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Basel III Proposals Could Strengthen Banks' Liquidity, But May Have Unintended Consequences

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*(**Editor's Note:** This article is part of a series of comments by Standard & Poor's Ratings Services in response to the Basel Committee on Banking Supervision's proposals on bank capital and liquidity released for comment in December 2009. This article supplements our views outlined originally in the report: "Basel 3 For Global Banks: Third Time's The Charm," published on March 4, 2010. The Basel Committee's comment period ends on April 16, and it is planning to issue final rules by the end of 2010 with implementation scheduled for 2012.)*

OVERVIEW

In assessing the Basel Committee on Banking Supervision's liquidity framework, Standard & Poor's overall view is that:

- The standards it sets out could serve to strengthen significantly banks' liquidity positions and the supervisory review process.
- An overly restrictive approach to the definition of liquid assets and requirements for funding certain types of assets with long-term funds, however, could constrain banks' profitability on lending and trading activities and cause displacements in markets for high-quality liquid securities by distorting supply/demand fundamentals.
- The overall ratings implications won't be clear until there is a final version of the framework, which is expected later in 2010.

The Basel Committee on Banking Supervision's (BCBS) December 2009 proposal for an international framework for liquidity risk measurement, standards, and monitoring includes two new measures of liquidity risk: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). In conjunction with the liquidity framework, the BCBS has also published "Strengthening the Resilience of the Banking System," which outlines recommendations for revised capital standards.

A Better Assessment Of Liquidity

The liquidity framework proposes two new internationally harmonized measures of liquidity risk exposure that aim to improve banks' resilience to acute (within 30 days) and long-term (within 12 months) liquidity stress:

- The short-term metric, named the liquidity coverage ratio (LCR), introduces a specified stress scenario and requires banks to maintain liquidity buffers sufficient to cover net cumulative cash outflows at all times during a 30-day period.
- The structural funding metric--the net stable funding ratio (NSFR)--introduces minimum requirements for the use of longer-term and more stable funding sources to finance less liquid assets.

The liquidity framework supplements the Basel committee's guidance paper "Principles for Sound Liquidity Risk Management and Supervision," published in September 2008, which provides additional supervisory guidelines for banks' liquidity management. The BCBS issued both publications in response to the financial market turmoil that

began in midyear 2007 and revealed its views of the deficiencies of banks' liquidity risk management.

From a credit perspective, we believe that the measures that the liquidity framework and the principles paper set out could significantly strengthen banks' liquidity positions and the supervisory review process. This, in turn, could reduce the risk of idiosyncratic or systemic stress for the economy. We also believe that globally harmonized liquidity measures could significantly augment the analytical tools used by market participants, including Standard & Poor's, to make comparisons among banks and track changes in their liquidity positions over time--assuming that there would be appropriate disclosure. However, we believe that the ultimate effect of the liquidity framework on the credit quality of particular banks, and on the utility of the metrics, largely rests on how the metrics are defined and calibrated.

We see a risk, however, that an overly restrictive approach to the definition of liquid assets and requirements for funding certain types of assets with long-term funds could have unintended consequences. Strict rules in these areas could impair the profitability of lending and trading activities due to lower net interest spreads and cause displacements in funding markets for high-quality liquid securities, potentially making some securities even less liquid. It is partly with a view to assessing potential market effects that we understand that the Basel Committee is pursuing an impact study.

The Liquidity Framework And Principles Could Bolster Confidence In The Financial Markets

The turbulent and unpredictable market environment of the past two to three years, in our view, showed that the management and monitoring of liquidity risk at many large systemically important institutions and the supervisory approaches to address risk-management deficiencies were not effective. An expansive global monetary policy, abundant liquidity at low cost, and low risk awareness paved the way for increasing leverage, often by means of short-term, wholesale funding. At the same time, increasing volumes of off-balance-sheet activities, which regulatory capital, liquidity regimes, and accounting standards did not fully capture, appeared to reinforce the trend of higher risk-taking without proper attention to the embedded risks. Reliance on the functioning of securitization markets and access to repo markets for the sale and repurchase of securities allowed the short-term refinancing of less liquid assets and contributed to increasing liquidity risks, in our view. We also believe that stress testing and contingency planning by regulators or the banks themselves, as well as macroprudential and bank-specific regulatory surveillance, proved inadequate when access to funding quickly evaporated. In addition, limited public disclosure and the diversity of regulatory regimes, which make comparisons of supervisory measures difficult, did not help to foster market discipline, in our view.

Broadly, the proposed liquidity framework, together with the principles paper and other initiatives, intends to address weaknesses we have observed. The liquidity framework sets a minimum standard for internationally active banks, and the principles require a higher standard of bank-specific analysis, as well as governance and supervision rules. We believe that together, the two represent a reasonable middle ground that combines elements of a highly detailed and prescriptive methodology and a purely principles-based methodology.

In our analysis, we factor the role played by national supervisors, central banks, and governments in monitoring trends in the system and at individual banks and their ability to take corrective action at an early stage to prevent the buildup of systemic problems. Although beyond the scope of the proposal, we believe that improved, regular cross-border collaboration among these authorities would strengthen the monitoring and assessment of systemic risk

in the global financial sector.

Calibration And Definitions: The Devil Is In The Details

The LCR aims to ensure that banks hold a sufficient amount of high quality unencumbered liquid assets, which they can convert into cash at little or no loss of value, to cover stressed net cumulative cash outflows at all times for up to 30 days. In order to calculate cumulative cash outflows--the amounts that may be withdrawn or not replaced in times of stress--the proposal applies roll-off assumptions to various categories of liabilities and off-balance-sheet commitments. Conversely, the proposal factors in the benefit of all unencumbered contractual cash inflows from performing exposures that are not expected to default within 30 days. The framework requires that liquid assets cover the gap between cumulative cash inflows and outflows.

The stress scenario embedded in the LCR generally captures deposit outflows and constrained access to wholesale funding. It also considers other contingent liquidity risks arising from rating triggers, margin and collateral calls, closure of structured financing markets, and unscheduled drawings on committed facilities.

The definition of "high quality liquid assets"--the liquidity buffer banks would need to maintain to offset potential net cumulative cash outflows--is in our view a particularly important aspect of the proposed LCR methodology. The proposed eligible high quality instruments essentially consist of cash and high quality government debt, plus, potentially, haircut (i.e., discounted) proportions of high quality corporate and covered bonds. We believe there is a risk that this standard is too conservative--to the point where it could create a shortage of liquid assets or significant concentration risks. In our view it is, for example, significantly more restrictive than the standards central banks typically maintain for collateral eligibility under the liquidity facilities that serve as a key backstop to the banking system. In light of central banks' crucial role in ensuring system liquidity in times of stress, collateral eligibility indicates that an asset is liquid. We would tend to adjust ratios in our analysis of liquidity if some eligible collateral were not considered as liquid. We would also look at the quality and diversity of "liquid assets" in order to assess event risk that could jeopardize the "liquidity" of a given asset.

The proposed LCR requirements would wholly exclude banks' and investment and insurance firms' debt from high quality liquid assets to alleviate governments' concerns about high levels of interconnectedness of financial institutions. In addition, among cash outflows, there would be the assumption of 100% drawdown of undrawn credit and liquidity facilities extended to other financial institutions. Yet, among cash inflows, it assumes that the banks are not able to draw on any lines of credit, liquidity facilities, or other contingent funding facilities that the bank holds at other institutions for its own purposes in order to reduce reliance on wholesale funding lines. While these assumptions appear defensible individually, we believe there is a risk that, on a combined basis, they could severely hamper the interbank lending market and also lead to other capital markets dislocations as banks could be forced to reallocate their liquidity buffers.

Under the proposal, the LCR would apply to corporate groups on a consolidated basis. In our view, this approach would fail to account for potential constraints to liquidity transfers within a banking group, both on a cross-border basis and among different legal entities in the same country.

The impact of the additional requirement that banks conduct their own stress tests, tailored to their specific situation and liquidity vulnerabilities, should in our view support risk management. Stress tests that also incorporate longer periods than the 30-day time horizon that the LCR uses would provide relevant information.

The NSFR aims to capture structural issues related to funding choices to ensure stable funding over one year in an extended firm-specific stress scenario. To calculate the required amount of stable funding, it applies various haircuts or percentage reductions to asset types depending on their liquidity characteristics. The component of each deemed illiquid must be covered by available stable funding, which includes equity, long-term debt with a maturity of more than one year, and proportions of short-term liabilities based on behavioral assumptions (roll-off factors)--for example, depending on depositor type. The NSFR complements the LCR because it looks beyond the 30-day time frame of the short-term metrics and aims to reduce the use of short-term funding to finance less-liquid assets.

We believe the NSFR has considerable merit as a monitoring tool for regulators, and that it could be very useful for our analytical purposes. We do see some risks in too stringent a requirement for match funding. We believe that some level of mismatching or transformation risk is inherent to the banking business and necessary for banks to fulfill their role in the economy. If implemented as proposed, we expect that one potential effect could be to encourage banks to shift toward short-term lending.

We expect the choice of parameters to calculate LCR and NSFR to have important implications. We will be further assessing the rationale behind the proposed haircut and roll-off factors, for example, whether BCBS derives these from empirical studies or expert judgment. We would be interested if the Basel Committee were to disclose how it derived its assumptions and to give further explanation to enable market participants to better assess them. We also observe that some definitions might be impractical (such as deposits used for operational functions) or require clarification (for example, the treatment of unfunded assets and liabilities). In addition, some definitions remain subject to national discretion. These include the case of liquid assets in jurisdictions where central bank eligibility is limited as well as definitions of stable and less stable deposits, liquidity needs related to market-valuation changes on derivative transactions, and liquidity needs related to other contingent funding liabilities

Although we believe that material changes in regulation require extended transition periods--particularly amid periods of fragile economic and market conditions, such as at present--we observe that the final standard would only become effective in 2013. Given the failures in recent years in some financial institutions' liquidity management, we believe that the delivery of more useful liquidity information sooner would be beneficial for general liquidity analysis.

Consistent Application And Regular Disclosure Will Be Critical For Our Analytical Purposes

We believe that globally harmonized LCR and NSFR metrics could be extremely useful for our analytical purposes--namely as one input we may consider in monitoring the development of companies' liquidity over time, in making comparisons among companies, and in tracking sector-wide trends. We expect that other market participants would also find these measures useful, and that widespread attention to these measures could ultimately serve to strengthen market discipline. At present, on matters related to liquidity, we have observed that the internal metrics and disclosure practices of banks vary considerably, even among those in the same country.

In our view, banks will need to implement the LCR and NSFR methodologies in a timely, internationally comparable, and comprehensible manner in order to maximize their utility. We believe the required disclosures should have sufficient detail to show the composition of the numerator and denominator and how the banks calculated these amounts. In our view, qualitative information, as the proposal suggests, but also detailed bank specific liquidity analysis should complement the quantitative disclosures.

The BCBS proposal also calls for the use of four monitoring tools that aim to identify longer-term funding mismatches, analyze funding concentrations, assess the quantity and quality of unencumbered assets, and consider market data. The aim of these tools is to strengthen the supervisory surveillance of institutions and market developments. We would welcome periodic and detailed disclosures regarding these matters--in particular, concerning funding mismatches, which we consider to be especially important in the case of predominantly wholesale-funded institutions with large loan books or less liquid investment holdings.

The Rating Implications Are Not Yet Apparent

The proposed liquidity framework is too preliminary for us to be able to assess the potential rating implications. Once finalized, however, application of the liquidity framework could reveal existing weaknesses--or strengths—within banks that were not apparent previously. Depending on the nature of the final standards, considerable adjustments could be necessary on the part of some companies, which they could have varying degrees of success in accomplishing. We expect smaller, deposit-funded retail banks to find it easier to comply with more stringent requirements than larger wholesale-funded institutions with extensive trading operations or large loan books and securities holdings. We believe that the latter will likely need to make more significant changes to their balance sheet structures or business models, possibly because the new liquidity and funding requirements could make holding illiquid assets less attractive or because of limited long-term wholesale funding capacity.

In considering the implication for ratings, we may also consider the combined effect of other new regulatory requirements that could emerge, such as those concerning capital. In addition, we may assess the consequences of new regulatory requirements for interbank, credit, and securities markets and for the competitive environment. Still, in many respects, the BCBS proposal lays out an approach that should, in our view, strengthen both banks' liquidity positions and the supervisory review process, through affording a methodology for assessing liquidity requirements under stress conditions.

Related Research

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S&P Ratio Highlights Disparate Capital Strength Among The World's Biggest Banks, Nov. 30, 2009

Methodology And Assumptions: Risk-Adjusted Capital Framework For Financial Institutions, April 21, 2009

FI Criteria: Bank Rating Analysis Methodology Profile, March 18, 2004

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