Client Alert

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The Basel III Liquidity Coverage Ratio and Securitization Transactions

On January 7, 2013, the Basel Committee on Banking Supervision (Committee) issued major revisions to the "liquidity coverage ratio" (LCR) it published in 2010, which can be found here. This Client Alert describes the LCR and how it affects securitization transactions.

What are the Basel III Liquidity Standards?

Basel III establishes two separate liquidity standards. The "liquidity coverage ratio" (LCR) described in this Client Alert will test a bank's ability to withstand a "liquidity stress" period in which the bank loses access to funding for 30 days. When the LCR test is fully implemented, a bank will be required to show it has enough "high quality liquid assets" to meet all its "net" funding requirements during the 30 day test period.

Basel III also establishes a "net stable funding ratio" (NSFR) test under which a bank must show it has enough long term funding to support its assets during a one year stress situation in which it is assumed not all short term assets will liquidate into cash and some contingent funding will take place. The Committee continues to review this standard, first published in 2010, and will issue any modifications it deems necessary before the standard becomes effective in 2018.

What Did the Committee Announce About the LCR in Early January?

Both a revised LCR test and that banks would have much longer to fully comply with the LCR test. The revisions to the LCR test (1) permit more items to qualify as "high quality liquid assets" (HQLA) and (2) reduce the "assumed outflows" that the test requires HQLA to cover. Perhaps more important, banks will not need to fully comply with this less strenuous LCR test until 2019. The scheduled January 1, 2015 effective date was revised to require 60% compliance, with the level of required compliance increasing by 10% each year after that until reaching 100% on January 1, 2019. During 2015, banks will only need to have HQLA equal to 60% (not 100% as originally required) of assumed net "outflows" under the LCR test. Along with these positive changes, some changes to the LCR test (1) increase assumed "outflows" based on potential collateral call or return obligations and (2) impose additional obligations to diversify and test the bank's ability to "monetize" HQLA used to meet the test.

LCR Compliance Timing and Percentages

1/1/2015	1/1/2016	1/1/2017	1/1/2018	1/1/2019
60%	70%	80%	90%	100%

The Committee lists in summary form the changes to the LCR test here.

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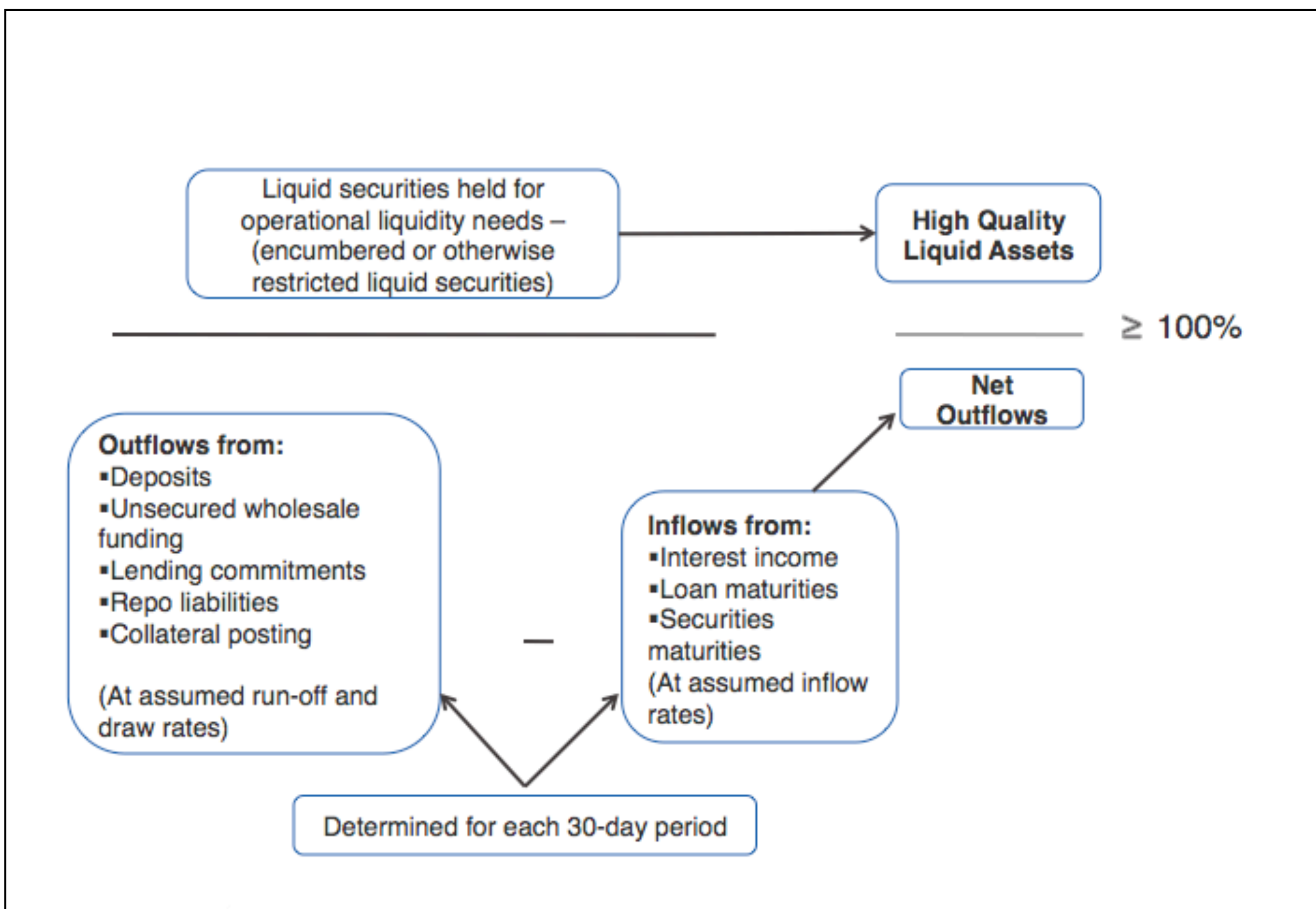
How is the LCR Computed?

It measures assumed inflows of cash against assumed outflows during a 30 day "liquidity stress" period. The test generally assumes all bank commitments supporting a securitization transaction (such as a liquidity commitment to an asset-backed commercial paper (ABCP) conduit or other special purpose vehicle) will be fully funded within the 30 day period *unless draws are not possible during the 30 day period.*

A bank must hold "high quality liquid assets" (HQLA) equal to the total amount of such funding commitments and other assumed "outflows," except that certain stressed assumed "inflows" serve as a credit against the assumed outflows up to 75% of the total gross assumed outflows. The assumed gross outflows netted against such assumed inflows produce the net outflows a bank must cover with HQLA.



What are High Quality Liquid Assets (HQLA) That Meet the LCR Test?

They are called "Level 1" and "Level 2" assets.

Level 1 assets are cash, central bank reserve balances (i.e., in the US, reserves at Federal Reserve banks), and marketable governmental obligations with a 0% risk weight under Basel II. The Committee did not change this list in its revision to the LCR test, although it did specify that "cash" refers to coins and paper money. Presumably, this "clarification" was intended to ensure "cash equivalents," including interbank deposits, would not qualify as "cash."

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Level 2 assets include (1) 20% risk weighted public sector entity marketable securities (e.g., FNMA securities) and (2) "plain vanilla" non-financial corporate debt securities or covered bonds rated at least AA- or the equivalent (including the short term rating equivalent), if they are readily traded in repo or sale markets. The Committee also retained this list, but relabeled it "Level 2A" assets, expanded "corporate bonds" in the old test to be "corporate debt securities," and accommodated short term corporate debt (such as commercial paper) by permitting short term ratings.

For LCR test purposes all Level 2A assets are reduced in value by a minimum 15% haircut. National regulators may impose higher haircuts for any or all Level 2A assets. National regulators may also subject non-cash Level 1 assets to a haircut based on conventional repo market haircuts or other collateral value considerations for a specific type of Level 1 asset.

The new LCR test most significantly expands the HQLA list by *adding* a list of Level 2B assets that will qualify as Level 2 assets subject to special quantity limits described below.

What is Included in the New Category of Level 2B Assets?

Level 2B assets include (1) traded residential mortgage-backed securities (RMBS) rated at least AA, backed by full recourse residential mortgages with a maximum average loan-to-value ratio of 80% at issuance, and issued subject to risk retention regulations; (2) traded non-financial corporate debt securities rated between A+ and BBB- or the equivalent and meeting maximum volatility standards; and (3) common equity shares meeting minimum trading and maximum volatility standards.

While Level 2A assets would remain subject to only a 15% haircut (except as specifically increased by a national regulator), the new Level 2B assets would receive haircuts of (1) 25% for RMBS and (2) 50% for corporate debt and equity securities.

Although commentators welcomed the expansion of the list of Level 2 assets, US critics have noted the strict rules for qualifying RMBS could not be met by any outstanding US securities. No US RMBS has been issued subject to risk retention rules, and mortgages from California and other states that prohibit recourse residential mortgages could not be included in Level 2B assets. As with all Basel III provisions tied to ratings, none of the rating requirements for Level 2 assets could be applied directly in the US. US regulators would need to craft "equivalent" criteria as they proposed in their June 2012 notices of proposed rulemaking (NPRs) for Basel III capital requirements.

How Much of the HQLA Used to Meet the LCR Test Must Be Level 1 Assets?

Level 1 assets must make up at least 60% of liquid assets used to meet the LCR test. This computation of adequate Level 1 assets must be made after determining what Level 1 assets (including cash) will be lost to the bank during the 30 day liquidity stress test period.

With Their Higher Haircuts Can Level 2B Assets Be Used the Same as Level 2A Assets As 40% of the Overall Amount of HQLA?

No. The original LCR test required that Level 2 assets be no more than 40% of the liquid assets used to meet the LCR test. The revised LCR test continues this limit, but adds a separate limit that Level 2B assets can not be more than 15% of the HQLA used to meet the LCR test. Assuming full use of the 40% Level 2 permission, this means Level 2B assets could not be more than 37.5% (3/8ths) of Level 2 assets.

What are the Restrictions For Holding HQLA Free of Liens and Other Restrictions?

The purpose of the HQLA definition is to provide a conservative definition of what assets can be used to meet funding obligations in a liquidity crunch. Non-cash assets are supposed to be readily usable to raise cash even in the liquidity crunch. These assets, therefore, must be free of any lien or other restriction on their free availability to be used to raise cash.

The revised LCR test explains any regulatory or practical restriction on the use of "liquid assets" can prevent their use as HQLA to meet the test. For example, liquid assets at a subsidiary could only be used to meet a holding company's LCR test if those liquid assets can be freely transferred to the holding company at all times.

The Committee notes, however, that a bank holding HQLA securities under a reverse repurchase, or other securities financing, transaction can treat the securities as HQLA so long as the bank is entitled to "rehypothecate" the securities to raise cash. Similarly, a bank could treat as HQLA any qualifying securities pledged to a Federal Reserve Bank (or other central bank) under a general pledge agreement, so long as those securities were not currently being used to borrow from the Federal Reserve Bank (or other central bank).

What are the "Outflows" that the LCR Test Requires be Covered by HQLA?

As originally issued in 2010, the LCR test required a bank to hold HQLA to meet very stringent assumptions about what funding would be lost, what commitments would be drawn, and what scheduled payments would be received during the 30 day liquidity crunch period. Banks and other critics of the LCR argued these assumptions were so unrealistic that they would reduce bank lending and other activities far more than necessary to ensure banks maintain adequate liquidity. In response, the revised LCR test is based on much less stringent "outflow" assumptions for several forms of bank funding and bank commitments.

What are These Reduced "Outflow" Assumptions?

Much of the criticism of assumed "outflows" related to assumptions about how much deposit funding a bank would lose in a liquidity crunch. The revised LCR test reduces these assumptions. For example, a bank need only assume that 40% (not 75%) of "non-operational" corporate deposits would be withdrawn during the 30 day liquidity crunch (or, if fully covered by deposit insurance, only 20%).

Aside from changes in assumptions about how much deposit funding would be lost during the 30 day liquidity stress scenario covered by the LCR test, the revised LCR test reduces the drawdown assumptions for lending commitments to non-financial corporate and financial company borrowers. Instead of assuming a 100% drawdown for all funding commitments to banks and other financial companies, the revised LCR test assumes only a 40% drawdown of "credit commitments" (defined as commitments to lend for general corporate purposes, not specifically to support outstanding debt) to such companies. Instead of a 100% drawdown of liquidity commitments (defined as commitments to refinance outstanding debt) to non-financial corporations, the revised LCR test assumes a 30% drawdown of liquidity commitments to such corporations.

Does the LCR Test Cover Both Liquidity and Credit Commitments Supporting a Securitization Transaction?

Yes. The LCR test distinguishes between liquidity (i.e., debt supporting) and credit (i.e., general working capital or other non-debt supporting) commitments. For example, the LCR test assumes 10% of an available credit commitment to a non-financial corporation will be drawn in the 30 day "liquidity stress" period, but 30% of a liquidity commitment to such a company will be drawn.This terminology can be misleading because participants in the bank securitization market usually think of "credit commitments" as guaranteeing debt obligations and "liquidity commitments" as only covering general market failures. As described in response to the previous question, the revised LCR test reduces the assumed funding of *credit commitments* to banks and other

financial companies from 100% to 40%. It also reduces to 40% the funding assumption for a *liquidity commitment* to a supervised bank. Only *liquidity commitments* (i.e., those specifically supporting outstanding debt) to other financial companies still receive a 100% funding assumption.

Unfortunately, the revised LCR test continues to assume 100% funding of both liquidity and credit commitments to special purpose vehicles (SPVs) and the loss of all funding provided to a bank by any SPV. As with the original LCR test, the only exceptions would be for commitments that could not be drawn within the next 30 days and funding from an SPV that could not be withdrawn during those next 30 days. Although the Committee greatly reduced the LCR test's assumptions about what funding financial institutions in general would require during the 30 day "liquidity crunch," the LCR test continues to assume SPVs would require full funding from all forms of commitments during the liquidity crunch.

Commitment Type	Assumed Drawdown Percentage of Unfunded Amounts
Committed credit facilities to non-financial corporates	10%
Committed liquidity facilities to non-financial corporates	30%
Committed credit and liquidity facilities to prudentially supervised banks	40%
Committed credit facilities to non-bank financial institutions	40%
Committed liquidity facilities to non-bank financial institutions	100%
Committed credit and liquidity facilities to SPVs	100%

What if the Bank Does Not Provide Full Liquidity and Credit Support For the Outstanding Debt In a Securitization Transaction?

The LCR test includes all assets that could be "returned" to the bank and all potential liquidity and credit support obligations of the bank. Regulators also have the discretion to treat the outstanding debt in a securitization transaction (such as the commercial paper issued by an ABCP conduit) as covered by a bank beyond any legal commitment if they determine the bank may nevertheless support the debt (as during the financial crisis some banks supported the debt of the SIVs they had sponsored). This means ABCP or other securities issued by a bank sponsored conduit might require support from HQLA beyond the level of any commitments from the sponsoring bank unless the bank can demonstrate it can not be required to provide such support *and* it is not subject to market expectations, reputation concerns, or other considerations that might motivate "implicit" support for the outstanding debt. As explained above, if the bank receives the proceeds of SPV funding, it must assume the loss of all that funding unless the funding can not be withdrawn during the 30 day LCR test period.

What if the Bank Has a Secure Source for Immediate Repayment of Any Draw on a Commitment That Occurs in the 30-Day Liquidity Stress Period?

The LCR test requires a bank to assume it will not receive repayment of any amount drawn under a facility supporting debt issued by an SPV. The only exception is if the bank holds HQLA as collateral for such facility *and* the bank has the contractual right to repledge (i.e., rehypothecate) the collateral in order to raise cash upon the draw occurring. Even then, the bank must show there is no “undue correlation” between the probability of a draw on the facility and the market value of the collateral. The most obvious correlation would be if an underlying exposure in the securitization transaction were to a party related to the HQLA (such as when the corporate customer in the transaction, or an obligor on the underlying receivables, was also the obligor on Level 2 HQLA posted as collateral to secure the facility).

While the specific procedures for netting collateral against a commitment will need to be specified by regulation, this seems to mean only HQLA will count as eligible collateral and that the value of Level 2 assets as collateral would be subject to the same haircuts as when such assets serve as HQLA to meet the LCR test.

But Doesn’t the LCR Test Permit A Bank to Assume It Will Receive 50% Repayment of Obligations Owned by Most Customers and 100% Repayment of Obligations Owed by Financial Institutions?

Yes, but these assumptions cover repayments of obligations outstanding before the 30 day “liquidity crunch” occurs. A bank is not required to show it has HQLA equal to the total amount of payments currently due to the bank in the next 30 days. Banks are, however, required to show they can cover unfunded contingencies that arise during the projected 30 day liquidity crunch. Thus, a typical unfunded support facility for a securitization transaction must be covered by qualifying HQLA, either HQLA pledged to secure the facility (and able to be “rehypothecated”) or HQLA held by the bank as part of its “liquid assets” reserve to meet its funding obligations.

At any time a bank is owed money for having funded its commitment supporting a securitization transaction, it is unlikely the “borrower” would be a “wholesale customer” that is “fully performing” its obligations to the bank. Even if an SPV were meeting all its obligations, it is unclear whether the SPV as “borrower” would qualify as a “wholesale” customer. The LCR test permits banks to assume 50% of all outstanding funding due from a “fully performing” non-financial “wholesale,” “retail,” or “small business” borrower will be repaid (with 100% assumed to be repaid, but 50% to be reborrowed). This assumed reborrowing is separate from any commitment, as banks are assumed to have business needs to fund non-financial borrowers. Because no reborrowing is assumed for “fully performing” wholesale financial customers (but they are separately assumed to fully draw all funding commitments) they are assumed to repay in full their outstanding obligations that are due. If SPV “borrowers” in a securitization transaction qualified as wholesale financial institutions (which is unclear) the assumed repayment would only mean (in most cases) that the repaid amount would be assumed redrawn under a commitment (or an “implicit” commitment), leaving the bank with the same net outflow as if no outstanding balance had been repaid.

What if the Bank Will Receive Inflows From Other Sources That Exceed The Assumed Outflows In the Liquidity Crunch?

Banks receive credit for inflows of funds that are expected to be received during the 30 day liquidity crunch period. These stressed assumed inflows, however, are not permitted to exceed 75% of gross assumed outflows. That means a bank can not have excess assumed inflows that might eliminate the bank’s concern with the assumed outflows created by securitization (or other) transactions. Instead, the LCR test requires a bank to always maintain HQLA with LCR test value equal to at least 25% of gross assumed outflows for the 30 day test period, even if gross assumed inflows exceed gross assumed outflows during that period.

Are Banks Required to Hold HQLA To Fund Securitization Transactions for Which They Do Not Issue Contractual Commitments?

Perhaps. If there is no contractual commitment, the LCR test gives regulators the authority to still treat a bank as providing support for outstanding debt funding any securitization transaction related to the bank (based on the experience with SIVs and other credit crisis events). This could mean bank involvement in any securitization transaction could create an HQLA coverage requirement even though the bank has no formal commitment to support the transaction. Banks would likely have a high burden to prove they incur no reputational or other risk that might force them to "rescue" an SPV sponsored by the bank or otherwise closely connected to the bank. If the bank is only one of many parties associated with a transaction and is not viewed as the transaction's "sponsor" it will presumably be easier for the bank to avoid any liquid asset requirement for an expected "implicit support" obligation.

If the Bank's Commitment Can Not Be Drawn During the 30-day LCR Test Period, Is There Still An HQLA Requirement?

Generally no, so long as the commitment truly can not be drawn under any circumstance at any time during the 30 day period beginning on the day the test is calculated. This means looking forward on any LCR test date, there are at least 30 days before the commitment can be drawn.

As indicated by the previous answer, however, if there is a market expectation that funding would be available from the bank, regulators could still require HQLA coverage for the commitment. At a minimum this suggests outstanding debt in a securitization transaction would need to price equivalent to paper due in more than 30 days, not as paper with a stated maturity beyond 30 days but with an "expected" or "anticipated" maturity within the 30 day period based on expected bank support (either based on reputation risk or the economics of the overall transaction for the bank).

Commitments that fall outside the 30 day LCR test, however, will be subject to the separate net stable funding ratio (NSFR) test mentioned above.

Are There Any Increases in "Outflow" Assumptions In the New LCR Test?

Yes. The new LCR test requires a bank to treat any "collateral call" obligation under a derivatives contract as being an "outflow" to the extent a reduction of 3 "notches" in the bank's long term debt credit rating (or equivalent change in short term rating) would require the posting of collateral. Similarly, any "liquid assets" held by a bank as collateral that would otherwise qualify as HQLA are treated as being lost as an "outflow" to the extent they are required to be returned either as excess collateral or in return for substitute collateral that would not qualify as HQLA.

How Often Will a Bank Need to Meet the LCR Test?

As originally proposed in 2010, banks would have been required to meet the LCR test every day (i.e., "continuously.") Commitments supporting a securitization transaction would, therefore, have created assumed outflows on any day unless *draws under the commitments were not possible looking forward from that day for at least 30 days*. The revised LCR test requires banks to use the test "on an ongoing basis to help monitor and control liquidity risk." Perhaps because the new LCR test explicitly authorizes banks to violate the test during "liquidity stress" periods (as discussed below), the test no longer requires banks to conform "continuously." The new LCR test instead requires banks to report to supervisors the results of the LCR test "at least monthly" with "the operational capacity to increase the frequency to weekly or even daily in stressed situations."

Does This Mean Banks Will Be Able to Have Less Than a 30-Day “Cushion” of HQLA During a Liquidity Crisis?

Yes. Critics of the original LCR test noted it seemed to require banks to always hold a 30 day reserve of liquid assets. The countries on the Committee had jointly announced in 2012 that this would not be true. The revised LCR test explicitly authorizes banks to use, and thereby reduce, their HQLA reserve during a period of “liquidity stress.” The Committee intends the LCR test to ensure banks have liquid assets to cover a liquidity crunch lasting 30 days. The Committee recognizes this means banks would use the HQLA during the 30 day period to satisfy liquidity needs and that this would leave them with less than a 30 day cushion. National regulators will need to establish procedures for identifying when banks would be permitted to begin liquidating their HQLA reserves.

The Committee notes regulators may need to deal differently with “idiosyncratic” liquidity stress particular to a bank and “system-wide” liquidity stress affecting the “entire financial system.” For idiosyncratic situations, the Committee expects regulators to seek individual solutions for restoring the affected bank’s HQLA reserves. When there is system-wide liquidity stress regulators would be more cautious in mandating corrective action because they would need to consider the system-wide effects of mandating corrective actions that could increase the liquidity stress. Presumably, banks would be able to liquidate HQLA reserves much more freely during a systemic liquidity crisis.

How Will All of This Be Implemented?

As with any Committee standard, the LCR test will need to be implemented through regulations or other legal action in Committee member countries. The Committee indicates the revised LCR is the “final” version, but nothing in the original 2010 LCR publication suggested it might be revised. The Committee only published that LCR after issuing, and revising, a proposal published for comment in 2009. We can not be certain this LCR test will remain unchanged.

In the US, any regulations based on the LCR will need to be proposed subject to comments. Only after US regulators receive comments can they publish final regulations implementing the LCR test. US banks, and banks elsewhere, are already subject to standards and supervision for their liquidity policies and practices. US banking regulators have indicated that the “enhanced standards” required for US bank holding companies with assets of $50 billion or more (including foreign banks with US operations of that size) will provide more extensive liquidity requirements that will include, but not be limited to, a 30 day liquid assets coverage test similar to the LCR test.

To discuss any of the topics covered in this Client Alert, please contact any member of our Asset Securitization Group.

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