Our Perspectives:
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The Basel Liquidity Framework[*]

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There has been much discussion in the financial press about the new Basel III Accord, which imposes new capital and liquidity requirements on large U.S. banking organizations. Controversy has arisen over whether the new rules will favor European banks over U.S. institutions, or will impede credit availability necessary for a strong economic recovery. This paper will provide background on the Basel process and then provide a basic explanation of the liquidity provisions. At a later date, we will provide a similar explanation of the capital changes required under Basel III.

What is the Basel Committee?

The Basel Committee on Banking Supervision is composed of the banking regulatory authorities and central banks from the "Group of 20" economically advanced nations. The name is somewhat of a misnomer, since the Group is now composed of 26 countries.[1] The United States is represented on the Basel Committee by the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Bank of New York.

What is the Basel III Accord?

In 2009, following the melt down in the world's financial markets in 2008, the leaders of the Group of 20 met in Pittsburgh and agreed that new minimum standards are necessary for bank capital and liquidity. In September 2010, the basic framework for revised capital rules and for the imposition of a new liquidity mandate was agreed to by the bank regulatory

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] The Group of 20 is actually composed of 26 countries and Hong Kong. The current members are: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxemburg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

agencies and central bankers in the G-20. On November 12, 2010, the heads of state of the G-20 met in Seoul and "committed" to "core elements of a new financial regulatory framework, including bank capital and liquidity standards." The details of the Basel III proposal were not released until December 16, 2010, in the form of detailed "rules" with regard to capital and liquidity.

Are the Basel Rules Binding in the U.S.?

The rules released by the Basel Committee in December are not legally effective. It is neither a treaty nor an international agreement that has the force or effect of law. Rather, the agreement is an understanding among the G-20 as to the regulatory changes each member country will implement. In the United States, implementation will be through notice and comment rules issued by the Federal banking agencies. As part of this process, these agencies will have some ability to "individualize" the international framework to take into account national differences, but a significant deviation from the international treaty would not likely be tolerated by the other members of the G-20. Thus, unless the international accord is modified at the international level, the ability of the U.S. regulators to make significant changes in the framework is very limited.

The banking agencies are not expected to release a proposed joint regulation to implement the Basel III Accord until late in 2011. Following the publication of the proposed regulation, there will be a comment period, typically for at least 60 days. The agencies are required to consider all comments, and then develop a final regulation. As explained below, the Basel III Accord includes tentative effective dates. However, the effective dates in the final regulation, which are binding with respect to U.S. institutions, must also take into account delays owing to the administrative process.

What is the Liquidity Framework?

The Basel III liquidity framework requires internationally active banking organizations to meet two liquidity tests: "a liquidity coverage ratio" (LCR) that is designed to assure that a bank could withstand a 30-day run off of liquid funds, and a "net stable funding ratio" (NSF) that is designed to encourage banks to rely on long-term and stable sources of funding. While the Basel III Accord is directed at internationally active banks, the U.S. regulators could apply these requirements, or a variant thereof, to other institutions, including non-bank financial companies deemed to be systemically significant.

How Does the Liquidity Coverage Ratio Work?

The "liquidity coverage ratio" (LCR) relates to the amount of high quality, unencumbered liquid assets a banking organization should have at hand in the event of a liquidity crisis that lasts for 30 days. In essence, this is the amount of liquid assets a bank needs to survive a 30-day period during which normal sources of funding are significantly diminished due to economic stress.

What is Meant by a Liquidity Stress Scenario?

The design of the liquidity stress scenario is not completely specified in the Basel III Accord, but it will assume a *combined* institution specific and market-wide event that results in a partial run-off of deposits, loss of both secured and unsecured financing, and market changes that cause collateral calls on derivative contracts. The stress scenario also envisions unscheduled draws on unused credit facilities. Finally, the scenario must include the potential need for a bank to buy back debt or support securitizations, even if there is no contractual requirement to do so. The rules also require a bank to assume that at least 25 percent of secured funding, such as Federal Home Loan Bank advances, will not be renewed, even if the bank has available collateral to support the renewal of such loans and advances.

How Can a Bank Satisfy the LCR?

To satisfy the LCR, a banking organization must have a pool of high quality liquid assets that will equal or exceed the 30-day outflow of cash. Qualified liquid assets must be easily and immediately converted into cash with little loss of value. The assets must be "unencumbered," meaning that they have not been pledged in any way to secure, collateralize, or enhance any transaction (other than assets that have been pledged to the *Federal Reserve* but not utilized). Further, the assets cannot be held as a hedge against another exposure. Lines of credit and funding commitments from other institutions are not counted toward meeting this liquidity test.

High quality liquid assets are divided into two classes or levels. Level 1 assets can be used to meet the liquidity test without limit, but level 2 assets can only be included up to 40 percent of total needed to satisfy the test.

In addition, level 2 assets are subject to a haircut of 15 percent off their current market value, and cannot be used for more than 40 percent of the liquidity requirement.

Level 1 assets are essentially limited to cash, reserves held by the Federal Reserve Banks, U.S. Treasury debt, municipal debt, and bonds issued by foreign governments that meet certain conditions. Level 2 assets are essentially limited to corporate bonds and covered bonds that have a rating of AA- or better, the debt issued by the GSEs and the Federal Home Loan Bank System, and the debt of certain other foreign governments. As noted, these level 2 assets are subject to a haircut of 15 percent and an overall cap of 40 percent of required liquidity.

What Does the Net Stable Funding Ratio Require?

As originally proposed, the NSF ratio is intended to encourage banks to rely on longer term and more stable sources of funding. This was to be accomplished by assigning a score for all of a bank's assets and off-balance sheet obligations indicating the potential for these assets and other positions to cause a liquidity drain on the institution due to a stress event. The required amount of a bank's capital and other sources of long-term funding would be determined based on this score. However, in light of numerous concerns raised by this proposal, the original design of this test was withdrawn, and it is anticipated that a new proposal will be issued by the Basel Committee.

What Are the Pros and Cons for the Liquidity Framework?

There is no question that a lack of liquidity played a central role in the economic crisis we experienced in 2008. Appropriate liquidity requirements will enhance the ability of financial institutions to absorb economic shocks, and will result in a safer and sounder financial system. However, mandating excess liquidity requirements will have the opposite effect. The assets that qualify for meeting the liquidity standard are essentially very high quality but low yielding investments. If a bank is required to purchase large quantities of U.S. Treasury bonds to meet the liquidity rules, its earnings will decline. Lower earnings will eventually weaken banks because they will be less attractive to investors and will have less funds available to build up a capital cushion. Some banks may seek to avoid this result by investing funds not needed for liquidity in higher yielding but more risky assets. Thus, an inappropriately high liquidity requirement may actually drive some banks to increase their risk profile.

Inappropriately high liquidity mandates will also have a detrimental impact on our economy. Banks that must meet such requirements will have to invest more and more of their available funds in Treasury bonds and similar instruments, rather than use their funds to make loans. Every dollar that must be devoted to a liquidity cushion is a dollar that cannot be lent to a small business or consumer.

As noted, the key is to find the correct balance between mandated liquidity and the likely need for liquidity. If the liquidity rules are designed to enable a bank to withstand a multitude of serious but unlikely stress events, institutions will have a liquidity buffer that protect them against an unlikely but very severe downturn. The cost will be much less economic growth and development and possibly more problem banks that have insufficient earnings to support operations. On the other hand, if the liquidity framework is based on reasonable assumptions of fund outflows and the impacts of more economic stresses that can be expected during a normal economic cycle, the liquidity rule could provide a very valuable tool in ensuring the health of our financial system.

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