LIQUIDITY COVERAGE RATIO

NEWS: The RBI's recent circular on the **Liquidity Coverage Ratio (LCR)** aims to improve banks' liquidity resilience while providing them with more resources for lending. By reducing run-off rates on certain deposits, the circular enhances credit growth potential and aligns with global standards, effective from April 2026.

WHAT'S IN THE NEWS?

About Liquidity Coverage Ratio (LCR)

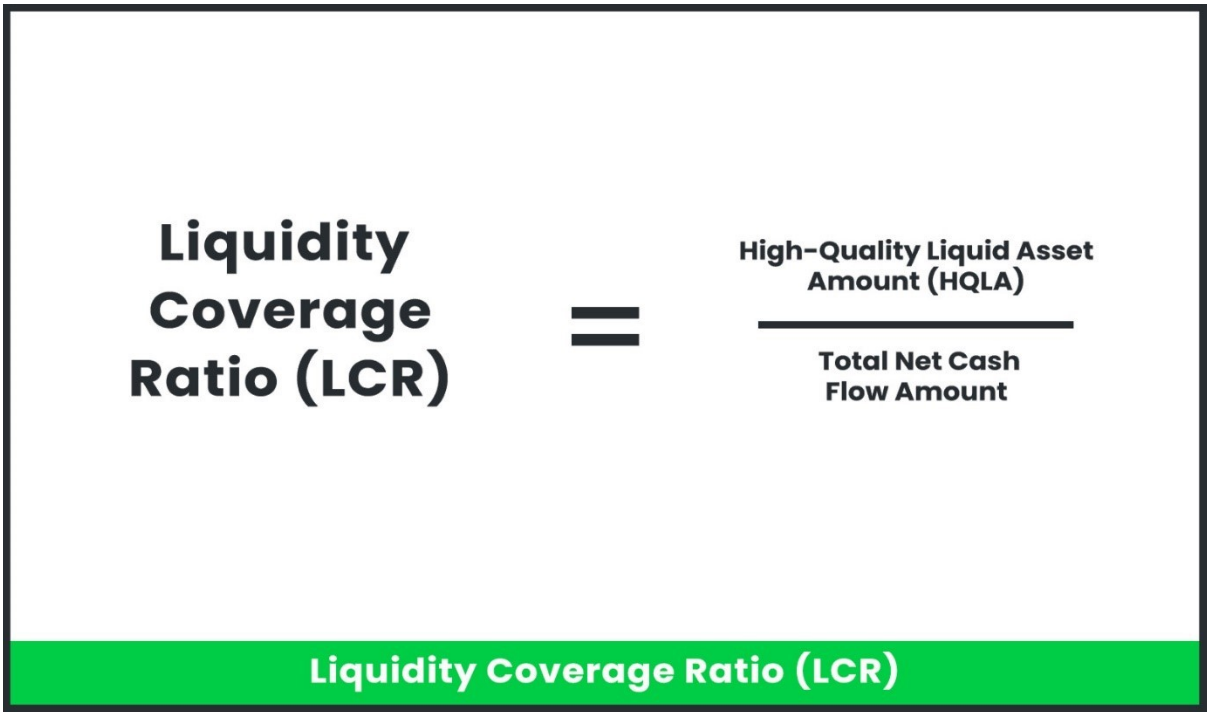
- **Definition and Purpose**:
  The Liquidity Coverage Ratio (LCR) is a key regulatory standard aimed at ensuring that banks maintain an adequate level of liquidity. It is designed to help banks withstand short-term financial stress by mandating that they hold sufficient high-quality liquid assets (HQLAs) to meet potential cash outflows over a 30-day stress period.

- **Operational Mechanism**:
  LCR requires banks to calculate their total expected cash outflows over a stressed 30-day period and ensure they have an equal or greater value of HQLAs available. These assets must be easily and quickly convertible to cash without substantial loss of value, allowing banks to cover unexpected funding needs without resorting to distress sales.

- **Simplified Understanding**:
  In simple terms, the LCR ensures that banks have enough readily available cash-like assets so that even during times of financial panic or market disruption, they can continue operating for at least 30 days without defaulting on obligations or selling critical assets at a loss.

- **Examples of HQLAs**:
  Assets classified as HQLAs typically include government bonds, Treasury bills, and state development loans—securities known for their liquidity, creditworthiness, and low market risk.

- **Basel III Requirements**:
  Under the Basel III global regulatory framework, banks are required to maintain a minimum LCR of 100%. This means that the value of a bank's HQLAs must be at least equal to its projected total net cash outflows over the upcoming 30 days during a hypothetical stress scenario.



Key Concepts

1. Run-off Rate

- **Definition**:
  The run-off rate refers to the proportion of liabilities, such as deposits, that a bank expects could be withdrawn or transferred during a period of financial stress. It reflects customer behavior under panic or market uncertainty.
- **Significance in Liquidity Management**:
  The run-off rate helps banks estimate potential cash outflows under stress. For example, if a particular type of deposit has a 10% run-off rate, the bank must plan for 10% of that deposit amount being withdrawn within the stress period.
- **Impact on LCR Compliance**:
  A higher run-off rate implies that more customers are likely to withdraw their funds, requiring the bank to maintain a larger stock of HQLAs to cover these outflows. Conversely, a lower run-off rate reduces liquidity pressures and allows the bank to allocate more resources to lending and investments.

2. High-Quality Liquid Assets (HQLAs)

- **Definition and Characteristics**:
  HQLAs are assets that can be converted into cash easily and quickly, with minimal loss of value even during periods of market stress. Their marketability and reliability make them critical for managing liquidity risk.
- **Examples**:
  Common examples of HQLAs include:

    - Government bonds (such as sovereign debt securities)
    - Treasury bills (short-term government securities)
    - State Development Loans (SDLs issued by Indian state governments)
- **Importance During Stress**:
  During financial turmoil, banks may need to liquidate assets to meet sudden cash demands. Holding a sufficient quantity of HQLAs ensures they can do so without incurring heavy losses or fueling market panic.

3. Basel III Framework

- **Background**:
  The Basel III framework was developed by the Basel Committee on Banking Supervision in response to the 2007–08 global financial crisis. It introduced reforms to improve the regulation, supervision, and risk management of banks worldwide.
- **Main Objectives**:
  Basel III aims to:
    - Strengthen banks' capital base by requiring higher and better-quality capital.
    - Enhance liquidity standards through tools like the LCR and Net Stable Funding Ratio (NSFR).
    - Minimize systemic risks by reducing the likelihood and severity of banking crises.
- **Role of LCR within Basel III**:
  The LCR is one of the core liquidity requirements introduced under Basel III to ensure that banks can survive short-term liquidity disruptions without relying excessively on external support.

Source: https://www.livemint.com/industry/banking/rbi-new-liquidity-coverage-ratio-norms-guidelines-banks-retail-deposits-lcr-11745410703074.html