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Basel III LCR, deposits strategy and potential business model impact

BTRM Working Paper Series # 1

After all the consultative papers, policy statements, lobbying, revisions and government legislation, the first genuine material regulatory change to banking operations arising as a result of the crash is finally upon us. We mean of course the Basel Committee's Liquidity Coverage Ratio, and while it is true that the requirement isn't at its full 100% level from 1 January, just about every bank will want to ensure that it does post a >100% result from next month. The risk of the extreme negative publicity that would arise should a bank report a lower than 100% level, when all of its peers are doing so, is too great to ignore.

But while the actual calculation of the ratio has been no more challenging than an administrative exercise (the ratio is, after all, a simple one), the impact of the metric's requirements on a bank's business model has been less thoroughly assessed. This is something of an omission because everything from expected return on capital to optimum liabilities mix to internal funds transfer pricing arrangements will be influenced by the need to be LCR compliant.

This article considers the impact of LCR on the balance sheet, particularly the liabilities side, and what it will mean for strategy and returns in the medium term. There are a number of things that banks need to be doing to ensure that their LCR metric is "optimised", and these play to their strategy and customer franchise.

The scope of liquidity risk

If liquidity is defined as the ability to meet obligations when they become due, the important part to understand is exactly what is meant by "when they become due"? Essentially this means in perpetuity, or at least as long as we wish the bank to remain a going concern. In other words, maintenance of liquidity at all times is the paramount order of banking.

The crash of 2007-2008 was as much a crisis of liquidity as it was of capital. Many banks ran a funding regime that was heavily overweight in short-term liabilities and volatile liabilities, such as wholesale funds. That this is accepted as a prime causal factor of the crash is apparent from the way banks are adjusting to the new requirements of Basel III. Basel I and Basel II did not concern themselves with liquidity, only capital. The new regime, which is introduced from January and will be fully implemented by 2019, makes material demands on banks with respect to the way they manage liquidity.

Liquidity Coverage Ratio

To some bankers LCR represented a step-change in liquidity management culture, but that is only because principles accepted as commonplace in the 1980s (and 1880s!) had been discarded by many European and US banks by 2008. Nevertheless sustained compliance with LCR will prove to be a challenge to work towards for many banks, which will now have to demonstrate the tenor behaviour characteristics of their customer liabilities to the national regulator.

The LCR for a bank is given by:

$$\frac{\text{Stock of high quality liquid assets (HQLA)}}{\text{Stressed net cash outflows over a 30-day time period}} > 100\%$$

In other words the LCR requires banks to maintain a liquidity buffer that matches expected cash outflows in a stressed environment. The amount of funds that might be observed in a market stress situation is given by the stress tests that banks run every month, under specified assumptions. The time period covered in the stress test is 30 days. This implies that a stressed environment would last for only a month, which is unrealistically short. For this reason banks should always treat the LCR-driven HQLA as a minimum size to maintain. Equally they should calculate and work to a 90-day time period over which the stress would be assumed to take place for their internal assessments.

Are the stress tests themselves reliable? Any analysis undertaken under assumed conditions is always at risk of inaccuracy, which is why continuous review and back-testing is also part of a bank's risk management regime.

However for this reason adherents of best-practice principles are beginning to suggest that the size of the liquidity buffer should be a function of other metrics, including the following:

- Set at 2.5 times the size of the aggregate of a bank's liabilities that are of less than 1-year maturity;
- Set at 110% of the LCR stressed outflow number.

There are other guidelines one can consider, but the above convey the general idea.

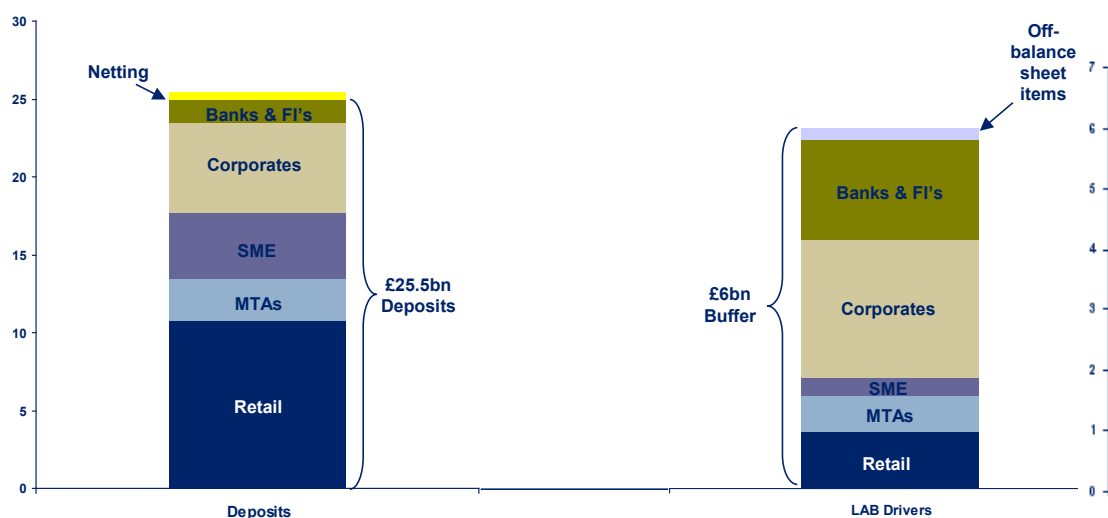
If we accept this, what forum should debate this and who will undertake oversight of these limits? The genuinely appropriate answer to this is the bank's asset-liability committee (ALCO), but only if it is an ALCO with real authority.

Given this, what is the implication of the LCR for the world's banks? In the first instance, that they will all be holding, in differing amounts, a stock of genuinely liquid assets. The challenge comes from the impact this will have on the bottom line, as a risk-free portfolio generates less income (if it is run at a profit at all), and so all else being equal a bank's profits will reduce. However it is not acceptable to suggest, as some practitioners do, that there is a "shortage" of liquid assets with which to populate the HQLA portfolio. One can always hold the HQLA as cash. The HQLA portfolio should be viewed as a cost of doing business, not as an investment portfolio to maximise return on.

The second, more problematic challenge for banks is that in order to optimise the balance sheet from an LCR perspective they will need to understand fully the liquidity value of every different type of customer liability. Basel III defines "stable" and "non-stable" types of funding and customers: the former generate higher assumed outflow results in stressed market conditions, thus increasing the size of the LCR metric. All else being equal, banks will wish to maximise stable liabilities and minimise non-stable ones, but this will not always be possible.

This is when it gets interesting. But there is more to it than that – to really appreciate the impact of LCR calls for a deep understanding of the entire liability structure (excluding equity) of the bank, and the impact of each type of liability on NII. Consider the example of a medium-sized UK commercial bank whose deposit base and LCR outflows are shown at Exhibit 1.

Exhibit 1 Balance sheet drivers of the HQLA portfolio



We conclude the following from Exhibit 1:

- Retail deposits are LCR efficient. The £10.8 of deposits form 43% of this bank's deposits, but due to the lower outflows expected from this customer type, retail outflows are only 15% of the Buffer required (the LCR denominator);
- SMEs place another type of deposit that is LCR efficient, as here SME deposits form ~17% of the overall deposit base, but contribute only 5% of the overall LCR outflows;
- "Operational" deposits such as current accounts appear to be relatively neutral to buffer requirements as those deposits form 10% of the overall 2015 deposit base, and are judged to be 11% of the outflow buffer requirements.

The deposits which carry the highest outflows risk are Corporates, Banks and non-bank FIs. Corporate deposits in Exhibit 1 are shown to be 22% of the balance sheet but account for 38% of the overall buffer. Banks & FIs are only 6% of the overall deposits base but impact 27% of the overall LCR outflows.

Of course, a bank cannot just tell whole swathes of customers that it no longer wants their deposits (or wishes to stop providing them liquidity or revolver facilities) – not unless it wishes some instant bad publicity. If a bank advertises itself as a (for example) "full service corporate bank", then it must accept that its LCR stress outflows will reflect this. The choice then becomes one of (a) redefine its customer value proposition, and target a more focused customer franchise or (b) accept that the cost of the HQLA will be material and that, all else being equal, its return on capital will be lower as a result. Such a bank must accept a substantial base of non-stable deposits and customers, but all else being equal this argues for a higher HQLA and consequently a bigger drag on net interest income (NII). Banks need to have an answer to this issue for internal and external stakeholders.

The "all else being equal" bit is significant, as it always is of course. To compensate for the higher cost of liquidity a bank will address its asset side, but a raft of products offered routinely to large corporates and non-bank FIs, such as liquidity lines and revolving credit facilities, are also treated quite punitively under Basel III. In effect, LCR puts whole groups of customers, and some important ones at that, in the "too expensive to do business with" category. And it is this result that needs addressing. What is less apparent is that any large or medium sized commercial bank has actually addressed its strategy in this way.

In summary we emphasise that banks need to integrate their liabilities strategy and asset origination mix into a coherent whole that emphasises:

- Deposit Growth in medium term and its optimisation potential;
- Deposit growth by customer type / product, with LCR optimisation potential to be assessed as part of the liability strategy exercise;
- LCR optimisation of both deposit growth and back book to be explored.

As part of this a bank needs to be realistic about the behavioural, stable funding factor and tenor characteristics of all of its different liabilities types.

Conclusions

Liquidity management is a discipline that is as old as banking itself, and under the new regime being implemented under Basel III the need to adhere to old-fashioned beliefs on sound liquidity practice is something that will be enshrined in law. However the new funding metrics reflect banking logic, and one feels that the principles behind them should be followed regardless, simply because bank management would be aware of their importance anyway.

The calculation of the LCR metric is not an intellectual challenge. However it is a technology challenge, because in order to optimise the balance sheet for LCR, a bank will need to have good data analytics capability for the entire balance sheet, for both assets and liabilities. This is not the case for many banks.

But perhaps the biggest challenge is for banks to recognise how the metric will impact their particular business model, and to revise their strategy and operating model if necessary to reflect this. A critical first imperative is to assess the LCR results for balance sheet impact, and use this assessment to influence strategy. This means integrating LCR into both the banks liabilities strategy and its internal funds pricing policy (FTP), to ensure that the bank works towards optimising the balance sheet from a regulatory, NII and customer franchise perspective. This is not a trivial undertaking.

About the Author

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