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New Bank Liquidity Rules in the EU: A Blessing or a Curse?

Liquidity Coverage Ratio (LCR)

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- In December 2010, the Basel Committee called for quantitative requirements in order to enhance banks' capability to absorb liquidity shocks (Liquidity Coverage Ratio, LCR). In July 2013, the EU transposed the Basel LCR requirements into European law by way of the Capital Requirements Regulation (CRR). In October 2014, the European Commission adopted a delegated act that specifies these requirements. They will become binding in October 2015.
- This cep**Input** deals with the LCR rules of the Basel Committee, of the CRR and, particularly, of the delegated act adopted by the Commission in October 2014.
- We illustrate the future challenges banks will be facing, the implicit political agenda followed by the Commission and the wider repercussions to be expected.

Essentials

Essential 1:	**Sovereign bonds privileges:** The LCR as proposed by the Commission privileges sovereign bonds to an extent which exceeds the already preferential treatment proposed by the Basel Committee. The Commission treats all sovereign bonds equally, irrespective of any ratings. This is inacceptable as these assets may not be sufficiently liquid, e.g. because the European Central Bank does no longer accept these bonds as collateral. The Commission's approach leads to a further concentration of risks by giving incentives to overly investing in domestic sovereign bonds, irrespective of their true liquidity. This is counterproductive to overcoming the interlinkage between banks and sovereign debt that has been a major cause of the economic problems Europe faces today.
Essential 2:	**Diversification**: The Commission's delegated act increases the diversity of assets qualifying for the LCR, also with regard to Level 2 assets. This reduces concentration risks and decreases the crowding-out effect of private assets by sovereign bonds. However, as long as the European supervisory framework continues to treat sovereign bonds preferentially – especially by the lack of any own equity coverage – this diversification effect will be contradicted.
Essential 3:	**Promoting of securitisations**: The Commission prematurely classifies certain "high quality" securitisations as liquid Level 2b assets. This can be seen as a means to promote banks' credit granting to the real economy. However, the LCR should be restricted to its function as a liquidity buffer and not be used additionally as an economic policy instrument. Whether or not these securitisations are liquid enough, is unclear at the moment. Moreover, there is a danger that their liquidity is heavily dependent upon the ECB's purchases in the context of its ABS purchase programme (ABS PP). This should be avoided, as it undermines the ECB's independency and provokes conflicts of interest between monetary policy and banking supervision within the ECB.
Essential 4:	**Promotion of covered bonds**: The preferential treatment of some covered bonds contradicts the recommendations given by the European Banking Authority (EBA). It is however justifiable.

CONTENT

1 Introduction

In December 2010, the Basel Committee of the Bank for International Settlements (BIS) presented its proposals to strengthen the prudential regulation for credit institutions and investment firms ("Basel III").[1] Besides numerous requirements such as improving the equity base of banks, introducing new governance rules, leverage requirements and a tougher sanctions regime, the Committee called for quantitative requirements in order to enhance banks' capability to absorb liquidity shocks.

According to the Committee, especially at the outset of the financial crisis, banks faced difficulties in managing their liquidity risks "in a prudent manner", although their capital endowments had been sufficient.[2] In order to tackle these liquidity issues, the Committee proposed two liquidity ratios: the Liquidity Coverage Ratio (LCR) that targets short-term liquidity shocks and the Net Stable Funding Ratio (NSFR) that aims at more stable funding of banks in the longer term.

In July 2011, the European Commission laid down its legislative proposals to transpose the Basel III framework into European law by way of the fourth Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR).[3] After years of intense negotiations, the Commission, the Council and the European Parliament (EP) reached a compromise on the new rules entering into force in July 2013.[4] While the rules on the short-term buffer (LCR) are quite concretely formulated, the framework does not yet include precise provisions on the NSFR.[5]

This cep**Input** focuses on the LCR rules, which are included in the CRR in the European Union. The CRR stipulates that banks have to report to their competent authority on their respective liquid assets. These reporting requirements came into effect in 2013 already. In a next step, the CRR required the Commission to adopt a delegated act by June 2014 defining the LCR as a quantitative requirement to be respected by banks.[6] In defining the LCR, the Commission must take utmost account of the assets that the legislator deemed worth reporting in the first place. "Quantitative requirement" means that banks have to hold a certain stock of assets that are deemed liquid enough to cope with severe liquidity stress. That is, banks must possess either extraordinary high liquidity outflows or exceptionally low inflows or both at the same time.

According to the CRR, the binding liquidity buffer should apply by (January) 2015. As the Commission adopted the delegated act only in October 2014 (instead of June 2014), it decided that the buffer should become binding only in October 2015.

First, we deal with the basics of the LCR as proposed by the Basel Committee. Next, we take a closer look at the provisions on the LCR within the Capital Requirements Regulation (CRR), before addressing the delegated act mentioned above that lays down the quantitative LCR buffer. We will focus our analysis on the delegated act as it will directly impact banks in the upcoming months and years. We illustrate the future challenges banks will be facing, the implicit political agenda followed by the Commission and the wider repercussions to be expected.

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1 For simplicity reasons, credit institutions and investment firms are hereinafter "banks".
2 Bank for International Settlements (2013): Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, p. 2
3 European Commission (2011): Proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms [COM (2011) 452]
4 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [CRR]
5 In October 2014 the Basel Committee issued final standards on the NFRS. The European Commission will deliver its approach to transpose these standards in the coming years.
6 Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions

2 The Basel Committee Liquidity Coverage Ratio: What is it and what is it good for?

The Liquidity Coverage Ratio sets the "stock of unencumbered high quality liquid assets" in relation to the "total net cash outflows over the next 30 calendar days". The numerator must always be equal to the denominator or outpace it.[7, 8]

$$\frac{\text{Stock of unencumbered high quality liquid assets}}{\text{Total net casg outflows expected over the next 30 calendar days}} \geq 100\%$$

The logic behind the ratio is the following:

Banks should be able to cope with a severe liquidity shock for a period of at least 30 calendar days. Thus, they should have enough high quality liquid assets (HQLA) at their disposal to fulfil their cumulated obligations that come due within these 30 days. Hence, the LCR serves as a short-term buffer against liquidity stress. During these 30 days of stress, the bank and its supervisor(s) should find ways either to solve the banks' liquidity problems or, if the problem proves to be a solvency problem, to provide for the orderly recovery or resolution of the bank.

2.1 The numerator: Stock of high quality liquid assets

The Basel Committee makes specifications on those assets that it deems sufficiently liquid and of a high quality.[9] In general, these assets, first, should be

- "liquid in markets during a time of stress"
- "central bank eligible",
- easily convertible into cash[10] and
- "unencumbered", which means that the bank must be able to "liquidate, sell, transfer, or assign the asset" and there are no "legal, regulatory, contractual or other restrictions" that inhibit the bank to do so.[11]

These criteria being fulfilled, the Basel Committee distinguishes between two categories of assets.

- Level 1 assets are most liquid and of the highest quality. This entails, inter alia, cash and cash equivalents, central bank reserves[12], certain marketable securities and sovereign debt. Banks can use these assets to fulfil the LCR requirement in an unlimited way, as long as they have been assigned a zero risk weight under the Basel II Framework. Haircuts are not foreseen by the Basel Committee, but supervisory authorities may apply them. In doing so, they shall take into account "duration, credit and liquidity risk, and typical repo haircuts".[13]
- Level 2 assets are assets such as corporate debt securities, covered bonds and residential mortgage backed securities. They may only represent up to 40% of the required total HQLA stock.

[7] Bank for International Settlements (2013), p.12 and 13
[8] Note: Banks are not allowed to include assets both in the numerator and the denominator.
[9] Bank for International Settlements (2013), p.17-21
[10] Bank for International Settlements (2013), p. 13
[11] Bank for International Settlements (2013), p. 15
[12] Central bank reserves include banks' overnight deposits and term deposits, if they are "repayable on notice" or if they" constitute a loan against which the bank can borrow on a term basis or on an overnight but automatically renewable basis" (Bank for International Settlements (2013), p. 18)
[13] Bank for International Settlements (2013), p. 18

Contrary to Level 1 assets, Level 2 assets are subject to different, but clearly defined haircuts.[14] According to the Committee these mentioned assets fulfil the requirement to be liquid and of a high quality because they (1) are low risk, (2) easy to value, (3) have a "low correlation with risky assets" and (4) are listed on developed exchanges. Furthermore, the markets for those assets are usually "active and sizeable" and their volatility is low.

2.2 The denominator: Total net cash outflows over the next 30 days

The total net cash outflows over the next 30 days are the difference between the "expected" outflows and the "expected" inflows of cash in the upcoming 30 days (in a stress scenario).[15] However, in case the expected inflows turn out to be higher than 75% of the expected outflows, the subtracted amount is capped at 75% of the expected outflows. Thus, in any case, the total net cash outflows cannot fall below a value of one fourth of the expected cash outflows.

2.3 Consequences

The restriction of the subtrahend in the denominator ensures that any bank must hold a stock of HQLA that amounts to at least 25% of the total expected cash outflows. This is to assure that (1) a bank has always a stock of HQLA available and (2) a bank does not solely rely on the expectation of having enough liquid assets flowing in.[16]

[14] Level 2 assets are further subdivided in Level 2a and 2b assets. The latter may be included at the discretion of supervisors. They are comparatively less liquid and include, inter alia, mortgage backed securities.
[15] The Basel Committee abstains from defining „stress scenarios".
[16] Bank for International Settlements (2013)

3 Liquidity Coverage Ratio in the European Union

The EU legislator decided to include the LCR requirement as proposed by the Basel Committee in the Capital Requirements Regulation (CRR).[17] As the consequences of a fast introduction of strict quantitative liquidity buffer requirements were deemed too uncertain, the European legislator decided to first introduce an observation period until 2015. This means, that banks, since 2013, are only required to report their liquid assets, outflows and inflows to their respective competent authorities.[18] Based on the banks' reporting and with the assistance of the European Banking Authority (EBA), the Commission has then been tasked to specify the LCR as a binding quantitative rule until mid 2014. Initially, the plan was then to start applying the quantitative LCR requirement in early 2015.[19] Due to delays in adopting the delegated act specifying the LCR requirement, the EU-Commission decided to postpone the starting date to October 2015. [20,21]

In the following, we first take a closer look at the LCR provisions in the CRR. Next, we deal with the special reports of the EBA on HQLA asset categorisation and on the impact of the LCR on EU banks and their current liquidity position. Finally, we address the delegated act by the Commission specifying the LCR.

3.1 The European LCR in the Capital Requirements Regulation (CRR)

As a general rule, the CRR states that banks have to hold liquid assets as to cover the liquidity outflows less the liquidity inflows under stressed conditions over a period of thirty days. In times of stress, the asset holdings may be used to cover the liquidity outflows.[22] Hence, the CRRs definition of LCR is close to identical with the one of the Basel Committee.

3.1.1 The schedule for introducing LCR as a quantitative rule

In the EU, the LCR shall be introduced as a binding quantitative rule according to the following schedule:[23]

Date	Phase-in[24]
October 2015[25]	LCR of 60% (18 days)
January 2016	LCR of 70% (21 days)
January 2017	LCR of 80% (24 days)
January 2018	LCR of 100% (30 days)

[17] Art. 411 ff. CRR
[18] The reports were considered as a basis for the later detailed calibration of the LCR by the Commission, in particular.
[19] Art. 460 CRR
[20] Commission Delegated Regulation (EU) 2015/61, p. 8
[21] According to Article 460 CRR, the Commission should have adopted a delegated act on the details of the general requirements on the LCR by end of June 2014. It did so only on the 10th of October 2014
[22] Art. 412 CRR
[23] Art. 460 para. 2 CRR
[24] The number of days signals for how many days liquid means must be available in times of stress and assumes a equal distribution of daily net cash outflow over all 30 days .
[25] The CRR stipulated January 2015 as implementation date. However, the Commission decided to postpone the date to October 2015.

Whether this schedule for full implementation is definite, is, however, still to be seen. The European Banking Authority (EBA) will review the phase in of the LCR by end of June 2016. In doing so, the EBA shall take into account international regulatory developments and "Union specificities". In particular, the EBA will assess postponing the "full" implementation of the LCR until the beginning of 2019.[26] If that case, the Commission may adopt a delegated act altering the phase in, so that the LCR has to be met by 90% in 2018 only and full application is necessary only as of 2019.[27,]

3.1.2 Existing reporting requirements in the CRR

Since 2013, banks in the EU must report their liquid assets, outflows and inflows to their respective competent authorities. Taking utmost account of the assets that the legislator deemed worth reporting, the EU Commission will define the LCR as a quantitative requirement.

3.1.2.1 Eligible liquid assets and valuation of assets

The CRR requires banks to report high quality assets (numerator of the LCR).[28] The list of assets is closely aligned with the suggestions made by the Basel Committee, however, substantiates them. It comprises, inter alia[29]

- cash,
- exposures to central banks, that can be withdrawn easily in times of stress ,
- transferable securities of a high liquidity and quality profile,
- transferable assets guaranteed by or representing claims on Member States, the ESM or third country governments with the domestic currency applicable,
- certain standby credit facilities by central banks; however, not emergency liquidity assistance (ELA).

Whereas the Basel Committee reserves the right to decide on haircuts for Level 1 assets to the supervisory authorities and stipulates specific haircut rates for Level 2 assets, the CRR requires a valuation based on market values with "appropriate haircuts" that reflect the "duration, the credit and liquidity risk and typical repo haircuts" in times of market stress for both types of assets.[30]

3.1.2.2 Liquidity outflows

The CRR requires banks to report expected liquidity outflows in the next thirty days. This comprises outflows regarding[31]

- retail deposits that are covered by deposit guarantee or equivalent schemes,
- other outstanding liabilities that come due (operating expenses, secured lending liabilities and capital market-driven transactions) and
- other outflows (e.g. collateral posted for credit derivatives).

For all of these outflows, different run off rates apply as it is expected that even in times of stress not all assets will be withdrawn at the same extent. For instance, dependant on their risk of being withdrawn, retail deposits are multiplied by 5% for rather stable or by 10% for less stable deposits. Stable deposits are deposits, with an "established relationship" between the bank and the deposi-

[26] Art. 461 para. 1 CRR
[27] Art. 461 para. 2 CRR
[28] Art. 416 and Art. 460, CRR
[29] Art. 416 para. 1, CRR
[30] Art. 418, CRR
[31] Art. 420 et seqq. CRR

tor and where the deposits account is a "transactional account" where, for instance, salaries are regularly credited.[32]

3.1.2.3 Liquidity inflows

The CRR requires banks to report expected liquidity inflows in the next thirty days. The CRR considers only "contractual inflows from exposures that are not past due"[33] and where the bank is sure that the obligations will be met in the thirty days timeframe. Similar to the provisions on liquidity outflows, the inflows values are weighed with roll-off rates, in order to reflect the uncertainty of certain inflows actually taking place within a period of stress.[34] As with the Basel Committee, the amount of inflows counting is capped at 75% of the total outflows, to ensure that at least 25% of the expected liquidity outflows are secured by the liquidity stock.

3.1.3 National discretionary measures

Until the quantitative LCR requirement comes into effect in October 2015, Member States can introduce or maintain national liquidity rules.

Until 2018, Member States or competent authorities may demand all or some domestic banks to meet the LCR at higher percentage rates than prescribed in the CRR schedule.[35] Nonetheless, they are not allowed to stipulate a ratio above 100%.[36]

After 2018, once the CRR's LCR requirements have taken full effect, the competent authority may still implement stricter national liquidity measures when risks arise "having serious negative consequences to the financial system and the real economy of a specific Member State". In that instance and based on a proposal by the Commission, the Council may decide with a qualified majority to reject these national measures. If the Commission does not propose a rejection, the competent authorities may apply the national measures for up to two years.[37]

3.1.4 Exceptions

- Assets which were initially considered liquid may become insufficiently liquid and may hence no longer be eligible for LCR purposes. In such case, banks may be allowed to further use these assets for LCR purposes for another thirty days until they have found replacement.[38]
- If a bank fails to comply with the LCR requirement, it has to provide the competent authority with a recovery plan to restore compliance. Until compliance has been reached, banks have to report daily on the assets that are part of the ratio.[39]
- It may be difficult for banks in smaller countries to reach a sufficient currency match, especially when there are not enough liquid assets available in a currency for the bank to be able to comply with the LCR requirement. EBA may propose derogations, which must be confirmed by the Commission.[40]

[32] The EBA issued guidelines on the categorisation in December 2013 (Guidelines on retail deposits subject to different outflows for the purposes of liquidity reporting, 6th of December 2013))
[33] This means pending inflows that should have already flown in in the past.
[34] Art. 425 CRR
[35] This holds true for a possible modified schedule prescribed by EBA in 2016 as well.
[36] Art. 412 para. 5 CRR
[37] Art. 458 CRR
[38] Art. 416 para. 7 CRR
[39] A lower reporting frequency can be adopted by the authorities in discretion.
[40] Art. 419 CRR

3.2 The EBA's Recommendations to the Commission

The CRR explicitly entails mandates for the European Banking Authority (EBA) to publish reports on the definition and categorisation of liquid assets as well as on the impact of the implementation of the LCR requirement.[41] The EBA published its first reports in December 2013 and a second one in January 2015. [42,43,44] The aim of these reports is to give guidance to the EU-Commission when drafting the delegated act clarifying the details on the LCR.[45]

3.2.1 EBA-Report on appropriate definitions and categorisation of liquid assets[46]

EBA qualifies as Level 1 assets[47] sovereign bonds from EEA-countries[48] when they are issued in domestic currency of the EEA state with an ECAI 1[49] rating and an issue size of at least € 250 million plus "appropriately regulated" covered bonds with an ECAI 1 rating and an issue size of at least € 500 million. [50]

The list of Level 2 assets comprises:[51]

- sovereign bonds (also of non-EEA-countries) issued in domestic currency of the issuing state with an ECAI 2[52] rating or better and an issue size of at least € 100 million,
- covered bonds with an ECAI 1 rating and an issue size of at least € 250 million,
- corporate bonds with an ECAI 4[53] rating or better, a issue size of at least € 250 million and less than 10 years remaining until maturity,
- bonds with an ECAI 1 rating which are issued by supranational institutions[54] in EEA-countries and an issue size of at least € 250 million,
- bonds with an ECAI 2 rating or better which are issued by local governments in EEA countries and an issue size of at least € 250 million and less than 10 years till maturity,
- residential mortgage-backed securities (RMBS) with an ECAI 1 rating and an issue size of at least € 100 million and less than 5 years till maturity (with additional EBA conditions[55]).

Interestingly, in its recommendation to the Commission, the EBA partly deviates from its own empirical findings. The empirical analysis of the EBA's report showed some degree of variety in the liquidity profile of EEA sovereign bonds and signals that some covered bonds are liquid enough to

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41 There exist various other mandates for reports to be drafted by EBA. However, we will focus on those two.
42 EBA (2013a): Report on appropriate uniform definitions of extremely high quality liquid assets (extremely HQLA) and high quality liquid assets (HQLA) and on operational requirements for liquid assets under Article 509(3) and (5) CRR
43 EBA (2013b): Report on impact assessment for liquidity measures under Article 509(1) of the CRR
44 EBA (2014): Second report on impact assessment for liquidity measures under Article 509(1) of the CRR
45 Recital 101 CRR
46 This report excludes cash and certain central bank exposures as they are deemed liquid by definition.
47 EBA (2013a), p. 22
48 European Ecomic Area (EEA) includes all EU countries plus Norway, Iceland and Lichtenstein
49 ECAI 1 rating means a rating between Aaa to Aa3 (Moody's) respectively AAA to AA- (Fitch/S&P)
50 EBA concludes that under different regulatory regimes, covered bonds differ in their liquidity profile. Thus, to qualify as category 1 asset they must fulfil requirements like a limit on overcollateralisation, transparency safeguards or preferential treatment in case the issuer becomes insolvent (EBA (2013a), p. 23).
51 EBA (2013a), p. 22 and 23
52 ECAI 2 rating means a rating between A1 to A3- (Moody's) respectively A+ to A- (Fitch/S&P)
53 ECAI 4 rating means a rating between Ba1 to Ba3 (Moody's) respectively BB+ to BB- (Fitch/S&P)
54 That is, inter alia, the Bank for International Settlements (BIS) or the European Stability Mechanism (ESM).
55 Those RMBS have to be, inter alia, first lien residential mortgages and must include only senior tranches (EBA (2013a), p. 23).

qualify as Level 1 assets. However, in order to reach regulatory alignment with the approach taken by the Basel Committee and to prevent a "fragmentation of the single market" and a reinforcement of the state-bank nexus, the EBA recommends that "all" sovereign bonds issued by EEA countries and all bonds issued by EEA supranational institutions should be equally treated as Level 1 liquid assets. Thus, there should be no distinction as regards the credit rating of those bonds, for instance. What is more, covered bonds should not be treated as category 1 assets at all.[56]

3.2.2 EBA-Reports on the LCR's impact

The EBA assessed the impact of introducing of a binding quantitative LCR requirement and concludes in its report (2013) that[57]

- the LCR requirement has no "material detrimental effect" on financial markets, the economy and bank lending given that banks on average have an LCR of 115% and lacking liquidity totals to only 0,8 % of available assets,[58,59,60]
- specialised banks like auto and consumer credit banks "hardly hold any HQLA" and face "critical adjustments" in order to meet the LCR[61],
- the LCR does not leads to a shortfall of lending to SMEs[62]

The EBA therefore recommends the Commission to consider derogations for these specialised banks. In particular, EBA calls for raising the 75 % cap on liquidity inflows for these banks. This should be subject to "stringent conditions" and "objective criteria".

3.3 The EU-Commission's Delegated Act on the LCR

3.3.1 General Approach

Early October 2014, the Commission finally adopted the LCR delegated act laying down the definitions of liquid assets, outflows and inflows.[63] Both the European Parliament and Council decided not to object to the delegated act. Consequently, the delegated act was enacted in January 2015[64] and will take effect starting October 2015.

Alike the Basel Committee, the Commission establishes two different categories of liquid assets (Level 1 and Level 2). The second one is splitted further in a Level 2a and a Level 2b.[65]

The Commission prescribes the following general rules:[66]

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[56] EBA (2013a), p. 26 and 27
[57] The empirical assessment of the report is based, inter alia, on the reporting by the banks to competent authorities. As binding reporting was only necessary for a short period before the release of the EBA report, it also took voluntary reporting and other sources into account. (EBA (2013a), p. 8)
[58] EBA (2013b), p. 10
[59] 66% of the banks covered by the analysis already fully (100%) complied with the LCR requirement at the end of 2012. 17% of the banks comply with the requirement, when taking the phase in into account (LCR>=60%). Consequently only 17% of the banks were non-compliant at the time of the analysis. (EBA (2013b), p. 27)
[60] The second report published in December 2014 shows an aggregated LCR ratio of 117,6%.
[61] EBA (2013b), p. 10 and 11
[62] EBAs analysis revealed that banks that made effort to comply with the requirement did not reduce lending to SMEs and banks more inclined to SME lending have no lower LCR ratios, EBA (2013b), p. 10 and 11
[63] Commission Delegated Regulation (EU) 2015/61
[64] Commission Delegated Regulation (EU) 2015/61
[65] Commission Delegated Regulation (EU) 2015/61, p. 5
[66] Commission Delegated Regulation (EU) 2015/61, Art. 17

- At least 60% of the "total stock of liquid assets" a bank brings forward to satisfy LCR-requirements must be Level 1 assets, at most 40 % may be assets qualifying as Level 2 assets.
- Covered bonds may represent at most 50 % of Level 1 assets or 30% of the total stock.[67]
- Level 2b assets may represent at most 15% of the total stock or 37,5 % of all Level 2 assets.
- In general, assets are valued by their market value. However, Level 2 assets are subject to haircuts, while Level 1 assets, except for covered bonds, are not.[68]

[67] Covered bonds' categorisation as Level 1 assets is one of the major modifications. This aspect is being dealt with in the next chapter.

[68] Commission Delegated Regulation (EU) 2015/61, Art. 9

Figure 1: Asset categorisation

Level 1 assets: – **Coins and banknotes,** – Claims on or guaranteed by central banks and reserves held in a **central bank**[69] – Claims on or guaranteed by public authorities and **governments**, **multilateral development banks** and **international organisations**[70], – Assets issued by **credit institutions with a public background**	Min. 60%	Thereof, these four categories of Level 1 assets: Min. 50%	Haircuts: No
– Extremely high quality **covered bonds**, with an issue size of at least € 500 million, either an ECAI 1 rating or an assigned risk weight of 10%, and an overcollateralisation of 2%.		Covered bonds: Max. 50%	Haircuts: Yes[71]
Level 2 assets: Level 2a assets: – Certain assets representing claims on or guaranteed by public authorities and **governments** that have an assigned risk weight of 20%, – **Covered bonds** with an issue size of at least € 250 million with an ECAI 2 or an assigned risk weight of 20% and an overcollateralisation of 7% or 2%, if minimum issue size is below €500 million, but all other criteria of extremely high quality covered bonds are fulfilled, – **Corporate debt securities** with an issue size of € 250 million, an ECAI 1 rating and a maximum time to maturity of 10 years.	Max. 40 %	Min. 62,5%	Haircuts: Yes[72]
Level 2b assets: – **Asset-backed securities, inclusive mortgage backed securities** meeting specific requirements, – **Corporate debt securities** with an issue size of at least € 250 million, an ECAI 3 rating and a maximum time to maturity of 10 years – **Certain shares** that are part of a major stock index and have been liquid even during stress periods, – **Restricted-use committed liquidity facilities** provided by central banks, – **High quality covered bonds** with an issue size of at least € 250 million and an overcollateralisation of at least 10% plus further distinctive requirements.		Max. 37,5%	Haircuts: Yes[73]

[69] There exist special rules for central banks of non-EU countries.
[70] Government bonds issued by non-EU countries do only qualify as Level 1 assets if they have been assigned a ECAI 1 rating.
[71] A haircut of at least 7% applies.
[72] A haircut of at least 15% applies.
[73] A haircut of 25% or 35% applies to ABS. A haircut of 50% applies to corporate debt securities and shares. No defined haircuts apply to restricted-use committed liquidity facilities. A haircut of 30% apply to covered bonds,

With its categorisation of liquid assets, the Commission by and large follows the approach taken by the Basel Committee. Beyond a number of minor issues, two major modifications deserve special attention.

3.3.2 First major modification: Treatment of covered bonds[74]

Deviating from the Basel Committee's framework and the EBA Recommendation, the Commission qualifies certain "covered bonds" as Level 1 assets. The EBA admitted that these assets "empirically" had an "excellent liquidity performance" but favoured an alignment with the framework of the Basel Committee. Yet, the Commission does not follow EBA's doubts and states that due to their "credit quality, liquidity performance and role in the funding markets", the specific covered bonds shall be treated as Level 1 assets.[75]

Yet, in order to qualify as Level 1 assets, covered bonds must fulfil certain conditions. They must have an ECAI 1 credit rating, an issue size of at least € 500 million and the cover pool must be over-collateralised by at least 2%. Covered bonds that meet these conditions are, however, subject to a haircut of at least 7% on the market value.[76]

Other covered bonds that have a ECAI 2 credit rating, or, if there is no rating available, a risk weight assignment of 20%, as well as an issues size of at least € 250 million and an overcollateralised cover pool of at least 7% shall be treated as Level 2a assets. For these assets, a haircut of at least 15% on the market value shall apply.[77]

Interestingly, the Commission defines further covered bonds as Level 2b liquid assets and, hence, deviates once again from the framework of the Basel Committee. This makes it even easier for institutions to fulfil the LCR requirement. Level 2b high quality covered bonds must fulfil, inter alia, the following conditions: Their issues size must be equal to or outpace € 250 million, must be linked to mortgage backed securities, the pool of underlying assets allow for a low risk weight for credit risk and is overcollateralised by at least 10%.[78]

3.3.3 Second major modification: Treatment of Securitisations

As EBA stated in its report, certain less diversified institutions such as auto or consumer credit banks might face difficulties coping with the LCR requirement and called for derogations for these institutions.

The Commission reacts to EBA's call and widens the scope of securitised assets which qualify as Level 2b assets.[79] The Commission qualifies securitised "auto-loans, SME loans and consumer credits" as Level 2b assets, given an ECAI 1 or equivalent rating and subject to additional conditions.[80] Amongst others, the ABS have to be "in the most senior tranche or tranches of the securitisation and possess the highest level of seniority at all times during the ongoing life of the transaction".[81] Furthermore, the underlying exposures must be "enforceable against any third party" for the ac-

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[74] Commission Delegated Regulation (EU) 2015/61, p. 5
[75] Commission Delegated Regulation (EU) 2015/61, Art. 10 para. 1 lit. f
[76] Commission Delegated Regulation (EU) 2015/61, Art. 10 para. 2
[77] Commission Delegated Regulation (EU) 2015/61, Art. 11 para. 1 lit. c
[78] Commission Delegated Regulation (EU) 2015/61, Art. 12 para. 1 lit. e
[79] The Basel Committee had qualified certain residential mortgage backed securities (RMBS) in the Level 2b category, which are subject to a haircut of 25%.
[80] Commission Delegated Regulation (EU) 2015/61, Art. 12 para. 1 lit. a and Art. 13
[81] Commission Delegated Regulation (EU) 2015/61, Art. 13 para. 2 lit. b

quiring special purpose vehicle, also in case the seller goes bankrupt.[82] The volume of the tranche issued shall be at least € 100 million to ensure enough market liquidity.[83]

This contradicts EBA's position on this aspect. EBA clearly stated in its report that "ABS not backed by residential mortgages" are "found to be insufficiently liquid".[84]

Whereas RMBS and auto-loans ABS shall be subject to a haircut of at least 25% off their market value, for ABS backed by SME-loans[85] and consumer credits a haircut of at least 35% is applied.[86] The Commission claims that including additional ABS will enhance diversification within the assets used to fulfil the liquidity coverage ratio, will "facilitate the financing of the real economy" and hence "contribute to economic growth". Further it argues that the nexus between banks and governments is weakened as the correlation between ABS and government bonds (a Level 1 asset) is low.[87]

3.3.4 Other modifications by the EU Commission

3.3.4.1 Preferential Treatment of stable deposits

Specifying the reporting requirements, the CRR sets the outflow rate of "stable" retail deposits (protected by national deposit guarantee schemes (DGS) at 5% and for less stable retail deposits at 10%. These rates remain in place only until the end of 2018.

From 2019 on, the Commission allows a lower outflow rate of 3% for "stable" retail deposits, if certain conditions are fulfilled:

- The deposits must be covered by a DGS.
- The reduced outflow rate only applies for covered deposits, that is, up to the € 100.000 ceiling.
- The DGS has financial means available that were raised ex ante and has "ready access" to extraordinary contributions from the DGS member and to "additional funding" by public or private third parties.
- Depositors receive repayment from DGS within 7 days.

If a bank wants to profit from such a preferential treatment for stable deposits, his competent authority has to notify the Commission thereof. The preferential treatment is then dependent upon a consenting case by case decision by the EU Commission. [88]

3.3.4.2 Treatment of other deposits

Additionally, the CRR provides for higher outflow rates for certain "other" retail deposits compared to those rates applicable to stable and less stable retail deposits.[89] EBA has been entitled to define those deposits through guidelines.[90] The Commission decided, however, to lay them down within this delegated act, thus making the guidelines obsolete. The Commission subdivides "other retail

[82] Commission Delegated Regulation (EU) 2015/61, Art. 13 para. 2 lit. c
[83] Commission Delegated Regulation (EU) 2015/61, Art. 13 para. 2 lit. c
[84] EBA (2013a), p. 24
[85] Loans used for „capital expenditures or business operations" only. No use for "acquisition or development of commercial real estate. At least 80% of the lenders must be SME.
[86] Commission Delegated Regulation (EU) 2015/61, Art. 13 para. 14
[87] Commission Delegated Regulation (EU) 2015/61, Recital 10
[88] Commission Delegated Regulation (EU) 2015/61, Art. 24 para. 1, 4 and 5
[89] This again is valid only for the reporting requirements.
[90] EBA issued these guidelines in December 2013 [Guidelines on retail deposits subject to different outflows for purposes of liquidity reporting under Capital Requirements Regulation (EU) No 575/2013]

deposits" into two buckets: One with outflow rates between 10% and 15% (Bucket 1) and the other with rates in the range between 15 to 20% (Bucket 2).

To qualify as "other retail deposit", the deposit has to fulfil (some) of the criteria set out in the following table:[91]

Bucket 1: Outflow rates between 10% and 15%	Bucket 2: Outflow rates between 15% and 20%
Total balance: More than € 500.000 in total per client plus **two of the four** following criteria: - Internet only account - Offers an interest rate, inter alia, that "significantly" exceeds the average rate for similar retail products - A fixed-term deposit with a notice period of less than 30 calendar days or which expires within 30 calendar days - Depositor resident in a third country or denominated in a currency other than a Member States' currency.	Total balance: More than € 500.000 in total per client plus **one of the four** following criteria: - Internet only account - Offers an interest rate, inter alia, that "significantly" exceeds the average rate for similar retail products - A fixed-term deposit with a notice period of less than 30 calendar days or which expires within 30 calendar days - Depositor resident in a third country or denominated in a currency other than a Member States' currency. or **Three or more of the <u>five</u>** listed criteria are fulfilled,

3.3.4.3 Derogations on the inflows cap

As prescribed in the CRR, there is a cap on liquidity inflows of 75% of the liquidity outflows to ensure a positive value of the total net outflows and provide for a realistic buffer.[92] This general rule is also applied in the delegated act.[93] Nonetheless, the Commission provides for a couple of exemptions:[94,95]

- Certain intragroup flows and flows within an institution protection scheme shall not fall under the cap, thus, they are counted fully, which means 100%.
- The cap does not apply to banks specialised in "pass-through mortgage-lending", leasing and factoring.
- The cap is raised to 90% for specialised banks that provide consumer credit and auto credit.

The inflows cap exemptions are subject to a prior approval of the competent authority and can only be granted, when the bank is, inter alia, not heavily reliant on retail deposits and its main activities is that for which the exemption is granted and sums up to80% of its total balance sheet.[96]

[91] Commission Delegated Regulation (EU) 2015/61, Art. 25
[92] Art 425 CRR
[93] Commission Delegated Regulation (EU) 2015/61, Art. 33
[94] The EBA suggested these amendments, as well.
[95] Commission Delegated Regulation (EU) 2015/61, Art. 20 para. 1 and Art. 33 para. 1-4
[96] Commission Delegated Regulation (EU) 2015/61, Art. 33 para. 5

4. Liquidity Coverage Ratio-Regulation: An Assessment

The LCR has been proposed in the aftershock of the financial crisis as one has seen banks with sufficient own funds at the edge to bankruptcy due to mismanagement of their liquidity risks. As such, a binding liquidity buffer like the LCR, now put into detail via the delegated act by the Commission, may help reduce the likelihood of a bank run and prevent bank illiquidity in times of stress. Thus, the buffer can help stabilise financial markets.

Nonetheless, (un)intended side effects that come with the introduction of quantitative liquidity ratio should be kept in mind.

- **Sovereign bonds privileges:** The LCR as proposed by the Commission privileges sovereign bonds to an extent which exceeds the already preferential treatment proposed by the Basel Committee. Basel foresaw Level 1 treatment for highly rated (ECAI 1) sovereign debt instruments only. The Commission treats all Member States bonds equally, irrespective of any ratings. Moreover, besides cash and central bank reserves, sovereign bonds are the only type of assets that can be used unlimitedly and without haircut to adhere to the LCR. In concrete terms, this means that a bank is able to fully adhere to the LCR by using, for instance, Greek sovereign bonds only. This is inacceptable as these assets may not be sufficiently liquid. It is absolutely necessary to take account of the level of liquidity as this may well be related to the debtor's solvency. The Commission's argument that "*discriminating between various Member States [...] would create incentives to invest in other sovereign bonds within the Union*" is absolutely correct.[97] What is rather bizarre though is the Commission's conclusion that this *"would result in the fragmentation of the internal market and increase the risk of mutual contagion in a crisis between credit institutions and their sovereigns".*[98] The opposite is the case. The Commission's delegated act gives a further incentive to concentrate risks by overly investing in domestic sovereign bonds, also when their liquidity is not sufficiently given, e.g. because the European Central Bank does no longer accept these bonds as collateral. It is hence counterproductive to overcoming the interlinkage between banks and sovereign debt that has been a major cause of the economic problems Europe faces today.
- **Diversification**: The proposals of the Basel Committee had a quite limited range of assets qualifying as Level 1 and thus adequate for banks to be used to cope with the LCR requirement, e.g. the concentration on sovereign debt securities. The delegated act increases the diversity of qualifying assets, also with regard to Level 2 assets, by including, based on preconditions, dedicated covered bonds and securitisations backed by auto loans, consumer and commercial credit (to SME). Thus, the broader pool of asset types permitted to fulfil the LCR decreases the crowding-out effect of private assets by sovereign bonds and may hence reduce concentration risks. However, as long as the European framework continues to treat sovereign bonds preferentially, especially by the lack of any own equity coverage, this diversification effect will be contradicted.

[97] Commission Delegated Regulation (EU) 2015/61, Recital 6
[98] Commission Delegated Regulation (EU) 2015/61, Recital 6

- **Promoting of securitisations**: Similar to the situation with covered bonds the Commission decided to classify certain "high quality" securitisations with auto loans, commercial and consumer credit as underlying exposures as liquid enough to fall under the bucket of Level 2b assets. This was not foreseen by the Basel Committee. As the Commission concedes, this can be seen as a means to promote banks' credit granting to the real economy.[99] However, the LCR should not be used as an economic policy instrument. Its aim is to guarantee that banks have enough liquid assets available in times of stress. It is, however, not dedicated to push credit granting to the real economy. Especially, there is a danger that securitisations markets' liquidity is dependent upon the ECB's purchases in the context of its ABS purchase programme (ABS PP). This should be avoided, as its undermines the ECB's independency and provokes conflicts of interest between monetary policy and banking supervision within the ECB.

  Securitisations as such may bring about a number of advantages for boosting credit granting to the real economy. And we therefore see the plans of the Commission to define standardised, high quality securitisations with a certain degree of sympathy.[100] However, speaking today, it is fully unclear, whether or not these securitisations will meet the liquidity levels necessary to justify the beneficial treatment proposed by the Commission. It would be better to first introduce the label and reconsider the question of the treatment of securitisations with regard to liquidity issues in a number of years.
- **Promotion of covered bonds**: The Commission's delegated act on the LCR provides for a more preferential treatment of covered bonds as compared to the concept of the Basel Committee. Whereas the latter grades them at most Level 2a assets, the Commission classify at least the most liquid ones as Level 1 assets. This step has been taken against the recommendations given by the European Banking Authority (EBA). However, the EBA explicitly found covered bonds to be very liquid. It advised against treating covered bonds as Level 1 asset only in order to align with the provisions by the Basel Committee. As we do not see the ECB's covered bonds purchases (in the context of the EBS Covered Bond Purchase Programme, CBPP) to be a precondition for ensuring liquidity on covered bonds markets, we believe the Commission's decision to be justifiable.

  Level 1 treatment of covered bonds is particularly relevant for Sweden and Denmark. Both countries witness a comparatively large national covered bonds market. Banks in these countries might have observed major difficulties in complying with the LCR requirement, were covered bonds not accepted as Level 1 assets.

[99] Commission Delegated Regulation (EU) 2015/61, Recital 10

[100] These plans are not only reflected within the LCR delegated act. They are also part of a delegated act on the prudential requirements for insurers (Solvency II), the recently released green paper on the Capital Markets Union and a dedicated consultation paper by the Commission on simple, transparent and standardised securitisations.

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