



# Module-B Unit-8

## CAIIB PAPER-2

### **BANK Financial Management(BFM)**



## CAIIB Paper 2 (BFM) Module B Unit 8: Basel III Framework on Liquidity Standards

### Objective

- The LCR standard aims to ensure that a bank maintains an adequate level of unencumbered HQLA, that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario specified by supervisors.
- At a minimum, the stock of liquid assets should enable the bank to survive until day 30 of the stress scenario, by which time it is assumed that appropriate corrective actions can be taken.

### Scope

- To start with, the LCR and monitoring tools would be applicable for Indian banks at whole bank level only i.e. on a stand-alone basis including overseas operations through branches.
- However, banks should endeavour to move over to meeting the standard at consolidated level also. For foreign banks operating as branches in India, the framework would be applicable on stand-alone basis (i.e. for Indian operations only).

### Liquidity Coverage Ratio (LCR)

The Liquidity Coverage ratio is computed as under:

$$\frac{\text{Stock of High-Quality Liquid Assets}}{\text{Total Net Cash Outflows over the next 30 calendar days}} \geq 100\%$$

### Calculation of LCR

- As stated in the definition of LCR, it is a ratio of two factors, viz. the Stock of HQLA and the Net Cash Outflows over the next 30 calendar days.
- Therefore, computation of LCR of a bank will require calculations of the numerator and denominator of the ratio, as detailed in the RBI Circular.

## **Liquidity Risk Monitoring Tools**

**In addition to the two liquidity standards, the Basel III framework also prescribes five monitoring tools/ metrics for better monitoring a bank's liquidity position.**

These metrics along with their objective and the prescribed returns are as under:

### **Contractual Mismatch Maturity**

- The contractual maturity mismatch profile identifies the gaps between the contractual inflows and outflows of liquidity for defined time bands. These maturity gaps indicate how much liquidity a bank would potentially need to raise in each of these time bands if all outflows occurred at the earliest possible date.
- This metric provides insight into the extent to which the bank relies on maturity transformation under its current contracts.

### **Concentration of Funding**

- This metric is meant to identify those sources of funding that are of such significance, the withdrawal of which could trigger liquidity problems. The metric thus encourages the diversification of funding sources recommended in the Basel Committee's Sound Principles.
- This metrics aims to address the funding concentration of banks by monitoring their funding from each significant counterparty, each significant product/instrument and each significant currency.

### **Available Unencumbered Assets**

- This metric provides supervisors with data on the quantity and key characteristics of banks' available unencumbered assets. These assets have the potential to be used as collateral to raise additional secured funding in secondary markets and/or are eligible at central banks.

### **LCR by Significant Currency**

- While the LCR standard is required to be met in one single currency, in order to better capture potential currency mismatches, the LCR in each significant currency needs to be monitored.

## Market-related Monitoring Tools

- This includes high frequency market data that can serve as early warning indicators in monitoring potential liquidity difficulties at banks.

## Basel III Liquidity Returns

S. No.	Name of the Basel III Liquidity Return (BLR)	Frequency of Submission	Time Period by which Required to be Reported
1.	Statement on Liquidity Coverage Ratio (LCR)- BLR-1	Monthly	within 15 days
2.	Statement of Funding Concentration- BLR-	Monthly	within 15 days
3.	Statement of Available Unencumbered Assets - BLR-3	Quarterly	within a month
4.	LCR by Significant Currency - BLR-4	Monthly	within a month
5.	Statement on Other Information on Liquidity - BLR-5	Monthly	within 15 days

## Net Stable Funding Ratio

RBI, vide its circular dated May 17, 2018 released the final guidelines on Net Stable Funding Ratio (NSFR). The NSFR guidelines was issued to ensure reduction in funding risk over a longer time horizon by requiring banks to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress. The objective of NSFR is to ensure that banks maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. A sustainable funding structure is intended to reduce the probability of erosion of a bank's liquidity position due to disruptions in its regular sources of funding that would increase the risk of its failure and potentially lead to broader systemic stress.

The NFSR limits overreliance on short-term wholesale funding, encourages better assessment of funding risk across all on- and off-balance sheet items, and promotes funding stability. The Reserve Bank originally proposed to make NFSR applicable to banks in India from January 1, 2018. However, these time lines have undergone

changes. RBI vide its Circular dated 5th February, 2021 deferred the implementation of NSFR upto 30th September, 2021 in view of the ongoing stress on account of COVID-19. Accordingly, the NSFR Guidelines came into effect from October 1, 2021. The NSFR would be applicable for Indian banks at the solo as well as consolidated level. For foreign banks operating as branches in India, the framework would be applicable on stand-alone basis (i.e., for Indian operations only).

The NSFR is defined as the amount of available stable funding relative to the amount of required stable funding. "Available stable funding" (ASF) is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year. The amount of stable funding required ("Required stable funding") (RSF) of a specific institution is a function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its off-balance sheet (OBS) exposures.

$$\text{NSFR} = \frac{\text{Available stable funding (ASF)}}{\text{Required stable funding (RSF)}} \geq 100\%$$

The above ratio should be equal to at least 100% on an ongoing basis. However, the NSFR would be supplemented by supervisory assessment of the stable funding and liquidity risk profile of a bank.

### **Definition and Computation of Available Stable Funding**

The amount of ASF is measured, based on the broad characteristics of the relative stability of an institution's funding sources, including the contractual maturity of its liabilities and the differences in the propensity of different types of funding providers to withdraw their funding. The amount of ASF is calculated by first assigning the carrying value of an institution's capital and liabilities to one of five categories as presented below. The amount assigned to each category is then multiplied by an ASF factor, and the total ASF is the sum of the weighted amounts. Carrying value represents the amount at which a liability or equity instrument is recorded before the application of any regulatory deductions, filters or other adjustments.

<i>Sr. No.</i>	<i>Components of ASF category (liability categories)</i>	<i>Associated ASF factor</i>
(i)	• Total regulatory capital (excluding Tier 2 instruments with residual maturity of less than one year)	100%
	• Other capital instruments with effective residual maturity of one year or more	
	• Other liabilities with effective residual maturity of one year or more	
(ii)	• Stable non-maturity (demand) deposits and term deposits with residual maturity of less than one year provided by retail and small business customers	95%
(iii)	• Less stable non-maturity deposits and term deposits with residual maturity of less than one year provided by retail and small business customers	90%
(iv)	• Funding with residual maturity of less than one year provided by non- financial corporate customers	50%
	• Operational deposits	
	• Funding with residual maturity of less than one year from sovereigns, PSEs, and multilateral and national development banks	
	• Other funding with residual maturity between six months and less than one year not included in the above categories, including funding provided by central banks and financial institutions	
(v)	• All other liabilities and equity not included in the above categories, including liabilities without a stated maturity (with a specific treatment for deferred tax liabilities and minority interests)	0%
	• NSFR derivative liabilities net of NSFR derivative assets if NSFR derivative liabilities are greater than NSFR derivative assets	
	• "Trade date" payables arising from purchases of financial instruments, foreign currencies and commodities.	

### Definition and Computation of Required Stable Funding (RSF)

The amount of required stable funding is measured based on the broad characteristics of the liquidity risk profile of an institution's assets and OBS exposures. The amount of required stable funding is calculated by first assigning the carrying value of an institution's assets to the categories listed in the Table

<i>Sr. No.</i>	<i>Components of RSF category</i>	<i>Associated RSF factor</i>
(i)	<ul style="list-style-type: none"> <li>• Coins and banknotes</li> <li>• Cash Reserve Ratio (CRR) including excess CRR</li> <li>• All claims on RBI with residual maturities of less than six months</li> <li>• "Trade date" receivables arising from sales of financial instruments, foreign currencies and commodities.</li> </ul>	0%
(ii)	<ul style="list-style-type: none"> <li>• Unencumbered Level 1 assets, excluding coins, banknotes and CRR</li> <li>• Unencumbered SLR Securities</li> </ul>	5%
(iii)	<ul style="list-style-type: none"> <li>• Unencumbered loans to financial institutions with residual maturities of less than six months, where the loan is secured against Level 1 assets as defined in LCR circular dated June 9, 2014 and updated from time to time, and where the bank has the ability to freely re-hypothecate the received collateral for the life of the loan</li> </ul>	10%
(iv)	<ul style="list-style-type: none"> <li>• All other 'standard' unencumbered loans to financial institutions with residual maturities of less than six months not included in the above categories</li> <li>• Unencumbered Level 2A assets</li> </ul>	15%
(v)	<ul style="list-style-type: none"> <li>• Unencumbered Level 2B assets</li> <li>• HQLA encumbered for a period of six months or more and less than one year</li> <li>• 'Standard' Loans to financial institutions and central banks with residual maturities between six months and less than one year</li> <li>• Deposits held at other financial institutions for operational purposes</li> <li>• All other assets not included in the above categories with residual maturity of less than one year, including 'standard' loans to non-financial corporate clients, to retail and small business customers, and 'standard' loans to sovereigns and PSEs</li> </ul>	50%

<i>Sr. No.</i>	<i>Components of RSF category</i>	<i>Associated RSF factor</i>
(vi)	<ul style="list-style-type: none"> <li>Unencumbered 'standard' residential mortgages with a residual maturity of one year or more and with the minimum risk weight permitted under the Standardised Approach 7</li> </ul>	65%
	<ul style="list-style-type: none"> <li>Other unencumbered 'standard' loans not included in the above categories, excluding loans to financial institutions, with a residual maturity of one year or more and with a risk weight of less than or equal to 35% under the Standardised Approach</li> </ul>	
(vii)	<ul style="list-style-type: none"> <li>Cash, securities or other assets posted as initial margin for derivative contracts and cash or other assets provided to contribute to the default fund of a CCP</li> </ul>	85%
	<ul style="list-style-type: none"> <li>Other unencumbered performing loans with risk weights greater than 35% under the Standardised Approach and residual maturities of one year or more, excluding loans to financial institutions</li> </ul>	
	<ul style="list-style-type: none"> <li>Unencumbered securities that are not in default and do not qualify as HQLA/SLR with a remaining maturity of one year or more and exchange-traded equities</li> </ul>	
	<ul style="list-style-type: none"> <li>Physical traded commodities, including gold</li> </ul>	
(viii)	<ul style="list-style-type: none"> <li>All assets that are encumbered for a period of one year or more</li> </ul>	100%
	<ul style="list-style-type: none"> <li>NSFR derivative assets net of NSFR derivative liabilities if NSFR derivative assets are greater than NSFR derivative liabilities</li> </ul>	
	<ul style="list-style-type: none"> <li>5% of derivative liabilities as calculated according to para 8.1</li> </ul>	
	<ul style="list-style-type: none"> <li>All other assets not included in the above categories, including non-performing loans, loans to financial institutions with a residual maturity of one year or more, non-exchange-traded equities, fixed assets, items deducted from regulatory capital, retained interest, insurance assets, subsidiary interests and defaulted securities</li> </ul>	
	<ul style="list-style-type: none"> <li>All restructured 'standard' loans which attract higher risk weight and additional provision</li> </ul>	

Sr. No.	Off-balance Sheet Items which require stable Funding	Associated RSF factor
(i)	Irrevocable and conditionally revocable credit and liquidity facilities to any client	5% of the currently undrawn portion
(ii)	Other contingent funding obligations, including products and instruments such as:	
	• Unconditionally revocable credit and liquidity facilities	5% of the currently undrawn portion
	• Non-contractual obligations such as:	
	– potential requests for debt repurchases of the bank's own debt or that of related conduits, securities investment vehicles and other such financing facilities	
	– structured products where customers anticipate ready marketability, such as adjustable rate notes and variable rate demand notes (VRDNs)	
	– managed funds that are marketed with the objective of maintaining a stable value	
(iii)	• Trade finance-related obligations (including guarantees and letters of credit)	3% of the currently undrawn portion
	• Guarantees and letters of credit unrelated to trade finance obligations	

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