BANKING METRICS · EPISODE 14

BANKING METRICS SERIES · LIQUIDITY TOPIC

HIGH-QUALITY LIQUID ASSETS

HQLA — the assets a bank can turn into cash in a crisis. Three levels, two caps and one 30-day test.

BANKING METRIC SERIES

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One Buffer, Three Levels

The Liquidity Coverage Ratio (LCR) numerator applies an haircut to everything the bank could sell

The LCR asks one question: can the bank survive 30 days of severe outflows (e.g., client going to the ATM and withdraw their money) using only the liquid assets it already holds?
The High Quality Liquid Assets contains low-risk assets, easy to value, tradable in a deep market and unencumbered.

LEVEL 1 0% HAIRCUT	**The cash tier.** Coins and banknotes, central bank reserves the bank can draw in stress, and bonds of 0% risk-weight sovereigns. Counted at full value, with no limit.
LEVEL 2A 15% HAIRCUT	**The near-cash tier.** Sovereign and public-sector bonds at a 20% risk weight, plus corporate and covered bonds rated AA– or better. Every €100 of face value enters the buffer at €85.
LEVEL 2B 25–50% HAIRCUT	**The tolerated tier.** Top-rated residential mortgage-backed security (RMBS) (25% haircut), corporate bonds down to BBB– and major-index equities (50% haircut). Those seems liquid in normal times but might not be the same in a crisis

Why the list is so strict

In 2007, AAA-rated securitisations were treated as liquid — until their market vanished in a matter of weeks.
The HQLA definition keeps only what stayed sellable through 2008-style stress, and discounts everything else.

KEY TAKEAWAY

The value into the HQLA is not what an asset is worth now, but what the asset is worth on the worst day you need to sell it. The haircut is that discount.

Two Caps Keep the Buffer Honest

Haircuts price the assets. The caps stop a bank from building its buffer using only lower levels.

The composition rule

- Level 2 assets can never make up more than 40% of the buffer
- Level 2B alone no more than 15%.

Both limits are measured after haircuts, so at least 60% of every HQLA buffer is Level 1, cash-like by construction.

$$\text{Level 1} \geq 60\% \quad — \quad \text{Level 2} \leq 40\% \quad — \quad \text{Level 2B} \leq 15\%$$

What else the rule demands

- **Operational control:** assets must be unencumbered: free to be sold on day one, not pledged as collateral somewhere else.
- **Prove it:**banks must periodically monetize a sample of the buffer, so that selling or repo-ing HQLA is a tested routine, not a first-time event in a crisis.
- **The EU additional rule:** extremely high quality covered bonds squeeze into Level 1 with a 7% haircut, but can never make up more than 70% of the buffer.

KEY TAKEAWAY

Whatever it holds, the majority of HQLA is forced into the assets that behave most like cash.

€160 the economic value, €144 in the Buffer

The haircut arithmetic in one portfolio — and what happens when the buffer is actually needed.

ONE PORTFOLIO · AFTER HAIRCUTS

€144

the HQLA value of €100 in Level 1 assets, €40 in Level 2A bonds and €20 in BBB– corporates.

The mechanism

Level 1 counts in full: €100.
The €40 of Level 2A loses 15% and enters at €34.
The €20 of BBB– bonds loses half and enters at €10.
Then the caps, checked after haircuts: Level 2 is 30% of the buffer and Level 2B is 7%: both within limits.

The buffer is meant to be spent

A liquidity buffer that could never be touched would not be a buffer at all — just a bigger requirement.

In a real stress, the bank sells its HQLA and the LCR falls below 100%: the rules allow it explicitly.
Supervisors then agree a path back to compliance instead – so called Recovery and Resolution plans.

HQLA is the answer to a simple question: what could the bank turn into cash in 30 bad days?
The answer is made in three levels, two caps, and a haircut on every assets.

This is Episode 14 of the Banking Metrics Series. Each episode takes one key metric that banks disclose under Basel III, breaks it down from first principles, and illustrates it with real data.