

Liquidity standards: LCR and NSFR

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Before the crisis, liquidity regulation had been left almost entirely to national authorities, with the Committee publishing only guidance on sound practices. The experience of Northern Rock in 2007 and of the investment banks in 2008 demonstrated that a bank could fail from a lack of liquidity long before its capital was exhausted. In September 2008, the Committee published its "Principles for Sound Liquidity Risk Management and Supervision". Two quantitative standards were proposed in December 2010.¹

The Liquidity Coverage Ratio requires banks to hold a stock of unencumbered high-quality liquid assets sufficient to cover their total net cash outflows over a thirty-day period of severe stress. The assets are divided into Level 1, consisting mainly of cash, central bank reserves and high-quality sovereign debt, and Level 2, which includes certain covered bonds, corporate bonds and, within limits, residential mortgage-backed securities and equities. After intense debate about the definition of liquid assets, the final standard was published in January 2013. It was phased in from 2015, starting at 60 per cent and reaching 100 per cent in 2019.²

The Net Stable Funding Ratio addresses the structural side of liquidity. It requires that the amount of available stable funding, weighted by its expected stability over one year, at least equal the amount of required stable funding, which depends on the liquidity characteristics of the bank's assets and off-balance-sheet exposures. The standard was finalised in October 2014 and was to take effect from 1 January 2018.³ Several jurisdictions implemented it late. The European Union introduced it through the amended Capital Requirements Regulation of 2019, applying from June 2021. In the United States, the agencies finalised their rule in 2020.

The liquidity standards reflect an important conceptual shift. The Committee had originally regarded liquidity as a matter for central banks acting as lenders of last resort and for the internal management of banks.

The new standards treat liquidity as a prudential requirement in its own right and thereby partially replace the implicit promise of central bank support with an explicit obligation to self-insure. Critics have argued that the LCR ties up liquid assets that cannot be used in a crisis without breaching the ratio. The Committee has responded by stressing that banks may draw on their liquidity buffers in times of stress and that supervisors should allow them to do so.⁴ The rapid deposit outflows suffered by several regional banks in the United States and by Credit Suisse in 2023 have since reopened the debate about the assumptions on which the LCR rests.

1 Notes

1. Basel Committee, Principles for Sound Liquidity Risk Management and Supervision (September 2008); Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (December 2010). To be verified. ↩
2. Basel Committee, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (January 2013), including the phase-in schedule from 60 per cent in 2015 to 100 per cent in 2019. To be verified. ↩
3. Basel Committee, Basel III: The Net Stable Funding Ratio (October 2014). To be verified. ↩
4. Basel Committee, Basel III: The Liquidity Coverage Ratio (January 2013), paragraph 17, on the usability of the stock of high-quality liquid assets during periods of stress. Paragraph reference to be verified. ↩

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