

## Basel III: Liquidity Rules

### 1 Introduction and timing

On 16 December 2010 the Basel Committee on Banking Supervision (the “**Committee**”) published the final form of a set of reforms to strengthen liquidity risk management by internationally active banks (the “**2010 Liquidity Paper**”). The Liquidity Paper brings together and, in parts, revises proposals set out in the initial framework for improving liquidity risk management and controlling liquidity risk exposures set out in the Committee paper adopted in September 2008 “Principles for Sound Liquidity Risk Management” (the “**2008 Liquidity Principles**”), the December 2009 Consultation Document, “International framework for liquidity risk measurement, standards and monitoring” (the “**December 2009 Consultation**”) and the proposals set out in the Annex to the 26 July Committee Press Release (the “**July 2010 Annex**”). The 2010 Liquidity Paper is intended to address concerns highlighted by the economic crisis, where a lack of liquidity and inadequate liquidity risk management operated together to amplify difficulties caused by credit losses and, due to the interconnectedness of markets, quickly infected all markets, with dire consequences.

The 2010 Liquidity Paper proposes transitional arrangements to implement the new liquidity standards set out in the 2010 Liquidity Paper. The Committee will also carry out an observation period which will be used to monitor the impact of the standards. During this period further quantitative impact studies will be carried out using data from year end 2010 and mid-year 2011 reference periods. To give banks more time to develop their reporting systems, reporting to supervisors will not first be expected until 1 January 2012. If any unintended consequences come to light during the observation period, the Committee is prepared to make any necessary revisions to the Liquidity Coverage Ratio (the “**LCR**”)<sup>1</sup> by mid-2013 and to the Net Stable Funding Ratio (the “**NSFR**”)<sup>2</sup> by mid-2016 at the latest. The LCR, including any revisions, will be introduced on 1 January 2015

<sup>1</sup> See paragraph 2(a) below.

<sup>2</sup> See paragraph 2(a) below.

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and the NSFR, including any revisions, will become a minimum standard by 1 January 2018.

This Memorandum summarises the proposals sets out in the 2010 Liquidity Paper and notes any significant changes from the proposals set out in the series of Committee publications outlined above.

## 2 Summary

The 2010 Liquidity Paper sets out two minimum standards for funding liquidity:

- (a) the LCR, which is designed to promote the short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for 30 calendar days; and
- (b) the NCR, which is designed to promote longer-term resilience by requiring banks to have capital or longer term high-quality funding which can survive over a one year period of less severe stress.

These standards are expressed to be minimum standards and, where appropriate, supervisors of internationally active banks are expected to require an individual bank to apply more stringent standards to reflect that bank's liquidity risk profile, including having regard to jurisdiction specific risks.

The 2010 Liquidity Paper also provides a set of monitoring tools to be used in the ongoing monitoring of the liquidity risk exposures of banks and in communicating these exposures among home and host supervisors. These tools are intended to further strengthen and promote global consistency in liquidity risk supervision.

## 3 The Minimum Liquidity tests

### 3.1 The Liquidity Coverage Ratio (LCR)

3.1.1 **Conceptual approach:** The LCR is designed to ensure that a bank has sufficient high quality unencumbered liquid assets to enable it to survive (i.e. to allow it to meet its cash commitments arising over) a short term (30 calendar day) period of significantly severe stress<sup>3</sup>. It therefore requires a bank to consider the cash outflows and cash inflows it can expect to be subject to over the 30 calendar day period of stress, recognising that it is likely to have increased commitments<sup>4</sup> and less available resources<sup>5</sup> as a result of the significantly severe stress, and then maintain a buffer of high quality liquid assets equal to or greater than its expected total

<sup>3</sup> The significant stress scenario is a scenario which incorporates many of the shocks experienced during the crisis that started in 2007 and one for which the bank would need significant liquidity on hand to survive for up to 30 calendar days.

<sup>4</sup> E.g. third parties drawing down on available facilities and possible margin calls etc.

<sup>5</sup> E.g. funding is repaid or withdrawn and replacement funding is harder to find etc.

net cash outflow. Banks will be required to meet the LCR, explained further below, at all times. Formulaically, the requirement is set out as follows:

$$\text{LCR} = \frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflow over the next 30 calendar days}} \geq 100\%$$

- 3.1.2 **Characteristics of high-quality liquid assets:** The stock of high-quality liquid assets which banks must hold under this standard must be unencumbered<sup>6</sup>, easily converted into cash with little loss in value in periods of severe idiosyncratic or market stress. They should ideally also be central bank eligible as this offers further liquidity support in stressed conditions. However, the Committee stresses that central bank eligibility does not in itself constitute an adequate basis upon which to classify an asset as a “high-quality liquid asset”.

The general characteristics of high-quality liquid assets are described in the 2010 Liquidity Paper as follows: low credit and market risk; ease and certainty of valuation; low correlation with risky assets; listed on a developed and recognised exchange market; an active and sizeable market; presence of committed market makers; low market concentration. Historically they reflect those assets which benefit from a flight to quality in times of stress.

Operationally, high-quality liquid assets:

- (a) must be unencumbered, available and managed with the sole/clear purpose of offering contingent funding;
- (b) must not be co-mingled with or used as hedges on trading positions, be designated as collateral or be designated as credit enhancements in structured transactions or be designated to cover operational costs<sup>7</sup>;
- (c) must be under the control of those who manage liquidity risk; and

<sup>6</sup> “Unencumbered” is defined as follows: not pledged (either explicitly or implicitly) to secure, collateralise or credit-enhance any transaction. Assets received in reverse repo and securities financing transactions that are held at the bank, have not been rehypothecated, and are legally and contractually available for the bank’s use can be considered as part of the stock. In addition, assets which qualify for the stock of high-quality liquid assets that have been pledged to the central bank or a public sector entity (PSE) but are not used may be included in the stock.

<sup>7</sup> The Liquidity Paper has provided further clarity on this point and explains that a bank is permitted to hedge the price risks associated with ownership of the stock of liquid assets and still include the assets in the stock. If a bank chooses to hedge the associated risks, the bank should take into account (in the market value applied to each asset) the cash outflow that would arise if the hedge were to be closed out early (in the event of the asset being sold). Client pool securities or cash received from a repo backed by client pool securities should not be treated as liquid assets.

- (d) a proportion of the assets must be monetised on a regular basis through repo or outright sale to the market.

The Committee notes that banks and regulators should be aware that the LCR stress test does not cover expected or unexpected intraday liquidity needs that occur during the day and disappear by the end of the day. The issue of if and how intraday liquidity risk should be addressed is currently under review by the Committee.

Banks will meet and report the LCR in a common currency but must be able to manage their liquidity requirements in each significant currency to which they are exposed. The 2010 Liquidity Paper introduces a new monitoring tool to facilitate the tracking of any potential currency mismatch issues that could arise (see below).

- 3.1.3 **Level 1 and Level 2 high-quality liquid assets:** The Committee has adopted the two tier classification of high-quality liquid assets set out in the Revised Proposals into Level 1 assets and Level 2 assets. Level 1 assets which can be included without limit and Level 2 assets which can only comprise up to 40%<sup>8</sup> of the stock.

Please see Annex 1 for a complete list of those high-quality liquid assets which qualify as Level 1 and Level 2 assets. In summary, Level 1 assets include cash, central bank reserves, marketable securities representing claims on or guaranteed sovereigns, central banks, non-central government public sector entities assigned a 0% risk-weight under the Basel II Standardised Approach and high-quality sovereign paper.

Level 2 assets include marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities which are assigned a 20% risk weight under the Basel II Standardised Approach for credit risk and high-quality non-financial corporate securities and covered bonds not issued by the bank rate at AA- or above. All Level 2 assets are subject to a 15% haircut.

- 3.1.4 **Total Net Cash Outflows:** Total Net cash outflows are cumulative expected cash outflows less cumulative expected cash inflows over the 30 calendar day period of stress being tested. Total expected cash outflows are calculated by

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<sup>8</sup> The calculation of the 40% cap should take into account impact on amounts held in cash or other Level 1 or Level 2 assets caused by secured funding transactions (or collateral swaps) maturing within 30 calendar days undertaken with any non- Level 1 assets. The maximum amount of adjusted Level 2 assets in the stock of high-quality liquid assets is equal to two-thirds of the adjusted amount of Level 1 assets after haircuts have been applied.

multiplying outstanding balances of various categories or types of liabilities and off-balance sheet commitments by rates expected to run off or be drawn down. Total expected cash inflows are calculated by multiplying outstanding balances of various categories of contractual receivables by rates at which they are expected to flow in under the scenario, up to an aggregate cap of 75% of total expected cash outflows. This 75% cap which effectively means that a bank must maintain a minimum amount of Stock Liquid assets equal to 25% of the expected outflows.

The 2010 Liquidity Paper identifies in great detail the assets and liabilities which can be taken into account in such calculation and, where appropriate, the relevant percentage of each to be included in the formula. As well as expected cash outflows from retail deposits and loss of various types of secured and unsecured funding which is callable or terminable within the 30 day period, Banks are required to account for a number of additional liquidity risk sensitive obligations which arise or increase in a stress scenario such as:

- (a) contingent funding obligations – revocable uncommitted funding lines, guarantees, L/C's;
- (b) drawing by third parties on committed credit and liquidity facilities;
- (c) increased liquidity needs caused by a 3 notch ratings down grade and greater downgrades which trigger specific contractual obligations; and
- (d) increased liquidity needs related to market valuation changes on derivatives (or the collateral securing them).

One of the most debated aspects of the proposals is the liquid asset requirement for credit and liquidity facilities. Under the LCR standard, a bank is required to hold liquid assets equal to the following amounts:

- (a) 5% of the value of committed undrawn “credit and liquidity facilities” to retail and small business customers;
- (b) 10% of the value of committed undrawn “credit facilities” to non-financial corporate, sovereigns and central banks, public sector entities and multilateral development banks;
- (c) 100% of the value of committed undrawn “liquidity facilities” to non-financial corporates, sovereigns and

central banks, public sector entities and multilateral development banks; and

- (d) 100% of the value of committed undrawn “credit and liquidity facilities” to other legal entities. Financial institutions (including banks, securities firms and insurance companies), conduits and special purpose vehicles, fiduciaries and beneficiaries are included in this list of other legal entities.

The difference between a “credit facility” and a “liquidity facility” is of crucial importance to banks given the significant disparity between a holding of 10% and 100% of high-quality liquid assets. The Committee defines a liquidity facility as 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 in the financial markets. Significantly in this respect, general working capital facilities for **corporate entities** (e.g. revolving credit facilities in place for general corporate and/or working capital purposes) should not be classified as liquidity facilities but as credit facilities, therefore attracting the 10% rather than 100% holding requirement. However, where a revolving facility is for a **non-corporate** (i.e. banks and those other legal entities in (d) above) it will attract a 100% liquid asset holding requirement regardless of whether it is classified as a credit or liquidity facility.

Cash inflows cover retail and wholesale funding, lines of credit, repayments under reverse repos and secured lending. However a bank can only include contractually expected inflows under assets which are and which are expected to be fully performing during the 30 day stress period. Additionally a bank will need to monitor and ensure it is not reliant on a small number of funding sources.

The 2010 Liquidity Paper adopts the amendments of levels of inflows and outflows set out in the Revised Proposals making the test less onerous than the one set out in the initial proposals in the December 2009 proposals.

Significant further details has been added to the 2010 Liquidity Paper with respect to the amount of high-quality liquid assets which must be held for credit and liquidity facilities, the practical implications of which are explored at the end of this Memorandum.

### 3.2 The Net Stable Funding Ratio (“NSFR”)

- 3.2.1 **Conceptual approach:** Where the LCR looks at addressing the liquidity risk inherent in a banks short term net cash

position, the NSFR test considers the robustness of a bank's funding position (based on the bank's assets/activities) over a one year period, assuming it is then subject to an institution specific stress of which there is public awareness and which results in:

- (a) a significant decline in profitability or solvency as a result of increased credit, market, operation or other risk;
- (b) a potential downgrade in debt; counterparty credit or deposit rating by any nationally recognised organisation; and/or
- (c) a material event which calls into the question the reputation/credit quality of the Bank.

Broadly this is achieved by requiring banks to increase longer term funding. This is particularly so for illiquid assets and off-balance sheet exposures, securitisation structures and other assets which during the economic crisis proved be a significant liquidity drain in times of stress.

The NSFR is expressly designed to provide structural changes in liquidity risk profiles of institutions, away from short term funding mismatches and towards more stable longer term funding of assets and business assets.

This approach requires a bank to: assess all its assets (on and off balance sheet); identify the illiquid proportion of each asset being that portion which, in all likelihood, could not be monetised<sup>9</sup> within a year in the stress scenario discussed above (referred to as its weighted amount); and then hold equity capital or particular types of longer term debt expected to be reliable sources of funds over a one year time horizon under conditions of extended stress (as outlined below). These types of liabilities are together referred to as “**Stable Funding**”. The amount of Stable Funding which a bank actually holds referred to as its Available Stable Funding (“**ASF**”), and the aggregate weighted value of its assets referred to as is its Required Stable Funding requirement (“**RSF**”). The NSFR requires banks to have more ASF than RSF. Formulaically this is represented as:

$\text{NSFR} = \frac{\text{Available amount of Stable Funding (ASF)}}{\text{Required Amount of Stable Funding (RSF)}} > 100\%$
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3.2.2 **Assets requiring Stable Funding (RSF):** Some very high quality low risk assets<sup>10</sup> (e.g. cash, money market

<sup>9</sup> For these purposes an asset can be monetised through sale or use as collateral in a secured borrowing arrangement.

<sup>10</sup> See above for the qualities associated with high quality liquid assets.



instruments and securities and loans to financial institutions with maturities of less than one year) will require no Stable Funding to support them. A proportion of all other assets, ranging from 5% to 100% of their value (described as their “**RSF Factor**” in the 2010 Liquidity Paper), are considered illiquid for these purposes and must be supported by Stable Funding. Thus, for example, it is proposed that highly rated unencumbered marketable securities issued by sovereigns, central banks, and certain other highly rated institutions, with maturities of greater than one year and for which deep/active repo markets exist will require Stable Funding equal to 5% of their value; particular highly rated unencumbered corporate and covered bonds require Stable Funding equal to 20% of their value; holdings in gold will require Stable Funding equal to 50% of their value and other assets require similar or additional support up to a maximum of 100% of their value. The 2010 Liquidity Paper followed the suggestions in the Revised Proposals for a reduction of the amount of Stable Funding required to support certain assets, including certain mortgages and loans which qualify for particular risk weights under Basel II and off balance sheet commitments which are allocated a RSF Factor of 65%.

The aggregate RSF for a bank is simply calculated as the aggregate of each asset and off balance sheet item multiplied by the RSF Factor relevant to it. (Refer to 2010 Liquidity Paper Table 2 on page 29 and Annex 2 of the 2010 Liquidity Paper for more details of assets and their RSF Factors.)

- 3.2.3 Details of liabilities constituting Stable Funding:** Stable Funding is described as those types and amounts of equity and debt financing which are expected to be reliable sources of funds over a one year period of stress i.e.: (i) capital; (ii) preferred stock (with maturity equal to or greater than one year); (iii) liabilities with maturity equal to or greater than one year; (iv) that portion of stable deposits which a bank is expected to retain notwithstanding suffering an extended period of idiosyncratic stress; and (v) the portion of wholesale funding with maturities of less than a year that is expected to stay with the institution for an extended period in an idiosyncratic stress event.

The ASF is calculated as follows. The carrying value of all equity and liabilities referred to in (i) to (v) above are assigned to one of 5 categories, each of which categories has a percentage multiplier (“**ASF Factor**”) allocated to it. The ASF Factor is intended to reflect the availability and quality of the Stable Funding type for these purposes. Unsurprisingly, Tier 1 and Tier 2 capital and funding with an actual maturity over 1 year form the highest quality liabilities,



and carry an ASF Factor of 100% (meaning it is available in full to support illiquid assets). All other funding is graded with an ASF Factor of between 0% and 90%. The carrying value of each equity or liability item is multiplied by the ASF Factor relevant to it and the aggregate sum of such amounts is the ASF for the bank. The 2010 Liquidity Paper (see Table 1 on page 27) provides further detail on what can be included (for example extended borrowing under central bank lending facilities outside regular money market operations are excluded) and the applicable ASF Factors. The Revised Proposals indicated areas (e.g. SME and Retail deposits) where the Committee was considering whether the ASF Factor could be increased to give more credit to the extent such liabilities are recognised. These have been reflected in the 2010 Liquidity Paper.

- 3.2.4 Implications of the NSFR:** Previously liquidity and capital were seen as two separate concepts, but this approach recognises there is a complex interrelationship between the two as highlighted by the economic crisis<sup>11</sup>. Requiring high quality liabilities to back particular types of assets has, historically, been the realm of capital, as opposed to liquidity, rules. In some ways the NSFR test is more blunt than the equivalent capital rules as it applies irrespective of the accounting treatment of the assets involved (i.e. whether trading, available for sale or held to maturity) and whether on or off the balance sheet. The implications of this test seem likely to prove costly and to act as a direct restraint on balance sheet growth in some areas.

## 4 Monitoring Tests

### 4.1 The Four Metrics

Separately, the 2010 Liquidity Paper sets the following five metrics as the minimum tools to indicate liquidity trends or potential/ actual liquidity difficulties and which are to be included in the overall liquidity risk framework implemented by a bank.

- 4.1.1 Contractual maturity mismatch:** This measures the mismatch between cash inflows and cash outflows over various time periods; these are currently suggested as overnight, 7 and 14 days, 1,2,3, 6 and 9 months and 1,2, 3, 5 years and over 5 years.
- 4.1.2 Concentration of funding sources:** This identifies significant wholesale funding sources withdrawal of which

<sup>11</sup> In the economic crisis credit failures in particular markets lead to lack of liquidity in those markets as well as causing capital write downs. Due to the interconnectedness of markets the liquidity failures had repercussions across all financial markets causing or further exacerbating credit and capital constraints, for instance by requiring “fire sales” to raise liquidity, which further drove down asset prices and capital levels.

could trigger liquidity problems. For these purposes funding from each significant counterparty, product or instrument and currency<sup>12</sup> is to be tested over different time periods of 1 month, 1 to 3 months, 3 to 6 months and 6 to 12 months and over 12 months.

- 4.1.3 Available unencumbered assets:** The aim of this test is to require banks to monitor and report the quantity, type, currency and location of available unencumbered assets which could be used to raise additional liquidity at reasonable cost and subject to reasonable haircuts. Consequently banks will be required to report the haircut which would apply to the relevant assets in the secondary market or at the relevant central bank where the bank would normally access liquidity and then estimate the expected monetised value of each such asset. Banks can only include assets for which procedures are already in place which allow the asset to be monetised. In addition, Banks must report assets by significant currency.<sup>13</sup>
- 4.1.4 LCR by significant currency:** This test was introduced in the 2010 Liquidity Paper and its aim is to capture potential currency mismatches as discussed above at 3.1.2. Whilst the standards are required to be met in one single currency, banks and supervisors should also monitor the LCR in significant currencies.

The metric:

**Foreign Currency LCR= Stock of high-quality liquid assets in each significant currency/ Total net cash outflows over a 30-day time period in each significant currency** (*note: amount of total net foreign exchange cash outflows should be net of foreign exchange hedges*)

The definition of the stock of high-quality foreign exchange assets and total net foreign exchange cash outflows should mirror those of the LCR for common currencies.

As the foreign currency LCR is a monitoring tool rather than a standard it does not have an internationally defined minimum required threshold. Nonetheless, the Committee provides that supervisors in each jurisdiction could set minimum monitoring ratios for the foreign exchange LCR, below which a supervisor should be alerted.

- 4.1.5 Market related data:** General market data allows supervisors to assess the markets generally and also analyse the position

<sup>12</sup> A significant counterparty, product/instrument and currency is one which accounts for more than % of a bank's total liabilities.

<sup>13</sup> A currency is significant if unencumbered assets denominated in that currency represent 5% or more of total unencumbered assets.

of a bank within the market, whether it is subject to particular risks having regard to its business profile and whether the assumptions it is adopting are sufficiently robust. It includes:

- (a) market wide information on the general behaviour of the markets derived from e.g. equity prices, specific market data (e.g. from debt, foreign exchange and commodities markets);
- (b) financial sector information which tracks the financial sector relative to the market more generally;
- (c) bank specific information which indicates how an institution is viewed relative to its peers and for example whether other institutions are losing confidence in it e.g. through equity prices, CDS spreads the price/yield of that bank debt etc).

## 4.2 Frequency of Calculation and Reporting

The Committee provides that the metrics set out in the 2010 Liquidity Paper should be used on an ongoing basis to help monitor and control liquidity risks. The LCR should be reported at least monthly, with the operational capacity to increase the frequency to weekly or even daily in stressed scenarios at the discretion of the supervisor. The NSFR should be calculated and reported at least quarterly. The time lag in reporting should be as short as feasible and ideally should not surpass two weeks for the LCR and for the NSFR, the **allowable time-lag** under the capital standards.

## 5 Link with UK regime

The FSA published its own liquidity rules (the “**FSA Rules**”) issued in October 2009 by way of a new Chapter 12 of the Prudential Sourcebook for banks and investment firms (“**BIPRU**”). The BIPRU 12 regime introduced tougher qualitative and quantitative standards, as well as new systems and controls, reporting requirements and international management of liquidity. All aspects of the FSA Rules, other than the Quantitative rules for larger firms (known as Standard ILAS firms), were originally subject to a staggered implementation between November 2009 and December 2010. However, the FSA issued a recent Calibration Statement effectively acknowledging that events had been overtaken by the Basel III 2010 Liquidity Paper and accepting that the FSA would not force its banks to follow a different regime. It has therefore decided to delay indefinitely implementation of the quantitative aspect of the FSA Rules. However, firms are still required to produce an Internal Liquidity Adequacy Assessment, and comply with the overall liquidity adequacy rule, which requires firms to assess for themselves what constitutes sufficient quantity and quality of liquidity resources. The FSA, “*will continue to conduct supervisory reviews of individual firm’s ILAAs which assess their compliance with that rule. and where necessary advise firms that it*

*expects them to hold liquidity reserves that differ in quality and quantity from those which they currently hold’.*

The main differences between the 2010 Liquidity Paper and the FSA Rules, include the following:

- the FSA Rules do require a liquid assets buffer which is driven off a supervisory approved process which includes stress testing, and which considers the impact of an idiosyncratic stress lasting 2 weeks, a market wide liquidity stress lasting 3 months and a combination of the two (this approach obviously has conceptual similarities with the LCR though the duration for the stress is different to the 30 days and one year in the Basel III 2010 Liquidity Paper).
- the FSA's test for liquid assets is tougher than the Basel III 2010 Liquidity Paper test in that highly rated corporate bonds and securities are not permitted, whereas they are under the Basel III 2010 Liquidity Paper. broadly apply the narrower definition of the two possible definitions of which assets are eligible as high quality liquid assets – see paragraph 3.1.3 (though a limited relaxation applies to simpler firms).
- the FSA rules apply to a broad range of financial institutions in addition to internationally active banks and, unless a waiver can be obtained, apply to each operating entity rather than on a consolidated basis.
- although there is no NSFR test, the FSA Rules are focussed on ensuring that a firm's funding duration profile more evenly matches it assets tenor.

## Annex 1

### Level 1 assets

*Level 1 assets are held at market value and are not subject to a haircut under the LCR. However, national supervisors may wish to require haircuts for Level 1 securities based on, among other things, their duration, credit and liquidity risk, and typical repo haircuts. Level 1 assets are not subject to a cap.*

- (a) Cash;
- (b) Central bank reserves, to the extent that these reserves can be drawn down in times of stress;
- (c) Marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government PSEs, the Bank for International Settlements, the International Monetary Fund, the European Commission, or multilateral development banks and satisfying all of the following conditions:
  - (i) Assigned a 0% risk-weight under the Basel II Standardised Approach;
  - (ii) Traded in large, deep and active repo or cash markets characterised by a low level of concentration;
  - (iii) Proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions; and
  - (iv) Not an obligation of a financial institution or any of its affiliated entities.
- (d) For non-0% risk-weighted sovereigns, sovereign or central bank debt securities issued in domestic currencies by the sovereign or central bank in the country in which the liquidity risk is being taken or in the bank's home country; and,
- (e) For non-0% risk-weighted sovereigns, domestic sovereign or central bank debt securities issued in foreign currencies, to the extent that holding of such debt matched the currency needs of the bank's operations in that jurisdiction.

### Level 2 assets

*Level 2 assets can comprise no more than 40% of the overall stock after haircuts have been applied. The Level 2 cap also effectively includes cash or other Level 1 assets generated by secured funding transactions (or collateral swaps) maturing within 30 days. The portfolio of Level 2 assets held by any institution should be well diversified in terms of types of assets, type of issuer (economic sector in which it participates, etc) and specific counterparty or issuer. A minimum 15% haircut is applied to the current market value of each Level 2 asset held in stock.*

- (a) Marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government PSEs or multilateral development banks that satisfy all of the following conditions:
  - (i) Assigned a 20% risk weighted under the Basel II Standardised Approach for credit risk;
  - (ii) Traded in large, deep and active repo or cash markets characterised by a low level of concentration;
  - (iii) Proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions (i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%); and
  - (iv) Not an obligation of a financial institution or any of its affiliated entities.
- (b) Corporate bonds<sup>14</sup> and covered bonds<sup>15</sup> that satisfy all of the following conditions:
  - (i) Not issued by a financial institution or any of its affiliated entities (in case of corporate bonds);
  - (ii) Not issued by the bank itself or any of its affiliated entities (in case of covered bonds);
  - (iii) Assets have a credit rating from a recognised external credit assessment institution (ECAI) of at least AA- or do not have a credit assessment by a recognised ECAI and are internally rated as having a probability of default (PD) corresponding to a credit rating of at least AA-;
  - (iv) Traded in large, deep and active repo or cash markets characterised by a low level of concentration; and

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<sup>14</sup> Corporate bonds in this case only include plain vanilla assets whose valuation is readily available based on standard methods and does not depend on private knowledge, i.e. these do not include complex structured products or subordinated debt. If firms merge, the assets issued by the new firm receive the liquidity value of the respective firm whose assets had the least liquid characteristics before the merger.

<sup>15</sup> Covered bonds are bonds issued and owned by a bank or mortgage institution and are subject by law to special public supervision designed to protect bond holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued instrument.

- (v) Proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%.

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