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The Liquidity Coverage Ratio: the need for further complementary ratios?

Roedl, Marianne

Covenant University, University of Heidelberg

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ABSTRACT

This paper considers components of the Liquidity Coverage Ratio – as well as certain prevailing gaps which may necessitate the introduction of a complementary liquidity ratio. The definitions and objectives accorded to the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) highlight the focus which is accorded to time horizons for funding bank operations. A ratio which would focus on the rate of liquidity transformations and which could also serve as a complementary metric given certain gaps which currently prevail with the Liquidity Coverage Ratio, as well as existing gaps with other complementary liquidity monitoring tools, is proposed.

Key Words: Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR), High Quality Liquid Assets (HQLA), liquidity monitoring tools, objectivity, comparability, transparency, disclosure

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Marianne Ojo¹

Introduction

Whilst the Liquidity Coverage Ratio (LCR)'s objective is aimed at „promoting the short-term resilience of the liquidity risk profile of banks by ensuring that banks have an adequate stock of unencumbered high quality assets (HQLA) that can be converted easily and immediately into cash“ to meet the liquidity needs of private markets for a 30 calendar day liquidity stress scenario, the Net Stable Funding Ratio (NSFR) is targeted at medium to longer term funding activities of banking institutions. By the very nature of the definition of these liquidity standards, the first to be introduced under Basel III, it is not difficult to comprehend why the Liquidity Coverage Ratio constitutes the more crucial standard and hence will be the focus of this study.

The NSFR serves as a complementary standard to the LCR in serving to „limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items“² as well as a „minimum enforcement mechanism.“³

The introduction of these standards is indeed a milestone and being relatively new, further revisions and updates will certainly be incorporated by the Basel Committee to ensure that the standards achieve their desired aims and objectives. For this reason the need for complements to the standards – in the form of other monitoring tools and metrics cannot be over emphasised. The ensuing section of this paper will consider components of the Liquidity Coverage Ratio – as well as certain prevailing gaps which may necessitate the introduction of a new liquidity ratio. As illustrated by the definitions and objectives of the Liquidity Coverage Ratio and Net Stable Funding Ratio, a focus is accorded to time horizons for funding bank operations. A ratio which would focus on the rate of

1 Primary Email contact: marianneojo@hotmail.com

2 Basel Committee on Banking Supervision, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring December 2010 at page 25

3 By:

- Establishing a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a one year horizon;
- Ensuring that long term assets are funded with at least a minimum amount of stable liabilities in relation to their liquidity risk profiles. See *ibid* at paragraphs 119-120

liquidity transformations and which could also serve as a complementary metric given certain gaps which currently prevail with the Liquidity Coverage Ratio, will be considered under the next section.

B. Components of the Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools

The LCR has two components:⁴

- (a) Value of the stock of (High-Quality Liquid Assets) HQLA in stressed conditions; and
- (b) Total net cash outflows, calculated according to the scenario parameters outlined below.

According to paragraph 24 of the *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*,⁵ assets are considered to have characteristics attributable to HQLA if they can be easily and immediately converted into cash at little or no loss of value. Further, it is also stipulated that the liquidity of an asset depends on the underlying stress scenario, the volume to be monetised and the timeframe considered.

As well as the subjective nature of the above-mentioned factors which determine whether an asset is to be considered a high-quality liquid asset, there also exists the need to ascertain whether it is „unencumbered“. The introduction of a metric or ratio would greatly assist in eliminating, to a great extent, the subjectivity also attributable to the need for ascertaining whether an asset is to be classified as an unencumbered high-quality liquid asset, as well as introduce greater accuracy and objectivity – which would facilitate greater consistency and comparability and between jurisdictions in terms of such determination.

As highlighted by the Basel Committee in its consultative document, *Liquidity Coverage Ratio Disclosure Standards*,⁶ there is no sole metric which is capable of quantifying liquidity risk – hence the bank is provided with a choice of disclosing additional quantitative information related to its

⁴ Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' January 2013 para 22, page 6

⁵ See *ibid* at page 7

⁶ Basel Committee on Banking Supervision, Consultative Document 'Liquidity Coverage Ratio Disclosure Standards' July 2013, paragraph 18, see also Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' January 2013 para 174, page 39

internal liquidity risk measurement and management. Monitoring tools outlined through the Basel III liquidity risk framework include: i) Contractual maturity mismatch; (ii) Concentration of funding; iii) Available unencumbered assets; (iv) LCR by significant currency; and (v) Market-related monitoring tools

Such monitoring tools „capture specific information related to a bank’s cash flows, balance sheet structure, available unencumbered collateral and certain market indicators“. The monitoring tool which is most closely related to the rate of liquidity transformations, in my opinion, is the contractual maturity mismatch which „identifies the gaps between the contractual inflows and outflows of liquidity for defined time bands.“

However, further gaps identified – in relation to the LCR, as well as the contractual maturity mismatch, in particular, include the fact that:

- Banks and regulators should be aware that the LCR stress scenario does not cover expected or unexpected intraday liquidity needs.⁷
- The contractual maturity mismatch metric is based solely on contractual maturities with no behavioural assumptions - hence the data not reflecting actual future forecasted flows under the current, or future, strategy or plans, ie, under a going-concern view. Furthermore, contractual maturity mismatches do not capture outflows that a bank may make in order to protect its franchise, even where contractually there is no obligation to do so.⁸

Even though as identified by the Basel Committee, metrics related to the contractual maturity mismatch are useful for examining the potential for a bank to generate an additional source of HQLA or secured funding, as well as provide a standardised measure of the extent to which the LCR can be quickly replenished after a liquidity shock either via raising funds in private markets or utilising central bank standing facilities, it is also reported that the metrics 'do not capture potential changes in counterparties’ haircuts and lending policies that could occur under either a systemic or idiosyncratic event and could provide false comfort that the estimated monetised value of available

⁷ Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' January 2013 paragraph 41 at page 11

⁸ Hence for analysis, supervisors are permitted to apply their own assumptions „to reflect alternative behavioural responses in reviewing maturity gaps“. See *ibid*; paragraph 185 at page 41

unencumbered collateral is greater than it would be when it is most needed.⁹

Further, supervisors are advised to „keep in mind that these metrics do not compare available unencumbered assets to the amount of outstanding secured funding or any other balance sheet scaling factor.“¹⁰

C. Conclusion

In view of the reasons highlighted under section B, and even though the frequency of calculation, reporting of LCR, as well as other considerations are given due attention to, by the Committee, a supplementary metric and ratio in the form of a Liquidity Transformation Rate Ratio (LTRR) may be worth consideration. This would not only introduce greater consistency and objectivity which would facilitate greater comparability between jurisdictions in terms of such determination, but also the added attribute of enhanced disclosure and transparency.

9 Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' January 2013 paragraph 208 page 45

10 And that „to gain a more complete picture, the information generated by these metrics should be complemented with the maturity mismatch metric and other balance sheet data.“ see *ibid*

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