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ALERT
Liquidity
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A JPMorgan analysis concluded that the Liquidity Coverage Ratio is the most "painful" piece of regulation to hit the sector, and will cost European Banks nearly 12 per cent of their 2012 earnings on average

A Comprehensive Liquidity Regime

The Basel III rules on liquidity, due to be brought into force through the fourth Capital Requirements Directive ('CRD IV') are aimed at strengthening the global banking sector. The new rules emerge as a result of the lessons learnt during the financial crisis which illustrated how adverse market conditions can quickly impact the liquidity margins of a credit institution. To this end, the Basel regime has brought about a number of measures to ensure minimum standards for funding liquidity as well as longer term sustainability in asset funding structures.

Short Term: Liquidity Coverage Ratio

The Liquidity Coverage Ratio ('LCR') will require banks to hold enough easy-to-sell assets to withstand a 30-day run on their funding. It is thus intended to ensure that banks have a stock of unencumbered high quality liquid assets to meet their liquidity needs for the time period of 30 calendar days.

The LCR consists of two components:

- value of stock of high quality liquid assets in stressed conditions; and
- net cash outflows, calculated according to the scenario parameters set by supervisors.

Assets qualifying as liquid assets possess the following fundamental characteristics:

- low credit and market risk;
- ease and certainty of valuation;
- low correlation with risky assets; and
- listed on a developed and recognized exchange market.

Credit institutions should periodically monetise a proportion of the liquid assets through repo or outright sale to market in order to test access to the market, as well as the effectiveness of their processes for monetisation and usability of the assets. This will also minimise the risk on negative signaling during a period of stress.

CRD IV loosened liquidity definitions under Basel III. It states that 60% of the liquidity buffer is to comprise:

- cash;
- transferable assets of extremely high liquidity and credit quality; and
- transferable assets representing claims on, or guaranteed by, the central government of a member state or a third country if the bank incurs a liquidity risk in that member state or third country that it covers by holding those liquid assets.

The remaining 40% can include transferable assets that are of high liquidity and credit quality.

Net cash outflows' are defined as cumulative expected cash outflows less cumulative expected cash inflows. This represents the *net cumulative liquidity mismatch position* under the stress scenario measured at the test horizon.

Cumulative expected cash outflows are calculated by multiplying outstanding balances of various categories or types of liabilities by assumed percentages that are expected to roll-off, and by multiplying specified draw-down amounts to various off-balance sheet commitments. Cumulative expected cash inflows are calculated by multiplying amounts receivable by a percentage that reflects expected inflows under the stress scenario.

Long Term: Net Stable Funding Ratio

The Net Stable Funding Ratio ('NSFR') addresses longer-term structural liquidity mismatches and encourages banks to move away from short-term mismatches. It thus aims to establish a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a one-year horizon. At all times, the NSFR, expressed as the ratio of 'Available Stable Funding' to 'Required Stable Funding', must not fall below 100%.

Required and available funding amounts are determined using weighing factors, reflecting the 'stability' of the funding available and the duration of the assets.

Available Stable Funding ('ASF') is defined as the total amount of Bank's:

- Capital;
- Preferred stock;
- Liabilities with effective maturity of over one year; and

- The portion of non-maturity / term deposits and wholesale funding with maturities of less than one year but that would be expected to stay with the institution over one year during a stress event.

In determining Available Stable Funding, the weighing factors vary from 100% for Tier 1 capital to 90% for core retail deposits and 50% for unsecured wholesale funding.

With respect to the amount of Required Stable Funding ('RSF'), each asset type held by the institution is assigned a 'RSF Factor' which is the amount supervisors believe should be supported with stable funding. Assets that are more liquid and more readily available to act as a source of extended liquidity receive a lower factor, whereas assets considered less liquid require more stable funding. Thus this reflects the possibility of the assets being monetised through sale or used as collateral in a secured borrowing during a liquidity crisis on a one-year horizon. The weighing factors for assets vary from 0% and 5% for cash and government bonds, respectively, to 65% for mortgages, 85% for retail loans, and 100% for other assets.

LCR:

$$\frac{\text{Stock of liquid assets}}{\text{Net Cash outflow over 30 days}} \geq 100$$

NSFR:

$$\frac{\text{Available Stable Funding}}{\text{Required Stable Funding}} \geq 100$$

Monitoring Tools

Over and above the LCR and NSFR, Basel III outlines a number of metrics which banks are to use as constant monitoring tools.

The *Contractual Maturity Mismatch Profile* is intended to evaluate the difference between contractual inflows and outflows for the defined time band. The *Concentration of Funding* metric is intended to identify large exposures to one particular party, product or currency, the withdrawal of which could trigger liquidity problems. Finally, the *Available Unencumbered Assets Metric* provides the institution with data on the quantity and characteristics of its available unencumbered assets.

Key implications

CRD IV sets out reporting requirements for LCR and NSFR during the 'observation periods' for these ratios, ahead of the LCR being implemented in 2015 and the NSFR in 2018. To improve short-term resilience of the liquidity risk profile of financial institutions, the Commission is proposing the introduction of the LCR - after an observation and review period - in 2015; however, institutions will be required to have appropriate liquidity coverage as of 2013. To ensure that the observation period is meaningful, institutions will report to national authorities the elements that are needed to verify that they have adequate liquidity coverage.

The introduction of the LCR will require banks to hold significantly more liquid, low-yielding assets to meet the LCR which will have a negative impact on profitability. Banks are likely to change their funding profile which will lead to more demand for longer-term funding. This funding may not be available from institutional investors that generally seek to reduce their holdings in the financial sector. Banks will need to increase the proportion of wholesale deposits with maturities greater than one year, which is likely to lead to higher funding costs. Managing the NSFR by altering the asset mix will result in an increase in the proportion of short-term assets, reducing the yield.

How can KPMG help?

KPMG's dedicated Risk Consulting team are well placed to assist entities prepare themselves for the entry into force of these new liquidity requirements. Given their extensive experience in advising banks, as well as the depth and quality of their expertise, KPMG are able to provide a professional and comprehensive service.

We can help you navigate the requirements in a number of ways by:

- Assisting you to understand the changes being introduced by the regime and their implications as part of the broader Basel III framework;
- Performing an assessment of the current liquidity position of the institution and assess its readiness to Basel III requirements; and
- Advising on any changes that may need to be affected in order to allow for a more efficient use of the bank's funds for the purposes of maintaining the ratios.

Contact us

To learn more on what the new rules mean for your institution and how to embed these requirements in your organisation contact:

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