Liquidity Coverage Ratio (LCR)

A First-Ever: LCR Applies to Assets No Longer on Bank Balance Sheets

Last updated: August 7, 2018

Executive Summary

- **The Liquidity Coverage Ratio (LCR) Rule under Basel III:** The LCR is one of two new liquidity ratios required under Basel III. The Basel III reforms are a direct response to the financial crisis and focus on global regulatory standards on bank capital adequacy and liquidity; these new standards were developed by the Basel Committee on Banking Supervision (BCBS) and endorsed by the G20 leaders. The LCR, in particular, is an effort to reinforce the liquidity risk profiles of banking institutions as it promotes the short-term resilience of a bank's liquidity risk profile by requiring banks to maintain an adequate supply of unencumbered 'high quality liquid assets' (HQLAs) that can be converted into cash easily and immediately to meet its liquidity needs for a 30-day stress period. In the U.S., the LCR requirement was phased in starting in January 2015 and took full effect in January 2017.

- **CMBS Doesn't Make the Cut**: HQLA assets are divided into three levels: 1, 2A, and 2B, with increasing market-value haircuts applied to the HQLA assets based on the level. While IG-rated corporate debt securities are deemed to be Level 2B (25% to 50% haircuts), triple-A rated CMBS do not qualify as HQLAs.

- **Reaching Beyond the Current Balance Sheet:** The LCR applies to CMBS – including those transactions that have been sold and that are no longer consolidated on the balance sheet of any bank – and to construction loans, as well as any credit facility with a revolving line.

- **Impact of the Rule:** While it is difficult to quantify, the LCR most likely has had some impact on the attractiveness of certain CRE-products (e.g., CMBS, CRE CLOs, and construction loans) to banks and other investors. It also plays a role in the redistribution of capital availability to multifamily projects versus non-multifamily projects, given the preferred status of GSE-related securities under the LCR HQLA regime. Market participants across CRE-related sectors and more broadly agree that the LCR has been highly influential in determining relative liquidity levels, raising the attractiveness of those asset classes that are included as HQLAs versus those, like CMBS, that are not HQLA-eligible.

LCR Quick Facts

- LCR applies to CMBS that are no longer on a sponsor's balance sheet.

- Despite historical performance, highly-rated CMBS are not counted as HQLAs unlike other asset classes, such as corporates, which are treated preferentially.

- Zero percent of CMBS triple-A and junior triple-As (AM and AS classes) issued since 2005 have defaulted.

- Treasury's report series, *A Financial System that Creates Economic Opportunities*, recommends several revisions to the LCR, including expanding HQLA eligibility to securities with a proven track record.

- U.S. LCR and HQLA requirements are often considered to be stronger than the international standards adopted by the Basel Committee on Banking Supervision (BCBS).

CREFC Resources

- Industry letter to the US Banking Agencies regarding Liquidity Risk Management, 12.28.2016
- Industry Letter to the US Banking Agencies regarding the Liquidity Coverage Ratio, 03.13.2014

For further Information, visit CREFC's Resource Center at: https://www.crefc.org/library

Potential Solutions

- **Bring CMBS Treatment into Alignment with Other Asset Classes:** U.S. CMBS market participants generally believe the LCR rule should be recalibrated for CMBS in order to better align the treatment of the sector to other similar asset classes and to converge with BCBS standards. Such recalibrations include:

    - Under U.S. LCR requirements, corporate bonds are bucketed as Level 2B and Ginnie Mae Project Loans are bucketed as Level A. Certain triple-A rated CMBS should also be considered as Level 2B HQLAs.

    - BCBS standards allow broad interpretation when applying the HQLA standards within a jurisdiction, and the European Central Bank promulgated rules allowing even private-label residential mortgage-backed bonds to be treated as HQLAs.

    - Furthermore, the BCBS adopted the "Simple, Transparent, Comparable" framework under which high-performing securitization bonds would be allowed safe harbors under capital and liquidity rules. U.S. regulators did not follow through on this work stream, despite the fact that the Europeans have adopted such a regime.

CREFC Policy & Strategy

- **Recommendation:** CREFC members generally agree that the regulators should consider HQLA status for highly-rated private-label CMBS.
- **Support for this recommendation:** CREFC members broadly support any measure that enhances CMBS liquidity.

Additional Background & History

- **Need for Liquidity Requirements:** Liquidity requirements are meant to complement capital requirements as a means to incent good judgment in bank balance-sheet management. The two liquidity requirements, LCR and the Net Stable Funding Ratio (NSFR), were mandated for the first time under the Basel III regime promulgated in the wake of the crisis.
  - The LCR addresses short-term balance sheet liquidity (both asset and funding), seeking to ensure that a firm has enough liquid assets to cover short-term funding obligations given a scenario in which the bank is shut out of debt markets.
  - The framing principle behind the NSFR is to ensure that the bank carries enough long-term debt to cover the risks held on the asset side of the balance sheet.

- **Extreme Reporting Burden:** The rule requires that these banks provide the regulators as many as 80,000 to 100,000 data points daily, many of which had to be mined for the first time for the purposes of compliance with this rule.