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Liquidity Coverage Ratio Primer Guidance for Community Banks

Regulation Update | By Stephen Brown Klinger

The liquidity coverage ratio was first put into place by the Basel Committee on Banking Supervision in January 2013 with the publishing of "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools." With liquidity talk still lingering as one of the main causes for the financial crisis, the rule migrated to the U.S. banking system later that year in October when the Federal Reserve Board proposed the regulation as a method of strengthening liquidity positions at large financial institutions. On Sept. 3, 2014, Liquidity Coverage Ratio (LCR) Rule was finalized by the Federal Reserve (12 CFR Part 249), OCC (12 CFR Part 5), and FDIC (12 CFR Part 329). Generally applicable only to the largest banks, here are the key components:

There are two versions of the LCR: the LCR for banks above \$250 billion and the modified LCR (for banks below this threshold, but above \$50 billion).

The liquidity coverage ratio is measured by dividing high quality liquid assets (HQLA) by the total net cash outflows over the next 30 calendar days.

For the HQLA measure calculation assets are separated into different levels (Level 1, 2A, and 2B), with different haircuts applied to the fair value of each. Level 1 assets are the most favorable, they do not receive a discounted multiple. However, they are limited to securities with only the lowest risk profile, extremely large markets, and the best pledging status at central banks for intraday liquidity needs.

The total net cash outflows are calculated by subtracting the expected outflows minus inflows. The expected inflows are fairly predictable, while projecting the expected outflows is more speculative as it combines contractual obligations and the product of outstanding balances of liabilities times expected run-off rates.

There is a transition period for the calculation of the ratio and the minimum required threshold. Banks subject to the LCR must calculate the ratio on a monthly basis starting in Jan. 1, 2015, and maintain a ratio above 80 percent for 2015. This stair-steps into calculating the ratio on a daily basis starting July 2015, a minimum ratio of 90 percent in 2016, and tops at 100 percent in 2017. Banks subject to the modified LCR have it slightly easier: needing to calculate the ratio starting January 2016 on a monthly basis, maintaining a ratio of 90 percent for 2016, and then 100 percent for the calendar year of 2017 and thereafter.

So the question begs to be asked; why should community bank executives and boards factor the Liquidity Coverage Ratio into their strategic planning? There are two primary reasons:

The shifting of big banks' balance sheets to increase HQLA has supplemented demand for Treasury securities in 2014 as the Fed has tapered purchases. According to FinPro research, the banking industry increased its total holdings in U.S. Treasury Securities from \$193 billion at end of 4Q 2013 to \$404.3 billion at the end of 4Q 2014. More than 85 percent of this increase comes from the nine largest banks in the U.S., all of which are over \$250 billion and are subject to the LCR ([click to see Exhibit 1](#)).

The industries' net increases time within a quarter of the Fed tapering its asset purchase program, stabilizing the demand for Treasury securities and shifting some of the power to control the stability of yield to be contingent on the continued demand from big banks ([click to see Exhibit 2](#)).

However, their appetite is not likely to continue as they build HQLA for the LCR. Subsequently, the yield on Treasuries may increase from their historic low as demand drops; an important point for community banks' interest rate management, product pricing and strategic planning.

The ratio is pretty simple to recite, but there are many nuances to the calculations for the numerator and denominator. This is evident in the fact that the financial institutions qualifying for the modified liquidity coverage ratio are given a break and only need to calculate the measure on a monthly basis. So while the calculation may not be mandatory for community banks, within the calculations are key insights into how regulators view assets eligible for liquidity and assess an institution's future potential cash flow relative to deposit relationships. Perhaps the most interesting is the classification of deposits in how "stable retail deposits" are defined. Whether or not a retail deposit is "stable" or "all other" makes a big difference within the calculation, as the multiplier for projecting "stable retail deposit" run-off is three percent while the multiplier for "all other retail deposits" is 10 percent ([click to see Exhibit 3a](#)). ([click to see Exhibit 3b](#))

This means a large institution that has smaller and more well-rounded accounts has a competitive advantage over others, as it does not have to maintain a smaller portfolio of lower yielding assets in order to satisfy a higher need for HQLAs. For the purposes of calculating projected outflows and multipliers, "stable retail deposits" are defined as "the entire amount of which is covered by deposit insurance, and either (1) held in a transactional account by the depositor or (2) the depositor has another established relationship with a covered company, such that withdrawal of the deposit would be unlikely."

The last part of the definition is a departure from the historic regulatory definition of a "core deposit," in that it acknowledges there is more to a stable/core/loyal deposit than just the balance. As a best practice for community banks, this definition should be a minimal consideration when developing modeling assumptions and projections. FinPro's research has found that when six variables are considered in totality, two of which are account size and number of client relationships, a probability for renewal retention for retail deposits is able to be calculated with a high degree of certainty.

The original Basel Accords were founded primarily to establish a uniform capital framework for large financial institutions as a means to reduce international counterparty risk. The primary focus of Basel III remains true to its roots, with a focus primarily on capital, but the recent financial crisis necessitated a liquidity component as well. While the rule does not apply directly to community banks, the aspects above should be taken into consideration when community banks discuss strategic planning.■

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