LIQUIDITY FRAMEWORK

The European Commission publishes the final version of the LCR Delegated Act

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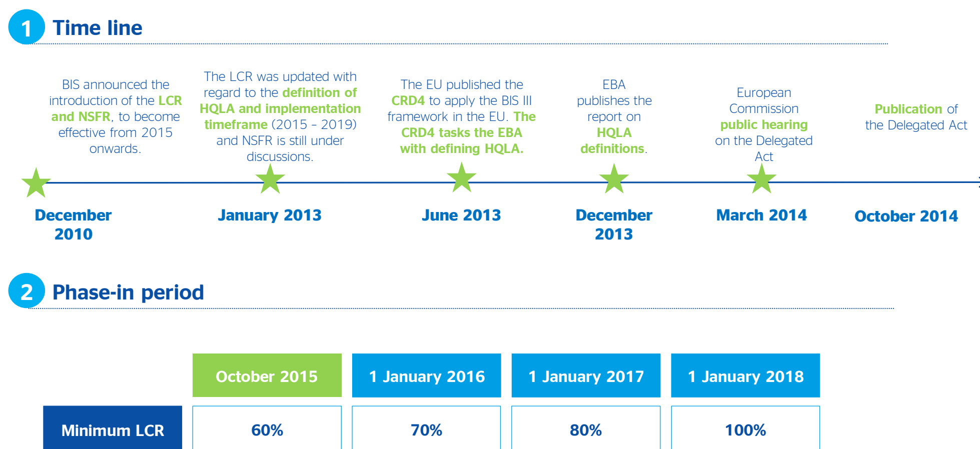
On 10th of October 2014, the European Commission (EC) published the final version of the LCR Delegated Act. Now, the European Parliament and the European Council have 6 months to present amendments to this final version which will entry into force in October 2015. The LCR together with the NSFR represent a milestone in the building up of the Pillar 1 liquidity framework within the European Union. Meanwhile the NSFR represents a more structural or long term, ratio; the LCR measures the liquidity position of a bank under stressed conditions.

Scope and timeline

The aim of the LCR is that financial institutions maintain a sufficient level of liquid assets to withstand the excess of liquidity outflows over inflows that could be expected to accumulate over a 30 day stressed-period. The LCR will be mandatory, on a consolidated basis, from October 2015 (i.e.: at 60%) later than expected and the phase-in period will finish by January 2018. In this regard, the phase-in period is more aggressive than Basel´s.

Graph 1: Timeline and phase-in period



Liquidity buffer (numerator)

The Delegated Act defines three levels (Level 1, 2A and 2B) of assets according to their liquidity properties. In fact, the European Banking Authority (EBA), as shown in graph 1, published two reports assessing the liquidity conditions of some assets and that served as a basis for the final decision adopted by the EC under this Delegated Act.

The final version of the Delegated Act defines some general requirements to be fulfilled by liquid assets included in the buffer, among others: i) they should not have been issued by the credit institution itself or ii) the issuer cannot be a financial institution, with the exception of covered bonds and ABS. In addition, the EC defines some operational requirements such as that these assets should be under the control of a specific liquidity management function and that, at least, once a year, credit institutions have to monetize a sufficiently representative sample of their holdings in liquid assets.

Graph 2: Haircuts and caps and floors to different liquid assets

Level	Asset	Conditions	Haircut	Caps and floors
Level 1	Coins and Central Banks		0%	Minimum 60%; Minimum 30%
	Sovereigns Member States and Third countries	All Member States; Third countries AA-	0%	
	Covered Bonds	>€500mn; AA- or 10%RW; 2%OC	7%	
Level 2A	Sovereigns and sub-nationals (third countries)	>A- or 20% RW	15%	Maximum 40%
	Sub nationals (EU)	>A- or 20% RW	15%	
	Covered Bonds	>€250mn; A- or 20% RW; 7%OC	15%	
	Covered Bonds Third countries	AA- or 10% RW; 7% OC	15%	
	Corporates	>€250mn; AA-; up to 10 years tenor	15%	
Level 2B	ABS (RMBS (LTV>80%, LTI <45%), Auto)	AA- senior tranche; €100mn; average life<5yr	25%	Maximum 15%
	ABS (SME, consumer)	AA- senior; €100mn; average life <5year	35%	
	Corporates	> € 250mm; > BBB-; up to 10 yrs	50%	
	Equity	Major indices	50%	
	Covered Bonds	>€250mn; no rating; 10% OC	30%	
	Liquidity facilities by ECB	Commitment fee		

Regarding the liquid assets, it is worth mentioning the following decisions:

- **Covered bonds**: they are treated as extremely high liquid assets. However, these covered bonds will be subject to a haircut of 7% meanwhile the rest of extremely high liquid assets will have no haircut. This is not in line with EBA recommendations published in December 2013 where it presented some doubts about the liquidity of these securities.
- **ABS**: they are considered as liquid assets but in the Level 2B bucket subject to some conditions. The novelty in this case is the inclusion not only of RMBS but also of Auto ABS and ABS backed by SME loans and consumer loans.
- **Restricted Committed Liquidity Facilities (RCLF)**: the EC has adopted a restricted position and it admits this when they fulfil several conditions, among others, such as: subject to a commitment fee or that the commitment term exceeds the 30 calendar day stressed period. This option is aligned to Basel recommendations.
- **Equities:** they are included in the level 2B bucket when, among other conditions, they form part of a major stock index in the Member State or in a third country.

Net liquidity outflows (denominator)

The Delegated Act clearly separates the net outflows coming from retail financing from the wholesale financing.

- Regarding **retail deposits**, the Delegated Act applies a 5% outflow rate for stable deposits and recognizes the possibility to apply a reduced outflow rate (i.e.: 3%) when deposits are covered by a Deposit Guarantee Fund (DGF) under certain conditions. These conditions (i.e.: available financial means, ready access to funding, etc.) are in line with Basel recommendations. However, the Delegated Act defines higher outflows for other retail deposits (i.e.: >€500k, internet-only account, 30 days, etc.).
- Regarding **wholesale financing** the Delegated Act differentiates between secured and unsecured financing being the treatment, in general, more benign to secured financing.

Assessment

The publication of the Delegated Act is a decisive step in the building up of the liquidity framework within the European Union. In general, the treatment to covered bonds and ABS has been positive. This is very important to foster these securities as funding tools not only to make the fulfilment of the ratio smoother. In addition to this, the final ratio does recognize the stability of retail financing. However, the possibility to apply a reduced ratio is still low. The depositor preference established in the BRRD, for instance, should enhance the stability of the deposits deserving therefore a better treatment. In addition, the final version does not consider the specificities of the decentralized liquidity management model. As such, a consolidated ratio or a ratio by currency cannot be used to assess the liquidity position of financial institutions with a decentralized model.

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