EUROPEAN CENTRAL BANK

EUROSYSTEM

Strengthening the resilience of the banking sector: the Basel proposal for an international framework for liquidity risk

Money Market Contact Group

Frankfurt, 10 February 2010

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I. Background

- The BCBS and national authorities should develop and agree by 2010 a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions (G20 Leaders at London summit)

- The BCBS should conduct further work to address funding and liquidity risk in 2009. A key component of this research agenda is to define robust measures of funding and liquidity risk, which could assist assessments of liquidity risk by the private sector (FSF report on addressing pro-cyclicality in the financial system)

- The BCBS issued a consultative document on International framework for liquidity risk management, standards and monitoring in December 2009

II. Proposal overview

- The consultation document puts forward two regulatory standards aiming at addressing liquidity risk:
  - in the short term, to ensure that banks hold sufficient high quality liquid assets to withstand acute stress scenario lasting one month (liquidity risk coverage ratio)
  - in the longer term, to increase incentives for banks to fund themselves using more stable sources on an structural basis (net stable funding ratio)
- Furthermore, it includes a set of tools for ongoing monitoring of liquidity risk exposures and information exchange among supervisors

III. The Liquidity Coverage Ratio

$$\frac{\textbf{Stock of high quality liquid assets}}{\textbf{Net cash outflows over a 30-day time period}} \geq \mathbf{100\%}$$

- Measures if banks hold adequate level of unencumbered, high quality liquid assets to meet net cash outflows under supervisory specified stress scenario for 30-day period
- Builds on methodologies used widely by banks, analysts and rating agencies
- Banks and supervisors expected to monitor and manage potential mismatches within 30-day period to ensure that sufficient liquid assets are available to meet cashflow gaps

III. The Liquidity Coverage Ratio

Characteristics for high quality liquid assets

- Fundamental, namely low credit and market risk; ease and certainty of valuation; low correlation with risky assets; and listed on a developed and recognised exchange market.
- Market-related, namely active and sizable market; presence of committed market makers; low market concentration; and flight to quality.
- Central bank eligibility desirable, as a further backstop to supply of liquidity in event of severe stress.

List of assets meeting these criteria

- Cash; central bank reserves, if can be drawn in times of stress; government bonds.
- Data to be gathered on high quality corporate and covered bonds.

III. The Liquidity Coverage Ratio

Stressed scenario deciding cash outflows and inflows

- Significant downgrade of the banks' public credit rating
- Partial loss of deposits
- Loss of unsecured wholesale funding
- Significant increase in secured funding haircuts
- Increases in derivative collateral calls and in calls of off-balance sheet exposures such as credit and liquidity facilities

IV. The Net Stable Funding Ratio

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

Ensures stable funding in an extended firm-specific stress scenario over one year involving:

- a significant decline in profitability or solvency from heightened credit, market or operational risk or other risk exposures.
- a potential downgrade in a debt, counterparty credit or deposit rating.
- a material event, which calls into question the reputation or credit quality of the institution.

V. Monitoring tools

Capture specific information related to a bank's cash flows, balance sheet structure, available unencumbered collateral and certain market indicators.

- Contractual Maturity Mismatch, measuring contractual cash and security inflows and outflows from all on- and off-balance sheet items, mapped to defined time bands based on their respective maturities.
- Concentration of funding, measuring wholesale funding sources from significant counterparties or instruments.
- Available Unencumbered Assets that are marketable as collateral in secondary markets and/or eligible for central banks' standing facilities.
- Market-related monitoring tools covering the entire market, the banking sector and the individual institution.

VI. Way forward

- Comments on the consultative document by 16 April 2010
- Impact assessment by mid-2010
- Fully calibrated standards by end-2010 (to inter alia include further guidance on possible application of standard at the solo level and treatment of intra-group flows; currencies; disclosure)
- Implementation envisaged to be phased in by end-2012

Thank you for your attention