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OSFI's Progress on Basel III Implementation: The Liquidity Adequacy Requirements Guideline

The comment period for the draft *Liquidity Adequacy Requirements Guideline* (LAR Guideline) issued by the Office of the Superintendent of Financial Institutions (OSFI) ends on January 24, 2014. The LAR Guideline will apply on a consolidated basis to banks, bank holding companies and federal trust and loan companies (not including insurance subsidiaries). It contains a number of different metrics for measuring short-term liquidity of federal deposit-taking institutions, including:

1. Liquidity Coverage Ratio (LCR)
2. Net Stable Funding Ratio (NSFR)
3. Net Cumulative Cash Flow (NCCF)
4. additional liquidity risk monitoring tools

Details on the application and the reporting requirements of each of the above metrics are discussed at the end of this bulletin.

Minimal Divergence from Basel III Text

The LAR Guideline is based in large part on the Basel Committee on Banking Supervision's (BCBS) *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Basel III Text). The centrepiece of the LAR Guideline, the LCR, adopts the Basel III Text with minor deviations, all of which are noted in the LAR Guideline as inapplicable to Canada. Similarly, all of the additional liquidity risk monitoring tools are also adopted directly and without significant departure from the Basel III Text (with the exception of the contractual maturity mismatch metric, which is subsumed by OSFI's NCCF standard). The NSFR chapter in the LAR Guideline is currently a placeholder until final guidance is issued by the BCBS later this year. The NCCF, which is a Canada-specific metric introduced by OSFI in 2009, marks the one area where OSFI departs from BCBS standards (the Basel III equivalent being the contractual maturity mismatch).

Institutions are expected to comply with the LCR and the additional liquidity risk monitoring tools starting on January 1, 2015. The NSFR is expected to become effective as of January 1, 2018. As noted above, the NCCF, subject to some revisions, has been in effect since 2009.

Subsequent Basel III Updates

Following OSFI's publication of the LAR Guideline, the BCBS published the final *Liquidity Coverage Ratio Disclosure Standards* document (BCBS Disclosure Standard) on January 12, 2014. The BCBS Disclosure Standard requires public disclosure of the LCR and the additional liquidity risk monitoring tools under the Basel III Text starting on January 1, 2015. The disclosure must be published concurrently with the publication of institutions' financial statements and requires a minimum LCR equal to 60%.

On January 14, 2014, the BCBS issued revisions to the NSFR as a consultative document. The NSFR metric has been revised by the BCBS to, among other thing, focus greater attention on short term, volatile funding sources and align the NSFR more closely with the finalized LCR metric. Comments on the BCBS revised NSFR standard can be provided until April 11, 2014.

Related Update: New Leverage Ratio to Replace Asset-to-Capital Multiple (ACM) Test

On January 12, 2014, the BCBS also published the *Basel III Leverage Ratio Framework and Disclosure Requirements* finalizing the leverage ratio framework for financial institutions. The Basel III

Leverage Ratio is designed as a simple, ancillary or supplementary measure to the risk-based capital and liquidity requirements in the Basel III toolkit. The leverage ratio is expressed as a percentage of the "capital measure" divided by the "exposure measure". The capital measure is Tier 1 capital as defined under the Basel III framework and the exposure measure is the sum of on-balance sheet exposures, derivative exposures, securities financing transaction exposures and off-balance sheet exposures. Institutions must attain a minimum Basel III Leverage Ratio of 3% by January 1, 2015.

In light of the adoption of the Basel III Leverage Ratio, OSFI announced that it will replace its Asset-to-Capital Multiple (ACM) requirement, which was first introduced by OSFI in the 1980s, with a Leverage Ratio requirement based on the Basel III Leverage Ratio. OSFI will issue a draft guideline later this year to introduce a new leverage standard to replace the existing ACM standard. The ACM standard differs from the Basel III Leverage Ratio in that the numerator is a much more lenient class of Total Capital as opposed to Tier 1 Capital, while the denominator is more restrictive and does not include off-balance sheet exposures. OSFI has indicated that Canadian institutions will be expected to have leverage ratios that exceed the three percent Basel III requirement and that OSFI will continue to apply more stringent requirements to certain institutions or under specific circumstances as it has done with the ACM in the past.

LAR Guideline: The Details

1. Liquidity Coverage Ratio

The LCR was developed by the BCBS to ensure that institutions have adequate high quality liquid assets (HQLA) to withstand a significant stress scenario lasting 30 calendar days. In general, assets are considered HQLAs if they can easily be converted into cash at little or no loss of value. This determination is made by considering the asset's life, legal risk, inflation risk, foreign exchange risk, ease and certainty of valuation, correlation with risky assets, trading status on a developed and recognized exchange, market size and activity, market volatility, and tendency for market participants to move into that type of asset during a systemic crisis.

The LCR is calculated by comparing the stock of HQLA under stressed conditions to expected cash outflows under the stress scenario parameters. Under the LCR framework, assets fall into various categories based on their characteristics. The categories determine the amount of the "haircut" required by each asset for its inclusion as an HQLA. The proportion of overall HQLA stock that may be comprised of certain asset categories is also limited.

The LCR also provides detailed instructions on how an institution's various cash outflows and inflows are to be calculated for the 30 day period. One significant restriction is that institutions are only ably to rely on expected cash inflows to offset up to 75% of expected total outflows for the period. Thus, institutions are required to maintain a minimum stock of HQLA equal to 25% of expected outflows.

Institutions are expected to maintain a minimum LCR of 100% beginning on January 1, 2015 with no phase in period. The LCR must be reported to OSFI on a monthly basis, with a maximum time lag in reporting of 14 days. Institutions are also required to maintain the operational capacity to increase the frequency of reporting to weekly or daily in stressed situations, should OSFI require it. Beyond regular reporting duties, institutions must immediately notify OSFI if their LCR has fallen or is expected to fall below 100%.

The LAR Guideline notes that OSFI does not consider the alternative liquidity approaches stipulated in the Basel III Text to be applicable in Canada or to the Canadian dollar. As such, those alternative liquidity approaches, including the recent revision to the Basel III Text providing that a central bank committed liquidity facility (CLF) can qualify as HQLA under certain circumstances, are not applicable in Canada.

2. Net Stable Funding Ratio

The aim of the NSFR is to ensure that institutions have "stable funding" on an ongoing, viable entity basis, over a one year, firm-specific, stress scenario. Stable funding is the portion of equity and liability financing that is expected to be a reliable source of funds over a one year time horizon under conditions of extended stress.

Under the NSFR framework, the amount of stable funding required is tied directly to the liquidity characteristics of its assets, certain off-balance-sheet exposures and the activities pursued by the institution. In essence, the less liquid an institution's various assets tend to be, and the more risky its activities, the more stable funding required. The ratio of available stable funding to required stable funding must exceed 100%.

As previously noted, the draft NSFR standard was recently released by BCBS with a comment period ending on April 11, 2014. OSFI has indicated that all references to the NSFR in the Draft Guideline should be viewed as placeholders until final guidance is issued by the BCBS. However, OSFI has also indicated that it expects some form of the NSFR to become a minimum standard by January 1, 2018.

3. Net Cumulative Cash Flow

The NCCF metric measures contractual cash inflows and outflows for various time bands over a twelve month horizon, after the application of certain assumptions. The NCCF also employs a liquidity scenario that combines idiosyncratic and systemic stresses. The purpose of NCCF is to identify potential cash flow shortfalls at different points over a twelve month horizon.

As previously noted, the NCCF is a departure from the BCBS standards and is being adopted by OSFI instead of the "contractual maturity mismatch" profile adopted by the BCBS. Both tools are designed to identify gaps between contractual cash inflows and outflows; however, the NCCF includes a level of detail not found in the contractual maturity mismatch tool and also incorporates a liquidity scenario that assumes certain idiosyncratic and systemic stresses.

The NCCF is calculated by measuring cash inflows from maturing assets and other unencumbered liquid assets against an institution's cash outflows under certain assumptions. Under the NCCF, an institution is required to report its findings in weekly time bands for the first four weeks, a monthly time band for months two to twelve, along with a greater than one year time band. The NCCF is assessed on a consolidated basis, a Canadian currency basis, and a major foreign currency basis.

There is no predetermined minimum NCCF that must be maintained. However, OSFI may require individual institutions to meet a supervisory-communicated, institution specific NCCF upon consideration of market characteristics, institution-specific liquidity metrics and business risks. The NCCF is to be reported on a monthly basis, beginning in January 2015, with a maximum time lag in reporting of 14 days. Institutions are also required to maintain the operational capacity to increase the frequency of reporting to weekly or daily in stressed situations, should OSFI require it. Once OSFI has communicated a specific NCCF to be maintained, an institution is required to immediately notify OSFI if its NCCF has fallen, or is expected to fall, below the supervisory-communicated level.

4. Additional Liquidity Monitoring Tools

In addition to the above metrics, the LAR Guideline outlines a set of additional liquidity monitoring tools that do not have defined regular minimum required thresholds but that must be regularly reported beginning in January 2015. OSFI reserves the right to impose a supervisory requirement for any of the following metrics as required.

Concentration of Funding

This metric is used to identify sources of funding that are of such significance that withdrawal could cause liquidity problems. Under this metric funding liabilities sourced from each significant counterparty, or product/instrument, as a percentage of total liabilities, must be calculated. A list of asset and liability amounts by significant currency must also be provided. This information is to be reported separately for the following time horizons: less than one month, one to three months, three to six months, six to twelve months, and more than twelve months. This information must be reported monthly with a reporting time lag of no more than 14 days.

Available Unencumbered Assets

Under this metric an institution must provide information, including currency denomination and location, regarding its available unencumbered assets. Unencumbered assets are those that are eligible as central bank collateral or, alternatively, can be used as collateral to raise additional HQLA or secured funding in secondary markets. This information must be reported monthly with a reporting time lag of no more than 14 days.

LCR by Significant Currency

While the LCR is measured and reported on a consolidated basis in a single currency, institutions must also report LCR by "significant currency". A currency is deemed significant if the aggregate liabilities of the institution denominated in that currency amount to greater than 5% of the institution's total liabilities. This information must be reported monthly with a reporting time lag of no more than 14 days.

Market-Related Monitoring Tools

Institutions must provide OSFI with information outlining costs of unsecured and secured funding for various tenors and by specific instruments, current short term secured and unsecured funding spreads, material balances held at central banks or other financial institutions, trends in collateral flows, and trends in cross border flows. This information must be reported weekly with a reporting time lag of no more than 3 business days.

Intraday Liquidity Monitoring Tools

This section of the LAR Guidelines contains tools that OSFI intends to use to monitor an institution's ability to manage intraday liquidity risk and meet obligations in a timely manner. An implementation date for reporting these metrics has not been announced and no reporting is required in the near term.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.