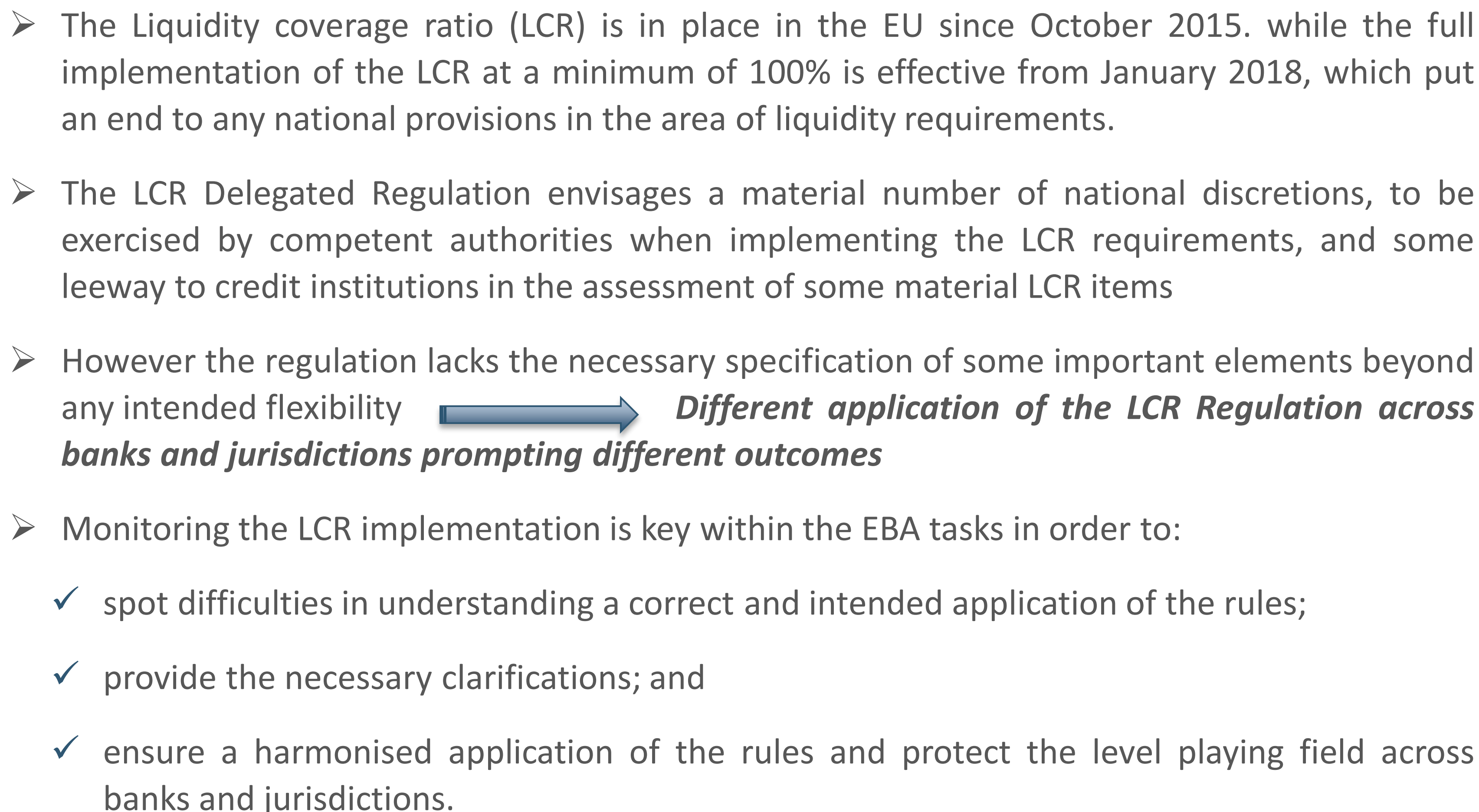
Monitoring of the LCR implementation in the EU – First Report

Paris, 8 July 2019

Background



- The Liquidity coverage ratio (LCR) is in place in the EU since October 2015. while the full implementation of the LCR at a minimum of 100% is effective from January 2018, which put an end to any national provisions in the area of liquidity requirements.
- The LCR Delegated Regulation envisages a material number of national discretions, to be exercised by competent authorities when implementing the LCR requirements, and some leeway to credit institutions in the assessment of some material LCR items
- However the regulation lacks the necessary specification of some important elements beyond any intended flexibility → ***Different application of the LCR Regulation across banks and jurisdictions prompting different outcomes***
- Monitoring the LCR implementation is key within the EBA tasks in order to:
  - ✓ spot difficulties in understanding a correct and intended application of the rules;
  - ✓ provide the necessary clarifications; and
  - ✓ ensure a harmonised application of the rules and protect the level playing field across banks and jurisdictions.

Work done

- The result of this monitoring will be materialised into a public report. Usual structures of the EBA have been involved:
  - ✓ Expert and policy groups, where competent authorities and supervisors have provided feedback to ensure that jurisdictional specificities are taken on board.
  - ✓ The EBA Board of Supervisors has endorsed the report that will be published before end of July.

- Exchanges with stakeholders have been held:
  - ✓ A roundtable with banks and associations took place in February 2019
  - ✓ A couple of presentations at the EBA Banking Stakeholder Group were made in April 2018 and February 2019

The report

- This is a monitoring report, similarly to the monitoring work that the EBA performs and publishes in the area of own funds.

- More precisely, the purpose of this report is to

  - provide some EBA's observations on some aspects of the LCR implementation;
  - provide EBA's views on the assessment of some observed practices;
  - identify best practices and/or areas where further guidance to banks and supervisors might be necessary while providing already some guidance for some of the areas monitored to date and;
  - underline areas where further monitoring is ongoing.

Upcoming reports

- This report will be enriched over time based on an ongoing monitoring of the implementation of the LCR considering new aspects that might need further guidance.

- The EBA is already working on other topics like the application of Article 26 of the LCR DR on outflows with interdependent inflows, concentration of the liquidity buffer or the LCR by significant currency or the liquidity risk beyond the 30 day window, among others.

- While some guidance is already proposed for some areas monitored in this report, the EBA will further assess how this guidance will be used by banks and supervisors and consider taking further steps if needed (including some fully fledged products like guidelines, recommendations etc) while continuing its monitoring on the aspects mentioned in the report.

Content of the first report

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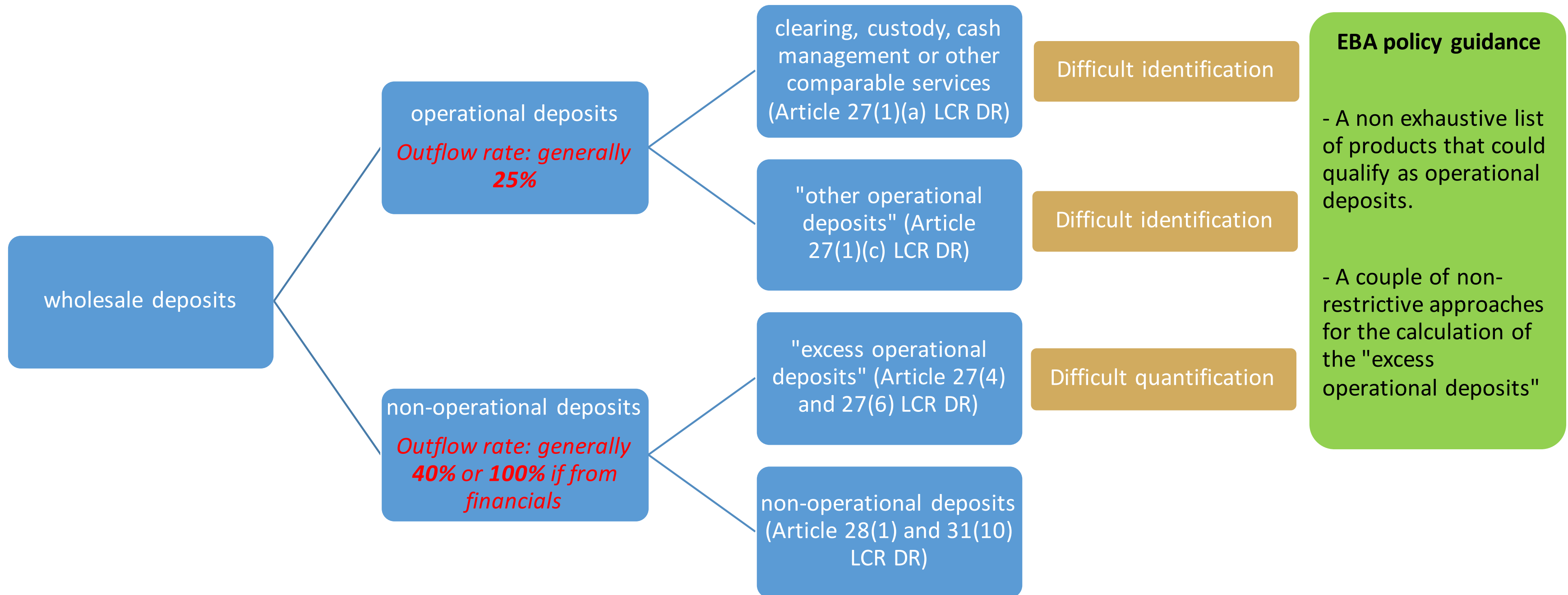
Areas investigated in the report

- Identification and quantification of wholesale deposits received that can benefit from the outflow preferential treatment of operational deposits
- Definition of ‘material penalty’ in the context of retail deposits maturing beyond 30 days that can be excluded from outflows
- Outflows from other products and services (article 23 LCR DR)
- 0ther implementation issues observed: recognition of inflows from maturing high quality liquid assets (HQLA), optionality and contingent inflows, interbank swaps of retained covered bonds or ABS (assets backed securities), time dimension of the LCR

Operational deposits: description (Art. 27 LCR DR)



- **Lack of clarity in the Regulation: Identifying operational deposits and “excess operational deposits” (as excess amount of operational deposits) is difficult.**
- **Risk: Very different rates if operational versus non-operational**
- **Very different approaches and results across banks and countries not explained by specific business models.**
- **EBA guidance provides a list of operational deposits and clarifies the amount of them that can be treated as such: Approaches based on historical data of operational payments or balances in the client’s trade cycle**

Excluded retail deposits from outflows: description (Art. 25(4) LCR DR)

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- No LCR-outflows for > 30 days retail deposits if:
  - Depositor is not legally allowed to early withdraw the deposit within 30 calendar days or
  - Depositor has to pay a material penalty
- Significant impact on the LCR value of banks due to
  - lack of a clear definition of material penalty: very different interpretations and outcomes
  - No outflow under stress is considered: No liquid assets are required to cover these deposits
- The EBA intends to provide some guidance to:
  - allow for a harmonized understanding when a penalty can be deemed material
  - ensure that prudent and sound approaches are used
  - Ensure that the level playing field is not jeopardized.

EBA policy guidance:

- Institutions to provide upon request a reasoned justification for an expectation of no early withdrawals (0% outflow rate) in a stress scenario.
- Generally retail deposits originally subject to 10% outflow rate fully covered by a DGS are the ones expected to be able to provide that reasoned justification.
  - A penalty defined as a percentage of interest, in the context of a situation of extremely low interest rates, is not expected to justify 0% expected withdrawal.
  - Cases where early withdrawable amount is **materially lower** than the principal amount justifies generally 0% expected withdrawal.
  - Cases where early withdrawable amount **equals or is not materially lower** than the principal amount necessitates additional factors to provide justification of 0% expected withdrawal (high opportunity costs or other transactional costs).
  - Cases where early withdrawable amount is **greater** than principal amount (including some interest) would likely not be able to justify 0% expected withdrawal.

Outflows from other products and services (Art. 23 LCR DR)

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- The LCR DR is not clear in the identification of the 10 broad outflow categories mentioned in its Article 23.
- Banks apply very different definitions with implications in the final outflow rates to be applied by CAs.
- There are concerns that very different interpretations of these categories can lead to very different outflows risking a good coverage of the liquidity risk and jeopardizing level playing field.
- This lack of clarity also poses difficulties for competent authorities to properly notify to the EBA on these elements as required in Article 23.

EBA policy guidance:

- The report will provide common harmonised definitions for the identification of each of these categories.
- Article 23 deals with uncommitted products generally but also with some committed ones.
- In this context, the guidance also clarifies the interaction of Article 23 with Article 31, on committed facilities, and with Article 32, as regards the contractual commitments to extend funding envisaged therein.
- While the guidance covers the product categories, at this stage due to lack of experience, it does not provide any support on the outflow rates to be determined by the competent authorities

Other aspects (1 of 3)

Implementation issue	Prudent practices expected
• Cases observed where HQLA subject to high haircuts are reclassified to non-HQLA during the 30 calendar days prior to their maturity. Banks arguing that some operational requirements were not fulfilled anymore. This allowed banks to compute much higher inflows than HQLA values.	• HQLA meeting general and operational requirements and maturing within 30 calendar days should be computed as HQLA and not as inflows. • Concern: Avoiding the risk of computing higher liquidity resources than those that would be available via a potential liquidation of the relevant HQLA prior to maturity. ➢ Supervisors and banks are reminded that changes in the compliance with operational requirements should be well substantiated.

Other aspects (2 of 3)

Implementation issue	Prudent practices expected
• Cases observed where banks have doubts on whether inflows subject to options can be computed as such or not? (e.g. options to withdraw beyond 30 days deposits, sold call options...).	➢ Generally inflows dependent on the exercise of an option are contingent and not eligible for the LCR. ➢ Outflows dependent on the exercise of an option are expected to happen under stress. The relevant rate would apply. ➢ Some relevant Q&As on specific cases are also published.
• Cases observed where banks swap retained own securities (covered bonds and ABS) and recognise the assets received as HQLA.	• Banks cannot compute retained own securities but could compute the assets received in this swap if meeting the definitional criteria for HQLA as well as their operational and general requirements. ➢ Banks and supervisors are advised to review detailed pricing evidence and marketability tests of those assets received

Other aspects (3 of 3)

Implementation issue	Prudent practices expected
• Window dressing of the LCR increasing month-end LCR values for reporting and disclosure purposes.	• Concern: the reporting values or disclosures not reflecting real LCR profiles. ➢ Banks are reminded to avoid any alteration that could intendedly distort the reporting or disclosure values. ➢ Supervisors are reminded the convenience of reviewing intra-month LCR values.
• Concentration of outflows out of the 30 day window to avoid the application of LCR rules with the expectation of a roll over of the funds or under informal early withdrawal options.	• Concerns that the liquidity risk might ultimately materialize and the bank might result uncovered: e.g.: if a roll over of the funding is not possible under stress or the investor early calls its funds. ➢ Banks are reminded to be prudent in mitigating liquidity risk and supervisors to use additional instruments to assess liquidity risk in other time horizons.

Main exchanges with the industry (1 of 2)

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COMMENTS RECEIVED

- Operational deposits:
  - Concerns were raised on the degree of stringency of the proposed approaches.
  - Additional products were suggested for the non-exhaustive list of potential operational deposits
  - It was suggested to use the "deposit activity cycle" in the quantification of the amount of the operational deposits necessary for operational services for simplicity reasons.
- Excluded retail deposits:
  - It was suggested that, in the quantification of the penalty, other "external factors" are taken into account like the loss of public subsidies, or tax advantages, which could have been acquired in the future.
  - It was asked about the applicability of the guidance in jurisdictions with national rules where the amount of the early withdrawable penalty is capped by the interest accrued.

EBA ANSWER

- Operational deposits:
  - Banks are expected to apply the general fundaments of the approaches. The specific metrics for estimates, number of data observations, etc. remains to banks' and supervisors' assessment.
  - Separate accounts for "custody specialized institutions" for securities settlement have been added to the non-exhaustive list of potential operational deposits.
  - The deposit activity cycle can be alternatively used to the client's trade cycle if the identification of the trade cycle is a very complex and highly burdensome.
- Excluded retail deposits
  - The report considers the loss of public subsidies, or tax advantages, which could have been acquired in the future had the deposit remained, as high opportunity costs for assessing a material penalty.
  - The guidance takes this into account and envisages the applicability of the provision when the withdrawable amount equals the principal amount of the deposit if additional factors/conditions are met, like high opportunity costs or other transactional costs, which do not necessarily mean higher payments by the depositor.

Main exchanges with the industry (2 of 2)

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COMMENTS RECEIVED

- Other aspects:
  - Some participants considered the treatment for contingent outflows very strict.
  - It was argued that having intra-monthly lower LCR figures does not contravene the rules in place if the bank remains compliant at every time.
  - Clarification of the specific categories in Article 23 was requested.
  - Some participants asked about the bindingness of the guidance in the report.
  - Other potential issues were suggested for clarification in upcoming reports such as:
    - Correspondent banking in the context of operational deposits
    - The treatment of structured notes with auto-callable and market based triggers features.
    - Reuse of the collateral obtained through a margin loan to cover a customer's short position (Internalisation)

EBA ANSWER

- Other aspects:
  - Contingent outflows should be recognized to the extent they are expected, according to the Regulation, which is the case under stress from a prudent perspective.
  - An intended increase of reporting or disclosure LCR values above the regular level during intra-monthly periods goes against sound principles of supervisory reporting and transparency even if the relevant institutions are LCR compliant within each month.
  - Clarification of the specific categories in Article 23 is provided in the report
  - The guidance is not formally a binding regulatory product itself but its content is expected to be applied in the interest of a harmonised application of the rules and constitutes a valid benchmark for supervisors in the application of rules.
  - The EBA will consider providing clarification on issues raised by participants for upcoming reports

Others area of work

- The EBA will publish CPs on NSFR reporting and disclosure during the second half of the year to ensure application date in parallel to the application of the requirement from June 2021.
- Article 17(5) of the amended LCR DR mandates the EBA to report to the Commission by November 2020 on the assessment and potential review of the unwind mechanism of securities financing transactions for the quantification of the caps in the liquidity buffer if found technically not suitable or with a detrimental impact.
- Article 510 of the CRR2 also contains a number of mandates to the EBA on reports to the Commission related to the NSFR:
  - ✓ Report for assessment and potential review of the NSFR treatment of assets used for providing clearing and settlement services of precious metals – by June 2021
  - ✓ Report for assessment and potential review of the NSFR treatment of securities held to hedge derivatives contracts – by June 2023
  - ✓ Report for assessment and potential review of the NSFR treatment of SFTs and short term unsecured transactions with financial customers – by June 2023
  - ✓ Report for assessment and potential review of the NSFR treatment of derivatives – by June 2024

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