Briefing Note

CRD IV – Liquidity

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Introduction

The European Commission’s proposal for a Directive and Regulation (collectively known as CRD IV) will replace the existing Capital Requirements Directive and implement the Basel III accord in Europe. Basel III introduces a new liquidity framework, which includes two minimum liquidity risk ratios – a 30-day Liquidity Coverage Ratio (‘LCR’) and a one-year Net Stable Funding Ratio (‘NSFR’) – and application standards.

The LCR aims to ensure banks maintain adequate levels of unencumbered high quality assets against net cash outflows over a 30-day period of significant stress, while the NSFR seeks to establish a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution’s assets and activities over a one year horizon.

For more detail on the liquidity requirements under Basel III please see the AFME Briefing Notes on the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

CRD IV Overview

In the context of the LCR, CRD IV follows the same broad principles as the Basel measure but calls for the reporting of liquid assets that are of high and extremely high liquidity and credit quality and does not use the Basel III definitions or labels of ‘Level 1’ and ‘Level 2’ assets. The European Banking Authority (EBA) has been tasked with reporting to the Commission the appropriate uniform definitions for transferable assets of high and extremely high liquidity and credit quality by 31 December 2013.

The CRD IV does not contain provisions in relation to the NSFR and has set out preliminary reporting requirements to assess the need for and availability of stable funding.

AFME’s Positions

Liquid Asset Buffers*

Key concerns in relation to Basel III which will need to be considered in the context of CRD IV, include (a) the relatively narrow definition of Level 1 liquid assets (which could result in an over-concentration of such assets); (b) the continuing uncertainty around the definition of Level 2 assets; and (c) the potential economic impact on those asset classes not recognised as either Level 1 or Level 2 assets.

There are a range of assets that can provide liquidity within a 30-day time frame, which include (1) central bank eligible assets, (2) other assets such as equities, high quality securitisation, and commodities. Ideally, assets which provide liquidity such as these should be eligible for inclusion in
the liquid assets buffer with appropriate haircuts. If this is viewed as not possible then the liquidity value they provide should as a minimum be recognised in the denominator of the LCR calculation.

It will be important also that there is consistency between the treatment of EU covered bonds and Fannie Mae and Freddie Mac paper in the US to ensure a level playing field.

**Operational Requirements for Holdings of Liquid Assets***

The inability to use assets designated as part of the liquid assets buffer for hedging and other trading purposes is considered a problem. In particular, AFME holds the view that as long as a firm can demonstrate that these assets are ‘tagged’ and that they can be taken by the Treasury/other central function for liquidity purposes in the event of need under a clearly-articulated policy, then the position of the assets and any other purposes for which they are held should not make a difference.

**Liquidity Outflows – Treatment of Corporate Deposits***

CRR Art. 410(5) states that institutions should multiply liabilities arising from client deposits from non-financial customers by 75% to the extent that they are not maintained for clearing, custody or cash management purposes or as part of a task-sharing arrangement within an institutional protection scheme.

The 75% run-off rate is considered punitive. In practice, corporate deposits have been seen to be far more stable during times of crisis and the current treatment will have a significant impact on banks with large corporate business activities. In addition, it should be emphasised that the category ‘corporates’ encompasses a very large range of organisations from large multinationals to comparatively small operations.

Furthermore, the categorisation of corporate deposits maintained for clearing, custody or cash management purposes as a proxy for the identification of ‘more stable’ funding does not properly consider the nature of relationships that corporates often have with banks in Europe which differs significantly from more transactional driven approaches in some other large economies (notably the US).

AFME would recommend therefore that run-off factors used in the LCR calculations must be reconsidered to reflect the main characteristics of corporate deposits in Europe. The criteria for classifying deposits as ‘more stable,’ and thus allowing reduced outflow factors, should also be sufficiently structured to allow the consideration of the real nature of ‘operational relationships’.

**Liquidity Outflows – Derivatives***

The treatment of derivatives under CRD IV has not been well thought through. In particular, the volatility of mark-to-market adjustments and the posting of collateral is considered to be of significantly greater importance than the cashflows associated with the contracts.

In addition, cashflows in relation to derivative exposures should be considered in combination with cashflows, arising from any associated hedges, and at the maturity of a derivative outflows should not be disassociated with the inflows arising from the sale of underlying assets and vice versa. This is particularly relevant in the case of derivatives where there is a contractual commitment to sell to a clearing house at the end of the given term and for derivatives which entail a physical delivery.

**Liquidity Outflows – Treatment of Undrawn Committed Facilities***

Article 412 (3) differs from BCBS paragraph 97 in that it refers to ‘undrawn credit and liquidity facilities’ rather than committed facilities. If such a distinction is intended, this would have a very large effect for firms, including for example the need to consider inter-bank lines. It is recommended therefore that the wording in CRD IV should be amended so that it is consistent with BCBS paragraph 97.

In addition, however, it is considered that the 100% outflow factor assigned to facilities to financial institutions is not appropriate and that a recalibration to reflect more realistic rates is needed.
remains scope also for the consideration of distinctions between liquidity and credit facilities together with the classification of counterparties to a sufficient level of granularity (e.g. for financial institutions – banks, insurance companies, pension funds, private equity firms etc.) based on substance and judgment rather than legal form.

**Liquidity Inflows – Cap on Total Inflows**

Article 413 caps liquidity inflows to 75% of outflows, AFME considers this cap to be inconsistent with well-reasoned approaches to the calculation of the inflows and outflows on a case-by-case basis.

**Liquidity Inflows – Corporate Finance Activities**

CRR Art. 413(2)(a) requires that monies due from customers that are not financial customers shall be reduced by 50% of their value or by the contractual commitment to those customers to extend funding, whichever is higher. However, no differentiation has been made between inflows received under general corporate finance transactions and those received under specific acquisition or project finance transactions. For the latter, there is no rationale to assume a further extension of funding since, by definition, project or acquisition finance is a one-off transaction. In addition, a distinction also needs to be made in relation to revolving loan facilities.

**Liquidity Reporting**

The EBA has been tasked with determining uniform formats for liquidity reporting, liquidity metrics, as well as IT solutions. AFME would remind the EBA to consider the need for common binding templates to avoid gold-plating, the need to take into consideration adequate notification periods for any IT changes, and more broadly the need to collect data on a broad pool of assets for robust and useful analyses for both NSFR and LCR. There are also concerns with regard to reporting in different currencies/foreign exchange positions and the need to ensure this does not implicitly result in LCR requirements by currency. Also, it is essential that public disclosure does not occur before the design and calibration of the new liquidity standards are finalised.

**NSFR**

It will be necessary for the data proposed as part of the preliminary reporting requirements to assess the need for and availability of stable funding to be sufficient to allow the consideration of all recalibration options and other liquidity metrics, including mismatches across different time periods.

**Interaction with the Pillar 2 Framework**

AFME would like to note the importance of considering the interaction of liquidity provisions within the Regulation in the context of the wider Pillar 2 supervisory framework. It remains unclear whether the Regulation is to set forth minimum standards with competent authorities (CRD Art. 84) and for competent authorities to then calibrate these with more specific, and potentially more stringent requirements. It will be important for policymakers and regulators to avoid Member State gold-plating and seek a harmonized and coordinated approach to liquidity regulation and supervision.

**Intra-Group and Home/Host Supervisory Issues**

It is not clear at this stage whether and the extent to which it will be possible for whole firm liquidity waivers, for non-EU banks to create liquidity groups in Europe and/or the extent to which liquidity groups can be created at a member state level. There are also important linkages with the resolution regime that will need to be considered.

**Interest Flows**

Basel III requires the inclusion of interest flows within the calculation of the liquidity ratios but this is not explicitly covered under CRD IV. Clarification of the proposed treatment of interest under CRD IV would be useful as this can have significant implications from an IT systems perspective.
Further information

AFME has broken down positions on the key CRD IV issues in more specific briefing notes:

- Overview of CRD IV
- Capital and Capital Buffers
- Leverage
- Counterparty Credit Risk

See also AFME's materials covering Basel III:

- Overview of Capital Requirements Reform

All of these documents are available on the AFME website.

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