Basel III- LCR Liquidity Framework

The Basel Committee on Banking Supervision (BCBS) proposed a new liquidity regime under the Basel III norms in January 2013 with a view of promoting resilience in the banking sector. The BCBS identified the stress that banking sector came under during the period of 2007-08 global financial crises and the need to promote prudent liquidity management. As a part of framework, the BCBS developed two standards under the liquidity regime of Basel III norms- Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Two distinct but complementary objectives have formed the basis of proposing these new liquidity norms:

- Promote short-term resilience of bank's liquidity risk profile
- Promote bank's resilience over a longer time horizon

The LCR is aimed at strengthening bank's short term liquidity profile by ensuring that banks have sufficient short term liquidity to tide over a 30 day stress period. On the other hand, the NSFR is aimed at encouraging stable source of funding over medium to long term. After deliberations, the LCR is part of key reforms of the Basel III package, while the NSFR is indicated to be finalized in upcoming years.

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In the subsequent discussion, we elaborate on the nuances of LCR guidelines as laid down by the RBI and attempt to analyze its impact on the banking system in India's context.

Introduction

Banks have traditionally relied on 'coverage ratios' as a part of exposure management with provisioning maintained for non-performing loans, for advances etc. Experience of 2007-08 financial crises highlighted that liquidity crunch and strain in interbank market can lead to sharp and extended period of illiquidity. The banking sector needs to proactively equip themselves with availability of adequate stock of unencumbered assets with a view to meet liquidity requirements arising in next 30 days.

The LCR states that at minimum and on an ongoing basis, the banks must maintain an adequate level of unencumbered High Quality Liquid Assets (HQLA) that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under severe liquidity stress scenario. The 30 day timeframe is perceived appropriate for the bank to undertake necessary and corrective measures in eventuality of stress situations as also keep the banks aware about potential mismatches in their cash flows. The stress scenario as envisages potential shocks like run-off of retail deposits, increased market volatilities, partial loss of secured / unsecured funding.

At the inception, the LCR is proposed to be maintained on a stand-alone basis.

The LCR consists of two components:

a. Unencumbered HQLA in stressed conditions
b. Total net cash outflow

$$\textbf{LCR} = \frac{\textbf{Stock of HQLA}}{\textbf{Total net cash outflow for 30 days}} \geq \textbf{100\%}$$

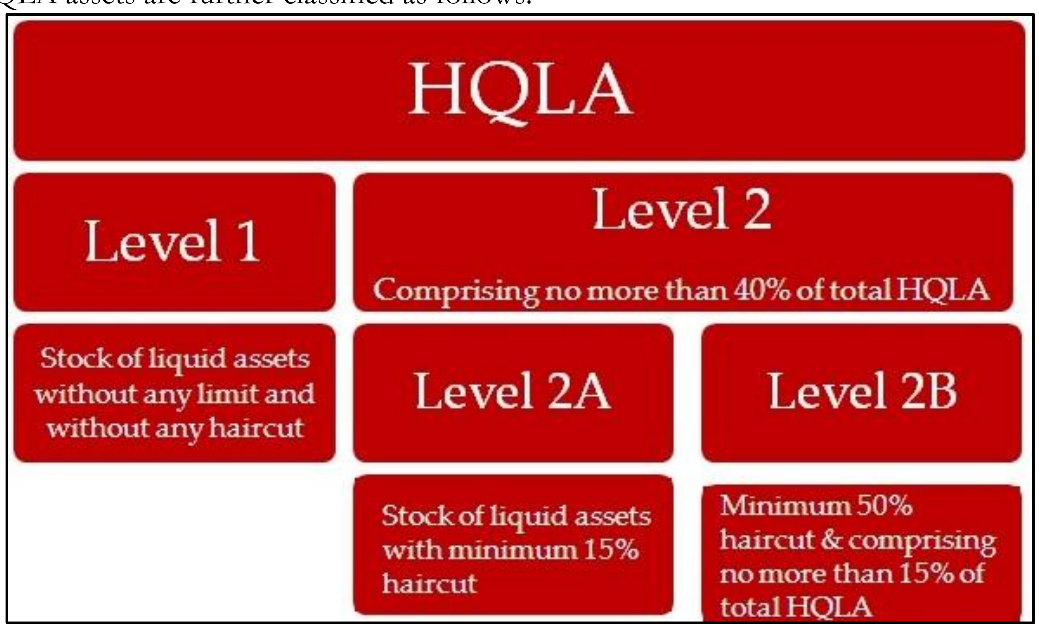
LCR maintenance is stipulated to be maintained at 100% on an ongoing basis. However, a transition path has been laid down to move towards full compliance. As a part of that path, beginning Jan-15, banks are required to maintain at least 60% LCR, with a 10% increase each year to reach 100% compliance by Jan-19. Post the completion of transition period, the banks mandatorily have to maintain minimum 100% LCR all the time. A dip in HQLA will be permitted during period of financial stress, which shall be immediately reported to the RBI.

1. High Quality Liquid Assets

Assets that can be readily sold or converted into cash as considered HQLA. The Basel III Liquidity Framework delineates clear guidelines on the composition and classification of HQLA and its different levels. The key characteristics for an asset to be classified as HQLA are:

- Unencumbered
- Low credit and market risk
- Ease and certainty of valuation
- Low correlation with risky assets
- Sizeable and active market with committed market players
- Low market concentration

HQLA assets are further classified as follows:



A summary of securities eligible under various categories of HQLA can be stated as under:

Table 1: HQLA Composition	
Level 1	Excess CRR
	Excess SLR
	Permitted SLR Dip in
	0% risk weight foreign sovereign securities not issued by Bank/FI/NBFC
Level 2A	Upto 20% risk weight securities issued by non Bank/FI/NBFC sovereign, PSE & MDB
	Non Bank/FI/NBFC AA- and above rated Corporate Bond
	Non Bank/FI/NBFC/PD AA- and above rated Commercial Paper
Level 2B	20%-50% risk weight securities issued by sovereigns
	Common Equity Shares listed on Sensex/Nifty and not issued by Bank/FI/NBFC

2. Net Cash Outflows

Total net cash outflows with various run-off factors are applied to liabilities and off-balance sheet liabilities to ascertain the impact on outflows; while run-in factors are estimated for receivables. A minimum of 25% of total expected cash outflows have to be provided for.

Total Net Cash Outflow = Total expected cash outflows – [Min (total expected cash inflows, 75% of total expected cash outflows)]

A summary of composition of inflows-outflows is presented. Different draw-down and run in factors are specified for each component ranging from 0%-100%.

Cash Inflows	Cash Outflows
Maturity of secured lending transactions	Retail Demand Deposits
Inflows from counter-parties	Unsecured Wholesale Funding
	1.Term Deposits
	2.Deposits with Clearing Corp
Inflows from Derivative transactions, other contractual inflows	Loss of Secured Funding backed by Level -2 Asset
	Additional Requirements
	1. Derivative Revaluation
	2. Collateral Depreciation,
	3.Guarantees being called

Impact of LCR on Banking System

Maintenance of adequate level of HQLA in face of growing economy is a challenging prospect for cross section of banks. With the view of moving smoothly towards LCR norms, RBI in its Monetary Policy Reviews of Jun-14 and Aug-14 brought the SLR preemption by 50 bps each, to provide banks with headroom to comply with the regulatory norms. In the Sept-14 policy, RBI permitted additional liquidity of up to 5% of NDTL within the mandatory SLR requirement to qualify as Level 1 HQLA. This has provided significant boost to banks' position with respect to complying with the prudential requirements.

A study of top six private sector and public sector banks highlights that most banks are now well within the first leg of 60% compliance target. To be sure, impact assessment on these twelve banks demonstrates that the banks appear to be well on course to comply with subsequent transition path's higher requirements of 100% as it stands right now. We estimate the banks' positions based on their FY14 annual reports and present the following analysis:

Table 2: LCR position across major banks (in Rs Cr)

LCR Calculation	Categories	Top 6 Public Sector Banks	Top 6 Pvt Sector Banks
Estimated L1 HQLA	1. Excess CRR	51,089	29,600
	2. Excess SLR	52,494	23,317
	3. SLR Dip in (7% of NDTL)	2,21,346	92,552
	Total	3,24,929	1,45,468
Estimated Net Cash Outflows	Outflows		
	1. CASA + Term Deposits	3,37,212	1,17,397
	2. Borrowings maturing in 30 days	63,939	27,725
	3. Guarantees, LCs etc	22,062	16,294
	Inflows		
	Loans maturing in 30 days	1,78,893	26,025
	Total	2,44,320	1,35,391
LCR Maintenance (with only L1 HQLA)		133%	107%

Source: Banks' individual annual reports, STCI PD Research Calculations

Notes to Table 2:

* The calculations above are based on approximations from banks' annual reports. Private sector banks considered are: HDFC, Axis, Kotak Mahindra, Indusind and Yes Bank. Public sector banks considered are: SBI, Bank of India, PNB, Bank of Baroda, Canara Bank and Federal Bank.

* The LCR calculation has utilized only L1 HQLA since information about L2A and L2B HQLA is not directly available. Inclusion of L2 assets will only enhance the LCR compliance.

Our analysis suggests that movement towards LCR compliance will not have material near-term impact on bank's profitability and asset mix. Most big banks are already well placed to meet the LCR requirements. Banks, especially PSBs, typically prefer to invest in excess SLR in a slow growing economy. In the present context, a low credit off-take has driven banks to invest in G-Secs. Therefore, the LCR requirement is not a restraining factor on banks' balance sheets currently.

Going forward, when the economy is expected to pick up, higher growth levels would be coupled with pick-up in credit demand as well. It is then that the banks' dynamic balance sheet management would become critical. Several challenges persist in this regard- one being banks' exposure to the financial sector. Corporate bonds or commercial papers of financial institutions do not qualify as HQLA, while the deposits from these entities are allocated higher run-off rates. This could potentially test the banks' ability to balance higher credit demand along with meeting the regulatory requirements. A systematic reduction in SLR requirement could aid the compliance process in medium term.

The current process of LCR compliance is largely expected to be seamless across banks. Any challenge arising would potentially surface only once the economy gains traction and the investment cycle picks up.

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