Basel Committee
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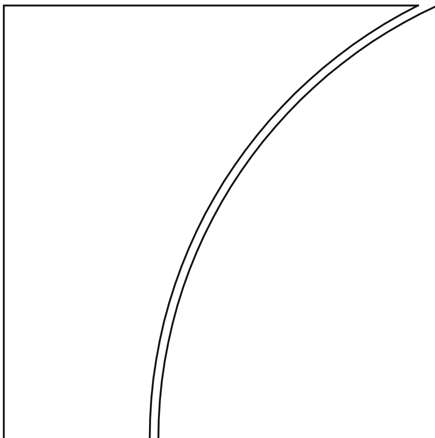
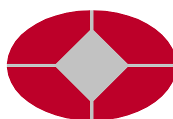


Frequently Asked Questions on Basel III's January 2013 Liquidity Coverage Ratio framework

April 2014



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Questions and responses

1. Secured transactions collateralised by a pool of assets

(a) A bank has a reverse repurchase agreement, receiving collateral that consists of a pool of assets including non-HQLA. Can the whole portion of Level 1 and Level 2 assets of the collateral basket be counted towards HQLA (subject to the other requirements on HQLA-eligible assets)?

Response – An HQLA-eligible asset received as a component of a pool of collateral for a secured transaction (eg reverse repo) can be included in the stock of HQLA (with associated haircuts) to the extent that it can be monetised separately.

(b) If a bank pledges a pool of HQLA and non-HQLA collateral with a clearing entity such as a central counterparty (CCP) against secured funding transactions, may it count any HQLA-eligible securities that are held as part of the collateral pool, but remain unused at end-of-day as part of the stock of HQLA?

Response – The bank may count the unused portion of HQLA-eligible collateral pledged towards its stock of HQLA (with associated haircuts). If the bank cannot determine which specific assets remain unused, it may assume that assets are encumbered in order of increasing liquidity value, consistent with the methodology set out in footnote 9 of the LCR framework.

(c) Which cash flow assumptions are applied if a bank pledges a pool of HQLA and non-HQLA collateral to secured funding transactions and a portion of the secured funding transactions has a residual maturity greater than 30 days?

Response – All secured transactions maturing within 30 days should be reported according to the collateral actually pledged as of close of business on the LCR measurement date applying the outflow assumptions in paragraph 115. If the bank cannot determine which specific assets in the collateral pool are used to collateralise the transactions with a residual maturity greater than 30 days, it may assume that assets are encumbered to these transactions in order of increasing liquidity value, consistent with the methodology set out in footnote 9 of the LCR framework in such a way that assets with the lowest liquidity value in the LCR are assigned to the transactions with the longest residual maturities first.

(d) Which cash flow assumptions are applied for secured transactions where assets are received on the basis of a collateral pool that is subject to potential collateral substitution?

Response – The risks associated with collateral substitution on secured lending transactions with a residual maturity greater than 30 days should be considered as a contingent outflow in accordance with paragraph 122 of the LCR framework.

2. HQLA-eligible RMBS *(Paragraph 54(a))*

(a) Does the maximum LTV criterion of 80% mean that the average pool LTV is to be less than 80% or that each loan has to have less than 80% LTV?

Response – The LTV requirement in paragraph 54(a) refers to the weighted average (by loan balance) LTV of the portfolio of underlying mortgages, not to any individual mortgage, ie mortgages that have an LTV greater than 80% are not excluded per se.

(b) Does "at issuance" in paragraph 54(a) refer to the issuance of the RMBS or of the underlying mortgages?

Response – "At issuance" refers to the time when the RMBS is issued, ie the average LTV of the underlying mortgages at the time of the issuance of the RMBS must not be higher than 80%.

3. HQLA eligibility of lower-rated sovereign debt *(Paragraph 54)*

(a) While corporate debt securities rated BBB+ to BBB– may be included in Level 2B according to paragraph 54(b), there is no explicit assignment of sovereign debt securities with such a rating. How should those securities be treated?

Response – Sovereign and central bank debt securities rated BBB+ to BBB– that are not included in the definition of Level 1 assets according to paragraph 50(d) or (e) may be included in the definition of Level 2B assets with a 50% haircut within the 15% cap for all Level 2B assets.

(b) Does "the sovereign" in paragraphs 50(d) and (e) refer to the bank's home country, host country, the country in which the bank does not have any presence but has liquidity risk exposure denominated in that currency, or all of them?

Response – Sovereign and central bank debt securities, even with a rating below AA–, should be considered eligible as Level 1 assets only when these assets are issued by the sovereign or central bank in the bank's home country or in host countries where the bank has a presence via a subsidiary or branch. Therefore, paragraphs 50(d) and (e) do not apply to a country in which the bank's only presence is liquidity risk exposures denominated in the currency of that country.

(c) In paragraph 50(e), could a bank use non-0% risk-weighted sovereign or central bank debt securities issued in foreign currencies to offset the amount of that specific foreign currency exposure in a country other than the issuing sovereign's or central bank's home country?

Response – In paragraph 50(e), the amount of non-0% risk-weighted sovereign/central bank debt issued in foreign currencies included in Level 1 is strictly limited to the foreign currency exposure in the jurisdiction of the issuing sovereign/central bank.

4. HQLA-eligible equities (*Paragraph 54(c))*

(a) Some jurisdictions have more than one index that could reasonably claim to be a "major" one. Can "the primary index" be construed to mean "a primary index" where there is more than one relevant index (to be defined, as already specified, by the supervisor in each jurisdiction concerned)?

Response – Home jurisdiction supervisors may determine what constitutes a major stock index in their jurisdiction, which in some cases may permit inclusion of more than one index.

(b) Paragraph 54(c), third bullet refers to "the major stock index in the home jurisdiction or where the liquidity risk is taken, as decided by the supervisor in the jurisdiction where the index is located". It is not clear what is meant by "taking a risk".

Response – Equities that are a constituent of a major stock index can only be assigned to the stock of HQLA if the stock index is located within the home jurisdiction of the bank or if the bank has liquidity risk exposure through a branch or other legal entity in that jurisdiction.

(c) In paragraph 54(c), when considering which common equity shares might satisfy the criteria for Level 2B assets of a maximum decline of share price not exceeding 40% over a "relevant period of significant liquidity stress", we assume that this criterion does not need to be applied for time periods prior to the shares' inclusion in the major index. Indicators of volatility prior to the shares' inclusion in the index will not be representative of current or future pricing.

Response – The criterion must be satisfied by all equity shares that enter the stock of HQLA. A consistent stressed period should be used for justification and whether the share was part of the index during that timeframe is not relevant.

5. Deposit run-off *(Paragraphs 73 and following)*

If a deposit is contractually pledged to a bank as collateral to secure a credit facility or loan granted by the bank that will not mature or be settled in the next 30 days, should the pledged deposit be excluded from the calculation of the total expected cash outflows under the LCR?

Response – The pledged deposit may be excluded from the LCR calculation only if the following conditions are met:

- the loan will not mature or be settled in the next 30 days;
- the pledge arrangement is subject to a legally enforceable contract disallowing withdrawal of the deposit before the loan is fully settled or repaid; and
- the amount of deposit to be excluded cannot exceed the outstanding balance of the loan (which may be the drawn portion of a credit facility).

The above treatment does not apply to a deposit which is pledged against an undrawn facility, in which case the higher of the outflow rate applicable to the undrawn facility or the pledged deposit applies.

6. Central counterparties *(Paragraphs 107, 109)*

How should central counterparties (CCPs) be treated in the context of the LCR? Specifically,

(a) Should deposits from a CCP be regarded as operational deposits, noting that such deposits are usually associated with clearing activities?

Response – As for any other qualifying operational deposits, the conditions set out in paragraphs 93–104 must be fulfilled.

(b) There may be various cash inflows and outflows between a CCP and its member banks. Can a bank net off such cash flows with respect to trades cleared with a CCP when calculating the LCR?

Response – There is no specific treatment of cash flows between CCPs and its member banks, ie netting is restricted to cases where it is permitted in the LCR framework (eg derivative cash flows that are subject to the same master netting agreement in paragraph 116).

7. Treatment of longs and shorts *(Paragraphs 113–115, 140, 145–146)*

Are client shorts covered by external securities borrowings subject to paragraph 146 (under "secured lending, including reverse repos and external securities borrowings") or paragraph 113 ("secured funding run-off")? Firm shorts covered by external securities borrowings are clearly covered by paragraph 146, and it seems more logical that client shorts covered by external securities borrowings should be as well. However, paragraph 113 makes references to customer shorts and the treatment is different.

Response – The treatments of customer shorts versus firm shorts are separate and distinct and for this reason are addressed in two separate paragraphs. Customer shorts are considered equivalent to other secured financing transactions, as the proceeds from the customer's short sale may be re-used by the facilitating bank to finance the purchase or borrowing of the shorted security. Contrary to firm short positions, customer short positions are initiated and maintained at the discretion of the customer, and therefore the availability of this financing may be uncertain during a period of stress. These characteristics explain why customer shorts are treated in accordance with the roll-off assumption in paragraph 115.

8. Derivatives *(Paragraphs 116–117, 158)*

The language of paragraph 158, which directly references paragraph 116 (the sum of all net cash inflows should receive a 100% inflow factor, but calculated as per paragraph 116) seems at odds with paragraph 142 (contractual inflows that are fully performing and for which the bank has no reason to expect a default within 30 days can be counted but contingent inflows cannot):

(a) Would it be correct to assume that expected contractual derivatives cash inflows from "in the money" options for which the bank is the option holder can be included without contravening the high-level principle in paragraph 142 that contingent inflows are not to be recognised?

Response – Yes, paragraph 116 states that "options should be assumed to be exercised when they are in the money to the option buyer", eg cash inflows from contractual derivatives that are "in the money" count towards derivatives cash inflows in the LCR. This is an exception to both paragraph 142, which excludes contingent inflows, and paragraph 152, which excludes inflows with no specific date from the LCR.

(b) Can it also be assumed that "in the money" options are exercised on expiry, for consistency across different option types and market practice?

Response – No, any option that expires or can be exercised within the next 30 days and that is "in the money" to the option buyer should be considered. The cash flow shall reflect the state of the transaction as of the reporting date.

(c) Could you confirm that options with delivery settlement during the relevant period could be considered as cash flows to the extent of the liquidity value of the delivered assets? Or whether all options are assumed to be cash-settled?

Response – Options with delivery settlement shall be considered according to the liquidity value of the delivered assets, ie the assets are subject to the haircuts that would be applied if these assets were collateral in secured transactions or collateral swaps. If contractual arrangements allow for both physical delivery and cash settlement, cash settlement may be assumed.

(d) What is the assumed behaviour in case of options with delivery settlement where the delivery obligation can be fulfilled with a variety of asset classes, ie the party liable has the choice between different securities?

Response – If the delivery obligation can be fulfilled with different security classes, delivery of the least valuable security possible ("cheapest to deliver") can be assumed. This applies symmetrically to both the inflow and outflow perspective, such that the obligor is assumed to deliver the security with the lowest liquidity value.

(e) What is the required treatment of FX derivatives in the LCR, ie where the gross amount for currency X is exchanged for the gross amount of currency Y? Does it depend on whether the cash flows are subject to a valid master netting agreement as indicated in paragraph 116?

Response – Cash flows arising from FX derivative transactions that involve a full exchange of principal amounts on a simultaneous basis (or within the same day) may be reflected in the LCR as a net cash flow figure, even where those deals are not covered by a master netting agreement.

9. Collateral treatment (*Paragraphs 118–122)*

(a) Do the bank's normal procedures apply to determine the notional amount pursuant to the penultimate sentence of paragraph 119?

Response – The notional amount to be collateralised in paragraph 119 is based on contractual terms (eg collateral agreements) that regularly include the methodology of calculating the amount to be covered ("notional amount").

(b) Do paragraphs 118–122 apply in the same way to all derivative instruments, whether OTC or on-exchange, whether cleared or not? In particular, can confirmation be given that margin posted for clearance through a CCP and held for the benefit of the bank in accordance with the rules of such CCP should be recognised under the logic of these paragraphs, although the point is not addressed explicitly?

Response – Unless expressly specified otherwise, the provisions apply generally. Any Level 1 assets in segregated accounts held in a bank's name by the CCP will be treated in accordance with paragraph 119.

(c) Paragraph 119 requires that an additional stock of HQLA be maintained for outflows where the bank is posting non-Level 1 collateral securing its derivatives. Can this be interpreted as applying on a net basis to the extent the bank uses non-Level 1 collateral received from one counterparty to secure derivative liability to another counterparty, if any decrease in the value of this collateral would affect both collateral posting to and by the bank?

Response – No. Netting of collateral inflows and outflows across counterparties is not provided for in paragraph 119 as the impacts of valuation changes (even of identical collateral) may be asymmetric across different counterparties.

(d) Assuming that a bank is a net poster of non-Level 1 collateral, can the net outflows under paragraph 119 be calculated taking into account any additional eligible non-Level 1 collateral that is unencumbered as of the date of the LCR or that would become unencumbered as a result of the stresses?

Response – No. The LCR framework provides no basis for separate sub-pools of (non-Level 1) HQLA dedicated to specific liquidity needs or for considering contingent inflows of collateral.

(e) Can it be assumed that a bank will post collateral in the most efficient manner practicable? For example, if a bank is currently a net poster of non-Level 1 collateral (with higher haircuts), it seems appropriate to assume that the bank would use its cash or lower-haircut Level 1 securities first, and not use that cash to purchase additional non-Level 1 collateral that would have a higher haircut.

Response – As with any other outflow captured in the LCR, the outflows addressed in paragraph 119 add to the bank's net cash outflow that must be met by Level 1 and/or Level 2 assets according to Section II.A of the LCR framework. No further assumptions have to be made in terms of what the bank actually "will post".

(f) Paragraph 122 sets a 100% HQLA requirement for the amount of received HQLA collateral that can be substituted for non-HQLA assets without the bank's consent. Does the outflow factor of 100% refer to the amount of HQLA collateral before or after the application of potential valuation haircuts (eg in the case of Level 2A collateral)?

Response – Paragraph 122 does not require an outflow for potential collateral substitution that is greater than the liquidity value of the received HQLA collateral in the LCR. The 100% outflow factor refers to the market value of the received collateral that is subject to potential substitution after applying the respective haircut in the LCR.

(g) Paragraph 122 refers only to the substitution of HQLA for non-HQLA collateral. Can it also be applied to potential collateral substitution of HQLA for other HQLA collateral of a lower liquidity value?

Response – Yes, if HQLA collateral (eg Level 1 assets) may be substituted for other HQLA collateral (eg Level 2A assets), an outflow amounting to the market value of the received collateral multiplied by the difference between the haircuts of the received collateral and the potential substitute collateral should be applied. If the substituted collateral can be of different liquidity value in the LCR, the bank should assume that the potential substitute collateral with the lowest liquidity value will be posted.

(h) Can you confirm that potential collateral substitution to non-HQLA assets according to paragraph 122 counts toward cash outflows only if the HQLA actually counts toward the bank's stock of HQLA in the LCR?

Response – Yes, outflows of HQLA that are excluded from the bank's stock of HQLA due to operational requirements are not considered in paragraph 122.

10. Historical look-back approach for market valuation changes (*Paragraph 123*)

What does "the largest absolute net 30-day collateral flow" refer to?

Response – The largest absolute net 30-day collateral flow is the largest aggregated cumulative net collateral outflow or inflow at the end of all 30-day periods during the preceding 24 months. For this purpose, banks have to consider all 30-day periods during the preceding 24 months. Netting should be considered on a portfolio level basis. Bank management should understand how collateral moves on a counterparty basis and is encouraged to review the potential outflow at that level. However, the primary mechanism for the "look-back approach" is collateral flows at the portfolio level.

11. Loss of funding on ABS, covered bonds and other structured finance *(Paragraph 124)*

Can Level 1 and Level 2 securities in a collateral pool (for covered bonds or other collateralised own issuances) that become unencumbered in the next 30 days due to maturity of the covered bond be considered as inflows?

Response – These inflows can be offset against the redemption payment for the maturing secured debt instrument. Such offsetting inflow amount should consider the respective haircuts for Level 2 assets applied to the market value of the asset. Any net inflow should be considered as other contractual cash inflow.

12. Special purpose entities (SPEs) and conduits *(Paragraphs 129–131)*

Paragraph 129 requires a facility provided to SPEs or conduits used to finance a bank's own assets to be captured as a liquidity facility to other legal entities (and assume a 100% drawdown of the undrawn portion per paragraph 131(g)). To what extent should this provision be applied to commercial conduits for clients?

Response – Facilities to SPEs and conduits are subject to the 100% drawdown rate of paragraph 131 (g). The LCR framework does not provide any other category for these entities independent of their business purpose.

13. Maturity of margin loans (*Paragraph 145)*

Many margin loans are "overnight" and can be terminated at any time by either side. Others, however, have "term" provisions whereby the bank agrees to make funding available for a given period, but the client is not obliged to draw down on that funding, and where the client has drawn down on the funding, they can repay it at any time. May banks apply paragraph 145 to such margin loans with a contractual maturity beyond 30 days?

Response – No, paragraph 145 and the table in paragraph 146 are specific to secured loans with a contractual maturity up to and including 30 days. No inflow can be assumed for funds extended under such "term" provisions that give the client the possibility to repay after more than 30 days.

14. Operational deposit inflows (*Paragraph 156)*

How should a bank determine whether or not a deposit it has placed at another financial institution is an operational deposit?

Response – The same methodology applied in paragraphs 93–104 for operational deposit outflows should also be applied to determine if deposits held at another financial institution are operational deposits and receive a 0% inflow. As a general principle if the bank receiving the deposit classifies the deposit as operational, the bank placing it should also classify it as an operational deposit.

15. Other cash flows *(Paragraphs 141, 160)*

What is the treatment of inflows and outflows of cash and collateral during the next 30 days arising from forward transactions (eg forward repos)?

Response – The following transactions do not have any impact on a bank's LCR and can be ignored:

- Forward repos, forward reverse repos and forward collateral swaps that start and mature within the LCR's 30 day horizon,
- Forward repos, forward reverse repos and forward collateral swaps that start prior to and mature after the LCR's 30 day horizon, and
- All forward sales and forward purchases of HQLA.

For forward repos, reverse repos and collateral swaps that start within the 30 day horizon and mature beyond the LCR's 30 day horizon, the treatments are as follows:

- Cash outflows from forward reverse repos (with a binding obligation to accept) count towards "other cash outflows" according to paragraph 141 and should be netted against the market value of the collateral received after deducting the haircut applied to the respective assets in the LCR (15% to Level 2A, 25% to RMBS Level 2B assets, and 50% to other Level 2B assets).
- Cash inflows from forward repos are "other contractual inflows" according to paragraph 160 and should be netted against the market value of the collateral extended after deducting the haircut applied to the respective assets in the LCR.
- In case of forward collateral swaps, the net amount between the market values of the assets extended and received after deducting the haircuts applied to the respective assets in the LCR counts towards "other contractual outflows" or "other contractual inflows" depending on which amount is higher.

Forward repos, forward reverse repos and forward collateral swaps that start previous to and mature within the LCR's 30-day horizon are treated like repos, reverse repos and collateral swaps according to paragraphs 113–115 and paragraphs 145–148 respectively.

Note that HQLA collateral held by a bank on the first day of the LCR horizon may count towards the stock of HQLA even if it is sold or repoed forward.

Unsettled sales and purchases of HQLA can be ignored in the LCR. The cash flows arising from sales and purchases of non-HQLA that are executed but not yet settled at reporting date count towards "other cash inflows" and "other cash outflows".

Note that, in accordance with the response to Q9 (g), any outflows or inflows of HQLA in the next 30 days in the context of forward and unsettled transactions are only considered if the assets do or will count toward the bank's stock of HQLA. Outflows and inflows of HQLA-type assets that are or will be excluded from the bank's stock of HQLA due to operational requirements are treated like outflows or inflows of non-HQLA.

16. Unsecured securities borrowings/lending *(Paragraphs 141, 160)*

What is the treatment of Level 1 and Level 2 assets that are lent/borrowed without any further offsetting transaction (ie no repo/reverse repo or collateral swap) if the assets will be returned or can be recalled during the next 30 days? Are these assets eligible HQLA on the side of the lender or borrower?

Response – These assets do not count towards the stock of HQLA for either the lender or the borrower. On the side of the borrower, these assets do not enter the LCR calculation. On the lender's side, these assets count towards the "other contractual inflows" amounting to their market value – in the case of Level 2 assets after haircut.

17. Loans with fixed interest rate periods *(Paragraphs 142, 152)*

Is it correct to exclude inflows from loans with a fixed interest rate period that ends in the next 30 days as we assume that these loans will be generally prolonged irrespective of whether the contractual arrangements provide for early termination of the loan if no agreement on the interest rate adjustment was reached?

Response – Yes, such loans should be considered as having an open maturity where any inflows exceeding those according the regular amortisation schedule would be "contingent" (in terms of a possible cancellation) in nature. Such inflows are excluded from the calculation of the net cash outflow under the LCR.

18. Received collateral used to cover short positions *(Paragraph 146)*

Can you confirm that the exception rule in paragraph 146 only applies where the reverse repo has a residual maturity of ≤ 30 days and the short position can be extended > 30 days?

Response – No, the inflow rates in the third column of the table in paragraph 146 apply to all reverse repos, securities borrowings or collateral swaps where the collateral obtained is used to cover short positions. The reference in the first sentence of paragraph 146 to "short positions that could be extended beyond 30 days" does not restrict the applicability of the 0% inflow rate to the portion of secured lending transactions where the collateral obtained covers short positions with a contractual (or otherwise expected) residual maturity of up to 30 days. Rather, it is intended to point out that the bank must be aware that such short positions may be extended, which would require the bank to roll the secured lending transaction or to purchase the securities in order to keep the short positions covered. In either case, the secured lending transaction would not lead to a cash inflow for the bank's liquidity situation in a way that it can be considered in the LCR.

19. Maturing Level 1 and Level 2 assets *(Paragraph 155)*

(a) Can banks count as inflows the difference between the actual redemption amount of Level 2 securities and the amount considered as HQLA (ie after application of the LCR haircut)?

Response – No, assets including Level 2 assets that fulfil the requirements of HQLA eligibility shall be considered as such and not as inflows.

(b) Can inflows from maturing Level 2 assets that are excluded from the stock of HQLA due to operational requirements count towards the inflows?

Response – Yes, maturing assets including Level 1 and Level 2 assets that are not HQLA-eligible due to operational requirements may be considered as inflows.

(c) Can inflows from maturing securities in a collateral pool for covered bonds be considered as inflows?

Response – Yes, inflows are not subject to operational requirements. Hence, these inflows are not per se excluded from the LCR even if the maturing securities are (or have been) excluded from the stock of HQLA due to being "encumbered" according to paragraph 31. However, if the matured securities need to be substituted in the collateral pool within the 30-day horizon, an "other outflow" per paragraph 141 should be considered amounting to the liquidity value of these securities in the LCR.