Morgan Stanley

INVESTMENT MANAGEMENT

Basel III Overview[1]

LIQUIDITY | GLOBAL LIQUIDITY TEAM | 2018

Originally released in 2010, Basel III focuses on preparing for bank runs and market stress while working primarily alongside Basel I and II rather than superseding those reforms.

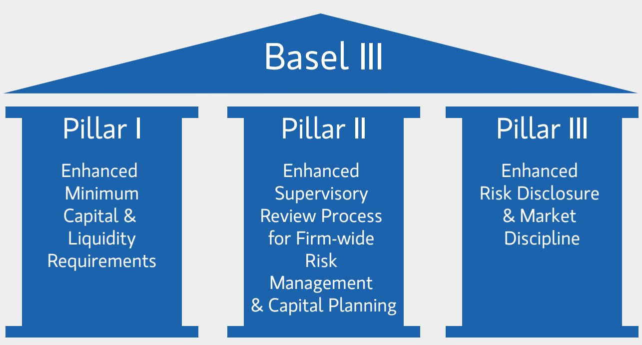
Background

BASEL III SETS INTERNATIONAL REGULATORY FRAMEWORKS FOR BANKS

Basel Committee on Banking Supervision (BCBS) is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability

- Basel III is a comprehensive set of reform measures, developed by the BCBS, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:
  - Improving the banking sector's ability to absorb shocks arising from financial or economic stress
  - Improve risk management and governance
  - Strengthen banks' transparency and disclosures
- Main focus of the reform:

CAPITAL



LIQUIDITY

- Liquidity Coverage Ratio
- Net Stable Funding ratio
- Principles for Risk Management and Monitoring

[1] Source: Morgan Stanley and the Basel Committee on Banking Supervision

Key Ratios

- **LIQUIDITY COVERAGE RATIO (LCR):** The objective is to promote the short-term resilience of banks' liquidity risk profiles. It specifically seeks to ensure that banks have a 30 day supply of cash to account for possible outflows under stressed scenarios
- **HQLA:** should be unencumbered in times of stress and, in most cases, eligible for central bank operations

$$\text{LCR} = \frac{\text{Stock of High Quality Liquid Assets (HQLA)}}{\text{Total net cash outflows over the next 30 days}} > 100$$

  - **LEVEL 1:** No haircut – Includes cash, sovereign bonds, and central bank reserves
  - **LEVEL 2A:** Subject to a 15% haircut – Includes certain government, covered, or corporate bonds
  - **LEVEL 2B:** Subject to 25-50% haircut – Includes lower-rated corporates, RMBS, and some equities
- **TOTAL NET CASH OUTFLOWS:** Total cash inflows minus total cash outflows in a stressed scenario for 30 day

Implementation

The Liquidity Coverage Ratio (LCR) implementation timeline could differ across jurisdictions. The Basel rules state that banks should be 60% compliant by 2015 and fully compliant by 2019. The Federal Reserve (Fed) proposal is more stringent, requiring that U.S. firms be 80% compliant by 2015 and fully compliant by 2017.

The Fed's proposal would apply to all internationally active banking organizations–generally, those with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure–and to systemically important, non-bank financial institutions.

Market Impact

- **LCR NUMERATOR IMPACTS:**
  - Demand Dynamic: Banks need to hold more liquidity through buying HQLA, which increases demand
  - Supply dynamic: Banks are discouraged from providing certain types of credit and liquidity facilities for CP, ABCP and Municipal VRDNs, which decreases supply
  - The Fed repo facility will play a large part in filling the supply void, especially for money market funds (MMFs)

- **LCR DENOMINATOR IMPACTS:**

The types of deposits that banks are willing to accept is changing due to different run-off rates for different account types

  - Operating accounts are more attractive than non-operating accounts
  - Does this dynamic lead to MMFs becoming an increasingly viable option for investors?

About Morgan Stanley Investment Management Global Liquidity Solutions

Since 1975, Morgan Stanley Investment Management has managed money market funds and is dedicated to offering clients unique investment solutions through institutional money market funds and highly customised solutions in multiple currencies. The Global Liquidity Solutions team, which has $162 billion[2] in assets under management, is comprised of highly experienced professionals across the U.S. and Europe.

[2] As of October 31, 2018.

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