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Briefing note

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# Basel III: relaxations to the Liquidity Coverage Ratio

The Basel Committee on Banking Supervision ("**BCBS**") published the finalised Liquidity Coverage Ratio ("**LCR**") on 7 January 2013. The finalised LCR is less onerous than the original formulation published in December 2010 and should therefore be welcomed by banks.

This briefing outlines the main amendments to the LCR and considers their effect.

## Key points

- The finalised LCR was published on 7 January 2013.
- Amendments to the previously published LCR include:
  - a wider range of high-quality liquid assets;
  - material reduction of the assumed drawdown rates on unused portions of certain committed liquidity and credit facilities; and
  - a revised definition of liquidity facilities.
- The LCR is intended to be introduced on 1 January 2015 in stages with an initial 60% liquidity requirement rising annually by 10% to 100% on 1 January 2019.

## The Liquidity Coverage Ratio

The LCR is one of the key components of Basel III and is intended to address banks' short term liquidity risk by requiring banks to hold enough unencumbered high quality liquid assets ("**HQLA**") to meet the net cash outflows over a 30 day period that they would expect to experience under a prescribed stress scenario. This requirement applies on an ongoing basis, except in a period of financial stress where the BCBS has confirmed that banks may use their stock of HQLA, thus falling below the requirement.

## Amendments to the definition of HQLA: introduction of lower quality assets

A new category of Level 2B assets has been introduced, which may be included in Level 2 at the discretion of national authorities. This has the effect that banks may be able to count a wider range of assets towards meeting the LCR, potentially reducing the cost of compliance.

Level 2B assets include lower rated corporate bonds, residential mortgage backed securities and equities that meet certain conditions. A larger haircut is applied to Level 2B assets (ranging from 25% to 50% depending on the asset) than to Level 2A assets where a 15% haircut is applied.

HQLA are therefore now comprised of Level 1 assets and Level 2A assets (previously Level 2 assets) and Level 2B assets. Level 2 assets may not in aggregate account for more than 40% of a bank's stock of HQLA and Level 2B assets may not account for more than 15% of a bank's stock of HQLA.

## Amendments to outflow rates: assumed drawdowns of committed credit and liquidity facilities

The assumed drawdown rates of the unused portion of certain committed facilities (which is available for drawing within 30 days) have been reduced as follows:

- committed liquidity facilities to non-financial corporates, sovereigns and central banks, public sector entities and multilateral development banks - reduction from 100% to 30%

- committed credit and liquidity facilities to banks subject to prudential supervision – reduction from 100% to 40%
- committed credit facilities to other financial institutions including securities firms, insurance companies, fiduciaries and beneficiaries – reduction from 100% to 40% (the drawdown rate in respect of liquidity facilities to such entities remains at 100%)

Therefore, when calculating net cash outflows for the purposes of the LCR, banks will no longer be required to assume that the undrawn portion of the committed facilities mentioned above are fully drawn. This has the effect that banks will be required to hold less HQLA as a consequence of providing those facilities than had previously been envisaged and is likely to reduce the LCR's impact on the syndicated lending market.

## Changes to the definition of liquidity facilities

A liquidity facility is now defined as "*any committed, undrawn back-up facility that **would be utilised** to refinance the debt obligations of a customer in situations where such a customer is unable to rollover that debt in financial markets (e.g. pursuant to a commercial paper programme, secured financing transactions, obligations to redeem units, etc).*"

This definition is arguably wider than the previous definition which referred to "*any committed, undrawn back-up facility put in place **expressly** for the purpose of refinancing the debt of a customer in situations where such a customer is unable to obtain its ordinary course of business funding requirements (e.g. pursuant to a commercial paper programme) in the financial markets.*"

The deletion of the requirement that a facility be "expressly" put in place for backstop purposes means that it is arguable that facilities which *could* be used for such purposes (even if not expressly so specified) could fall within the revised definition. More attention may therefore need to be paid to the purpose clause in loan documentation and consideration given as to whether borrowers should be expressly prevented from using a facility for backstop purposes.

## Changes to the implementation of the LCR: staged introduction

The BCBS has indicated that the LCR will still be introduced as planned on 1 January 2015, however, it will be introduced in stages. Initially, banks will be required to hold HQLA which represent at least 60% of the total net cash outflows over a 30 day period during the prescribed stress scenario. This minimum requirement will rise annually by 10% and reach 100% on 1 January 2019.

The staged approach, together with the amendments to the LCR, are intended to facilitate the introduction of the LCR with the minimal disruption to the orderly strengthening of banking systems or the ongoing financing of economic activity.

## Next steps: Capital Requirements Regulation ("CRR") and the Net Stable Funding Ratio ("NSFR")

Basel III is not legally binding and must be implemented by national authorities to take effect. It is proposed as a minimum standard and national authorities are free to impose more rigorous standards. The European Commission intends to implement the majority of Basel III, including the LCR, by way of a new regulation (the CRR) which is part of the CRD IV package of reforms. Legislative proposals for the CRR were published in July 2011. They may now need to be revisited to take into account the amendments to the LCR and a key question will be the extent to which the EU adopts the new relaxations. It is likely that the EU will apply this rule to investment firms as well as banks.

In the meantime, the BCBS has also advised that it is currently reviewing the NSFR (which it still intends to become a minimum standard by 1 January 2018) and the outcome of its review is therefore awaited. Any changes to the NSFR may also require to be reflected in the CRR.

Clifford Chance will continue to monitor the progress of Basel III and the CRR and will keep you updated as developments occur. For further information or advice on the LCR or Basel III generally, including its potential implications for documentation, please contact one of the partners listed in this briefing or your usual Clifford Chance contact.

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