Liquidity Coverage Ratio (LCR) – Executive Summary

A failure to adequately monitor and control liquidity risk led a number of financial firms into difficulty in 2007, and the years that followed, and was a major cause of the Great Financial Crisis. To improve internationally active banks' short-term resilience to liquidity shocks, the Basel Committee on Banking Supervision (BCBS) introduced the LCR as part of the Basel III post-crisis reforms. The BCBS also addressed structural resilience through a second liquidity ratio – the Net Stable Funding Ratio (NSFR), which is presented in another Executive Summary.

The LCR is designed to ensure that banks hold a sufficient reserve of high-quality liquid assets (HQLA) to allow them to survive a period of significant liquidity stress lasting 30 calendar days. The supervisory scenario capturing the period of stress combines elements of bank-specific liquidity and market-wide stress and includes many of the shocks experienced between 2007 and 2012. The 30-calendar-day stress period is the minimum period deemed necessary for corrective action to be taken by the bank's management or by supervisors.

The LCR requires internationally active banks to hold a stock of HQLA at least as large as expected total net cash outflows over the stress period, as summarised in the following formula:

$$\frac{\textbf{Stock of HQLA}}{\textbf{Total net cash outflows over the next 30 calendar days}} \geq \textbf{100\%}$$

However, this floor for HQLA can be breached during periods of stress. Supervisors are expected to provide guidance on the usability of HQLA according to circumstances.

Estimating net cash outflows

Total net cash outflows are defined as the total expected cash outflows minus the total expected cash inflows arising in the stress scenario. The total expected outflows are determined by multiplying the outstanding balances of various categories of liabilities and off-balance sheet commitments by the supervisory rates at which they are expected to run off or be drawn down. Total expected cash inflows are estimated by applying inflow rates to the outstanding balances of various contractual receivables. The difference between the stressed outflows and inflows is the minimum size of the HQLA stock.

HQLA

HQLA are cash or assets that can be converted into cash quickly through sales (or by being pledged as collateral) with no significant loss of value. A liquid asset can be included in the stock of HQLA if it is unencumbered, meets minimum liquidity criteria and its operational factors demonstrate that it can be disposed of to generate liquidity when needed. HQLA include Level 1 assets, which can be included without limit, and Level 2 assets, which cannot exceed 40% of the liquidity reserve. Level 2 assets are themselves subdivided into Level 2A assets, whose value is subject to a 15% haircut, and Level 2B assets, which are subject to higher haircuts but cannot exceed 15% of the stock of HQLA.

Alternative Liquidity Approaches (ALA)

Subject to conditions, jurisdictions that do not have enough assets in their own currency to meet banks' needs for HQLA may use ALA. These include the provision of central bank liquidity facilities, the coverage of liquidity needs in the domestic currency by foreign currency HQLA, and the use of additional Level 2 assets but subject to a higher haircut.

Implementing the LCR

There are three major sets of issues to consider. One relates to the LCR's scope of application since national supervisors may extend it to all banks in their jurisdictions. They may also impose more stringent liquidity requirements because the LCR, like all BCBS standards, is a minimum requirement. The second issue relates to the need to use monitoring tools developed by the BCBS to supplement the LCR. The last issue is about practical implementation considerations. These include the need for supervisors to review the characteristics of the assets that banks use as HQLA and their cash flow assumptions as part of their Pillar 2 Supervisory Reviews. The LCR became a minimum requirement for BCBS member countries on 1 January 2015, with the requirement set at 60% and rising by 10 percentage points annually to reach 100% on 1 January 2019 to avoid disruption to the orderly strengthening of banking systems or ongoing financing of economic activity.

This Executive Summary and related tutorials are also available in FSI Connect, the online learning tool of the Bank for International Settlements.