Public Hearing on Liquidity Coverage Requirement (LCR) and Leverage Ratio (LR)

Monday 10 March 2014, 14:00-18:00

Background document

The Leverage Ratio

The 2010 Basel III framework introduced a "simple, transparent, non-risk based leverage ratio that is calibrated to act as a credible supplementary measure to the risk based capital requirements".

According to the Basel III framework the LR aims at: 1) constraining the build-up of leverage in the banking sector, and 2) acting as a backstop to risk-based capital requirements. The LR is defined as follows:

$$LR = \frac{Tier\ 1\ capital}{exposure\ measure}$$

While there is no difference between the numerator of the LR and the numerator of the Tier 1 capital ratio (i.e. they both use Tier 1 capital), the two differ in the denominator. The Leverage Ratio uses the so-called exposure measure while the Tier 1 capital ratio uses risk-weighted assets (RWAs).

By and large the Leverage exposure measure uses accounting values of exposures. It has the following broad components:

1. Balance sheet asset exposures (All balance sheet assets minus: items deducted from T1 capital such as goodwill, and derivatives)

2. Derivatives (bilateral netting allowed and exposure value reduced with cash variation margins)

3. Securities Financing Transactions (no netting of collateral, netting of cash receivables and payables of REPOs and reverse REPOs with the same counterparty, netting of "add-on")

4. Written credit derivatives (liability)

5. Off balance sheet exposures

Compared to the final Basel rules text the current CRR text (Article 429) differs in the following areas (non-exhaustive list):

- Calculation of the Leverage Ratio shall use end quarter numbers;
- Scope of consolidation shall be the regulatory scope of consolidation;
- Using the credit risk conversion factors for off-balance sheet exposures (0%, 20%, 50%, or 100% depending on the risk category), but subject to a floor of 10%;
- Netting of repo cash receivables and payables with the same counterparty;

- Allowing cash variation margins to be deducted from derivatives values;
- Applying gross notional values for written credit derivatives with deduction of fair value losses recognised through P&L.

EBA issued on 4 March 2014 an own initiative analytical report on the Leverage Ratio. For the delegated act EBA recommends aligning the CRR to Basel III in terms of the definitions of the leverage ratio exposure measure. Moreover, EBA emphasised that the analysis underlying their report has not indicated any EU specificities which would lead to recommend a divergence from the Basel rules text.

The Basle rules text on the Leverage Ratio framework include some final changes on which the Commission seeks the views of market participants so as to ensure that these treatments capture properly leverage and can be applied in a uniform way throughout the single market and internationally.

In particular the Commission services would like to receive feedback from stakeholders on:

1. The criteria for netting of SFT cash receivables and payables with the same counterparty?

2. The criteria for allowing cash variation margins received to be deducted from the derivative exposure value?

3. The criteria for allowing the notional amount of written CDS to be reduced with the protection recognition?

Stakeholders are welcome to submit written contributions by 31 March 2014 as indicated on the DG MARKT website[1].

[1] http://ec.europa.eu/internal_market/conferences/2014/0310-lcr-lr-hearing/index_en.htm

Global Liquidity Standards – the Liquidity Coverage Ratio

The financial crisis revealed a clear need for banks to better manage and price liquidity risk. At the request of G-20, Basel developed for the first time two new, internationally harmonised, quantitative liquidity metrics:

- **Liquidity Coverage Ratio (LCR)**, a 30 day, stressed metric which improves the short-term resilience of financial institutions to liquidity shocks;

- **Net Stable Funding Requirement (NSFR)**, a one year, structural measure to ensure a bank has sufficient stable funding to support its activities over the medium term. The NSFR limits over-reliance on short-term wholesale funding to finance long-term lending.

A key concept of these metrics is to rely on private market, and not central bank, liquidity. The CRDIV/CRR package adopted last year provides the framework for EU implementation of these metrics.

The LCR will be implemented in 2015 by a Commission delegated act and the NSFR in 2018 by a Commission proposal. CRDIV/CRR progressively implements the LCR, rising from 60% in 2015 to reach 100% in 2018, one year earlier than Basel.

The impact assessments carried out by the Commission and EBA identify the benefits of the LCR. The Commission study estimates the LCR could produce net annual GDP benefits in the range of 0.1% to 0.5%, due to a reduction in the expected frequency of systemic crises.

The data analysis in the EBA Impact Report shows that the specification of the general liquidity requirement is not likely to have a material detrimental impact on the stability and orderly functioning of financial markets or on the economy and the stability of the supply of bank lending, with a particular focus on lending to SMEs and on trade financing, including lending under official export credit insurance schemes. The EBA also finds that the calibration of the liquidity coverage requirements defined by Basel is generally appropriate and that there are no EU specificities which should justify significant deviations from this internationally agreed framework.

However, EBA notes that there are a few areas where further work is needed. In particular, this is the case for the specification of inflow/outflow rates for intragroup flows and in the area of the ongoing work of the international community of central banks regarding the interaction between the introduction of the liquidity coverage ratio and the monetary policy.

EBA also notes that diversified business models tend to be more adapted to the LCR than specialised banks. Adjustments may be required for auto, consumer credit banks and pass-through financing banks. Specific derogations could be introduced for some specialised business models under stringent and objective conditions such as derogations from the 75% inflow cap or a higher cap.

As regards the definition of HQLA EBA generally very closely follow Basel.

Stakeholders' views on the following issues are of particular interest. *(No importance should be attached to the order)*

- **Liquidity – Definition of HQLA**

  a) Should the Basel caps at 40%/15% for level 2A/2B HQLA be established?

  b) Should covered bonds be included at level 1 or on an enhanced level 2 basis?

  c) Should securitisations other than RMBS included in level 2B HQLA?

  d) On what terms should committed liquidity facilities at central banks be accepted?

  e) What promotional bank bonds should be eligible as level 1/2 HQLA?

  f) What rules should apply to deposits in a cooperative network (Basel/CRR)?

  g) What should be the operational requirements for liquid assets (Art. 417 CRR)

- **Liquidity – Outflows and Inflows**

  a) What criteria should be applied to qualify as an established operational relationship for lower deposit outflows (Art. 422(3)(c) CRR)

  b) Should there be a natural person deposit threshold (Art. 411(2) CRR) and on what basis should possible higher outflow rate for retail deposits (Art. 421(3)) be included having regard to the three higher risk buckets/ risk methodology set out in the EBA guidelines? In addition should the LCR specify the outflow rates for higher risk deposits?

  c) In the light of the political agreement on the DGS, should and if so when, a lower 3% retail deposit outflow rate be envisaged?

  d) What additional objective criteria for cross-border intragroup flows (Art. 422(9) and 425(5) CRR) should be applied? Should inflows/outflows be symmetrical/asymmetrical?

  e) Should a distinction be made between credit and liquidity facilities in outflow rates (Art. 424 CRR) and according to counterparty?

  f) Should there be an inflow cap equal to 75% of outflows (Art. 425 CRR) and what exemptions should be granted? (pass-through financing, promotional loans, auto and consumer loans, leasing and factoring)

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