Assets that May Be Used for the Liquidity Reserve

The original liquidity agreement separated high quality liquid assets into two groups or levels. Level 1 assets, such as cash and government issued or backed securities, count without limit to meet the LCR test. Level 2 assets are limited to no more than 40 percent of the required amount of

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liquid assets and are subject to a 15 percent haircut. The revised agreement adds a new category, Level 2B assets, which can be included in the liquidity reserve at the option of the national regulator. Level 2B assets are capped at 15 percent of the required liquidity reserve, and are subject to a haircut of either 25 percent or 50 percent, depending upon the asset. The aggregate cap on all Level 2A and 2B assets remains at 40 percent.

Corporate Debt and Covered Bonds

Under the prior agreement, highly rated corporate debt and covered bonds (AA- if rated or internally rated to be equivalent to AA- if not rated) are considered Level 2 assets, subject to a 15 percent haircut and 40 percent cap.

Under the new agreement, lower rated corporate debt can be included as Level 2B assets, subject to a 50 *percent* haircut. Lower rated *covered* bonds are not included. To qualify for the liquidity pool, the debt must have a credit rating of between A+ and BBB- (or an equivalent internal credit rating), trade in a large, deep and active cash or repo market, and have a proven track record as a reliable source of liquidity with a maximum decline in price not exceeding 20 percent in times of stress.

Residential Mortgage Backed Securities

Residential mortgage-backed securities may now be included, subject to a 25 *percent haircut*, and subject to the 15 percent cap on Level 2B assets. The underlying mortgages may not have been issued by the banking organization or any affiliate. The securities must have a credit rating of AA or higher, and the underlying assets cannot include structured products. The underlying loans must be full recourse, so that in the case of foreclosure, the "mortgage owner" remains liable for any shortfall in sales proceeds from the property.[1] The underlying mortgages in the securitization pool must have a loan-to-value ratio of at least 80 percent, on average, at issuance, and the securitization must be subject to "risk retention regulations which require issuers to retain an interest in the assets they securitize." It is not

[1] In the agreement, the term "mortgage owner" appears to be referring to the debtor, but this is not entirely clear from the language used in the agreement.

clear if mortgage securitizations involving only QRM mortgages would qualify as liquidity assets, since issuers are not required to retain risk when the underlying loans meet QRM standards.

Common Equity Securities

Common equity securities are also included in Level 2B, subject to a 50 percent haircut and the 15 percent aggregate Level 2B cap. The securities may not be issued by a financial institution or affiliate, must be actively traded and centrally cleared, and must be a constituent of the major stock index in the home jurisdiction where the liquidity risk is taken. The securities must be traded in a large, deep and active repo or cash market, and have a proven track record as a reliable source of liquidity such that even during periods of stress the share price has not declined more than 40 percent.

Cash Outflows

The LCR stress test requires banking organizations to assume that specified cash outflows will occur during the stressed environment.

Stable Retail Deposits

The prior agreement required banking organizations to assume that insured deposits placed by individuals would experience a runoff rate of 5 percent. The revised document permits national regulators to allow banks to apply a 3 percent runoff rate, if the deposits are protected by a pre-funded insurance system, such as the FDIC.

Unsecured Funding

To the extent that a Federal Home Loan Bank or other GSE provides unsecured funding to a banking organization, the presumed runoff rate is reduced from 75 percent to 40 percent.

FHLBank Secured Advances

The revised agreement continues to apply a 25 percent runoff assumption for FHLBank advances secured by mortgage loans or qualifying residential mortgage-backed securities. Advances backed by Level 2A assets, including highly rated corporate debt and covered bonds, will be subject to a 15 percent runoff rate. Advances backed by Level 1 assets, such as cash and government issued or guaranteed debt, will have a 0 percent runoff assumption.

Bank Issued Credit and Liquidity Facilities to Public Sector Entities

The original agreement assumed that any *credit* facilities issued by banking organizations to public sector entities, such as the Federal Home Loan Banks, would be drawn down at a 10 percent rate, and that any *liquidity* facilities to public sector entities would be 100 percent drawn down. The revised agreement continues to apply to a 10 percent drawdown on credit facilities to public sector entities, but reduces the drawdown on liquidity facilities to 30 percent.

Credit and Liquidity Facilities Issued to Corporations

Previously, credit and liquidity facilities issued to corporations, trusts, special purpose vehicles, fiduciaries and similar entities were presumed to be 100 percent drawn down. The new agreement provides for a 10 percent drawdown on credit facilities and a 30 percent drawdown on liquidity facilities, but only if the counterparty is a non-financial company. For financial companies, the drawdown rate for both credit and liquidity facilities is 40 percent.

Phase-In of Effective Date

The original international agreement called for full implementation of the LCR as of January 1, 2015. The new agreement provides for a phase-in of the LCR. Under the new agreement, banking organizations must have 60 percent of the required amount of liquidity reserve as of January 1, 2015. In each of the following four years, the required percent of liquidity reserve increases by 10 percent, so that by January 1, 2019 banking institutions must hold 100 percent of the required liquidity.

Next Steps

The revised liquidity agreement is not self-executing. The agencies are required to publish a notice of proposed remphaking, solicit public comments, and then issue a final regulation. The international agreement recognizes that each signatory country may have unique circumstances or supervisory concerns, and that therefore there is some flexibility for the regulatory implementation to differ somewhat from the international agreement. Therefore, the regulatory remphaking process will provide an important opportunity for the Federal Home Loan Banks and the Council to provide input into the final regulatory language.

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