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Die Deutsche Kreditwirtschaft

Position Paper

On the Liquidity Coverage Ratio (LCR)
for the survey lcr-lr-hearing on 10 March 2014

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Further to the public hearing on Liquidity Coverage Requirements and Leverage Ratio of 10 March 2014, we appreciate the present opportunity to comment on the Liquidity Coverage Ratio (LCR).

I. General Comments

In an attempt to make the financial sector more resilient with regard to crises in general, minimum liquidity standards were newly introduced by Basel III and implemented in Europe by the CRR. These standards seek to ensure banks' financial solvency at any given point in time. The liquidity standards adopted are based on the lessons learnt during the financial market crisis and were primarily geared towards the liquidity rules for large institutions featuring international activities and a complex business model. Yet, the CRR liquidity rules shall be applicable to all banks.

Through its loan supply to European SMEs, the financial sector makes a considerable contribution towards safeguarding and enhancing business development in Europe as well as towards job security or, moreover, the creation of new jobs. The LCR introduction will lead to far-reaching switching into – what is deemed from a regulatory perspective – high quality liquid assets (HQLA); partly, this process has already begun. On the one hand, this particularly concerns investments into government bonds, on the other hand it may result in a squeeze on lending to clients. These switching activities will tend to trigger adverse effects on the overall economic development in Europe and thus, by default, also in Germany.

Furthermore, in banks' securities book, the necessary switching into assets deemed liquid from a regulatory point of view has negative repercussions on banks' earnings position; this is due to the low yield for highly liquid assets. In addition to this, during a crisis, a concentration of own account investments on recognised government bonds may lead to unwanted market stress. The experience during the European sovereign debt crisis has shown that government bonds are not risk-free.

As a funding source, retail deposits are of pivotal importance for the Liquidity Coverage Ratio (LCR). This is due to the fact that, in the event of a crisis, especially these exposures feature a comparatively low likelihood of liquidity outflows and that – during the calculation of the LCR – retail deposits are thus subject to rather low outflow rates. More likely than not, especially their positive effects both on the LCR and also on the NSFR will lead to fiercer competition for retail deposits. As a result, there will tend to be negative effects for banks' net interest income and thus also on the profit retention as well as banks' risk bearing capacity.

II. Specific Comments

Determining suitable outflow rates for retail deposits

As far as the calculation of the outflow rates for retail deposits is concerned, the EBA/GL/2013/01 requires a general identification of deposits that are subject to higher outflow rates in a stressed market environment (so-called high risk deposits). To this end, in order to determine whether it shall be deemed a high risk deposit, every retail deposit has to be assessed on the basis of eight specific risk factors using a scoring approach.

We hold the view that the need for a mandatory comprehensive review of each and any retail deposit with regard to all risk factors set out under EBA/GL/2013/01 should be eliminated; our petition is owed to the fact that such an approach would involve excessive implementation burdens for small and medium-sized banks. In addition to this, during these classifications, the identification of historic outflow rates is extremely complex (let alone the fact that the respective data history may not even be available). Instead, in order to allocate the retail account deposits to the appropriate buckets and for an appropriate determination of the respective liquidity outflow rates, the review should first and foremost be predicated on verifying the presence of the two material criteria "established business relation" as well as "transactional account". The presence of these two criteria should generally give rise to the rebuttable assumption of a stable deposit meaning that a review of the risk factors for higher outflow rates would become redundant.

There should only be a review of the risk factors and thus a potential assignment to higher outflow rate buckets if and when there is a failure to meet the criteria "established relationship" as well as "transactional account". Furthermore, one of the idiosyncrasies of the cooperative sector consists in the fact that clients frequently also hold shares in the cooperative. Hence, we are of the opinion that membership in a cooperative bank is usually also an indicator of an established relationship.

Apart from this, we have difficulties in comprehending why European banks which are securely covered by a deposit protection scheme should not be able to benefit from a 3% outflow rate for retail deposits articulated by the Basel Committee as early as January 2013. At this juncture, an equitable treatment of all deposit protection schemes within the EU which are covered by the regulatory scope of the Deposit Guarantee Directive is paramount. In its reports on Art. 509 CRR which were published in December 2013, the EBA refrained from any further investigation of this issue; neither did it comment on this matter.

We still have difficulties in comprehending the rationale for the fact that "high value" and "very high value deposit" risk factors shall apply to the deposits in their entirety, i.e. as of the first euro, if and when the amount drops below a certain lower limit. As far as stability aspects are concerned, the rationale for this remains utterly intransparent. Amounts up to EUR100,000 are covered not only by a statutory deposit protection scheme but also by a bail-in-protection. Also, the reason for the assumption that clients will withdraw the entire deposit during a given stress scenario remains unclear. After all, clients need to be able to invest the money elsewhere – at this point, again, they will need to be able to rely on the statutory deposit protection scheme.

Hence, "high" and "very high value" risk factors should not be treated any different to other risk factors: In other words, when it comes to the calculation of the higher outflow rates, the additional risk factors should be considered only for that part of the deposits which is actually exposed to these risk factors.

Renouncement to the introduction of the cap on Level 2 assets

Art. 509(2) (c) CRR sets out that the elimination of the cap for Level 2 Assets shall remain an issue during the discussions and that it shall be assessed by the EBA. In its "Report on impact assessment for liquidity measures under Article 509(1) of the CRR", the EBA comes to the conclusion that it currently does not recommend eliminating the cap for Level 2 Assets (limiting the Level 2 Assets to 40% max. as well as a limitation of the Level 2b assets to 15% max.). The EBA cites quantitative analyses as a reason for this.
In this context it is worth noting that the cap may lead to potential misallocations due to a lack of diversification thus incurring concentration risks which need to be prevented. Furthermore, imposing restrictions upon the own account investment strategy may weaken banks' risk bearing capacity due to the fact that banks will not have enough opportunities for a diversification of their counterparty default risk as well as their spread risk. The experience during the European sovereign debt crisis has shown that a concentration on government bonds recognised as Level 1 Assets is not without risks and that considerable concentration risks may emerge during crises along with a stronger need for impairments with direct repercussions for banks' results.
Furthermore, the cap on the Level 2 Assets has a negative impact on banks' net interest income. This is due to the fact that the rate of return on Level 2 Assets is usually higher than the rate of return on Level 1 Assets. In the medium term, this may lead to a decline in the profit retention which could thus weaken banks. Furthermore, the cap also has considerable repercussions on the non-finance sector. After all, the capital market funding options for companies will be curtailed by this.
Based on the above, we suggest to reconsider the reintroduction of the cap on Level 2 Assets.

"Suitable" recognition of the liquid assets from special funds

"Special funds" (Spezialfonds) are common in Germany. They are covered by the provisions under Art. 418(2) CRR. However, there is no distinction between public funds and special funds. As a consequence, the applicable haircuts for the underlying assets from a special fund shall be determined on the basis of the look-through approach. Under the provisions of Art. 416(6) CRR, shares in special funds shall be eligible for recognition as liquid assets up to an aggregate amount of EUR500 million provided that the special fund has invested entirely into liquid assets (the sole exception being the liquidity reserve).
As regards a special fund with only one investor i.e. a 100% shareholding with one bank, in terms of the recognition of liquid assets there will be a different treatment compared to the banks' own securities portfolio. Firstly, there is the upper limit. In addition to this, from now on, the HQLA funds created will have to be "pure". This will trigger the need for comprehensive regroupings. Particularly for smaller and medium-sized banks such an approach will incur considerably higher costs. However, with regard to a special fund with only one investor, due to the rights of direct access, the respective liquid assets can be realised just as well as the own securities portfolio. Furthermore, contrary to publicly offered funds, a potential sale of liquid assets will not be detrimental to the other investors, since the latter are non-existent.
In our view, this differential treatment is inappropriate. Based on the reasons above – when it comes to special funds with only one investor - a special approach to the actual application of the look-through principle should be permissible i.e. recognition of the liquid assets should be possible even if the special fund is not exclusively invested in HQLA.

Covered Bonds

The analyses conducted by the EBA provide empirical evidence for the fact that covered bonds are highly liquid. Notwithstanding the foregoing, the EBA recommends their non-recognition as Level 1 Assets. This means that, as far as we can see, there is an inappropriate discrepancy between the EBA data analysis and the EBA recommendations regarding covered bonds.
Empirical analyses by the European Covered Bond Council (ECBC) confirm the stable liquidity and good creditworthiness of covered bonds.[1] Due to the statutory protection schemes, particularly German-type covered bonds (*Pfandbriefe)* constitute a tool for banks liquid investments and risk diversification.
Furthermore, covered bonds constitute an important funding instrument the attractiveness of which would suffer in the event of a non-recognition as a Level 1 Asset.

Bonds issued by local governments (i.e. in Germany issued by the Bundesländer)

It is worth noting that bonds issued by German local governments are deemed extremely high liquidity assets (Level 1) i. e. Level 1 LCR assets without haircut and limit under the CRR. In our understanding, this is also the conclusion drawn by the EBA report. Whilst local government bonds are only deemed Level 2 assets *per se*, all securities guaranteed by Member States shall be recognised as Level 1 assets. For Germany's local government level, the *Bundesländer* of the Federal Republic of Germany, this government guarantee is regulated in Germany's Constitution and it is regularly recognised by rating agencies. A similar view of the *Bundesländer's* good risk profile can be found in Article 115(2) CRR which regulates exposures to regional governments or local authorities: "Exposures to regional governments or local authorities shall be treated as exposures to the central government in whose jurisdiction they are established where there is no difference in risk between such exposures because of the specific revenue-raising powers of the former, and the existence of specific institutional arrangements the effect of which is to reduce their risk of default." Undoubtedly, these criteria are met by bonds issued by Germany's Federal States.

Promotional bank bonds

Promotional bank bonds, as public sector entity bonds, undoubtedly meet the operational requirements for liquid assets provided for in Article 416(3) CRR (EBA report on extremely high quality liquid assets (extremely HQLA) and high quality liquid assets (HQLA) published on 20 December 2013, page 62).

Promotional banks are being set up by a Member State regional government. That government has an obligation to protect the institution as a going concern and to maintain its viability throughout its lifetime; also, the bonds are explicitly guaranteed by that regional government; as a result, these bonds are not covered by the waiver for bank bonds as liquid assets (Art. 416(2) lit. a iii) CRR). This assessment was explicitly endorsed by the European Banking Authority in its interpretative decision 2013_222 of 20 December 2013.

Based on the above, in their capacity as bonds issued by non-central government public bodies and for the purposes of reporting liquid assets pursuant to the CRR, bonds issued by German regional promotional banks shall be recognised as liquid assets according to Art. 416(1) lit. c ii) CRR.

[1] Cf. ECBC Position Paper on the Treatment of Covered Bonds in the Liquidity Coverage Ratio (2012)

The EU Commission is called upon to specify the design of the LCR and thus also the definition of the liquid assets as part of a delegated legal act (Art. 460(2) S. 3 CRR). In this regard, in accordance with the CRR liquidity rules (Part 6 Title II), its forthcoming provisions shall be "based on the items to be reported‟ (Art. 460(1) Sentence 2 CRR). This also includes the assets to be reported accordance with Art. 416(1) lit. c CRR. Yet, under Recital 100 of the CRR, when determining a harmonised definition of the liquid assets "it would also be appropriate that assets corresponding to Article 416(1)(a) to (c) should be included in the buffer without limitations.” In our view, this is a clear expression of the legislator’s will to recognise the assets mentioned thereunder as liquid assets without any further qualifications. In our view, the legislator’s specifications do not allow any room for any other interpretation: Bonds issued by German promotional banks (*Landesförderbanken)* which are guaranteed by the regional government shall be treated *on a par* in each and every respect with the liquid assets specified under Article 416(1) lit. a) and b) CRR; whilst not limited to this particularly applies to the haircuts and the potential share in the liquidity buffer.

Automotive-ABS

The EBA recommends merely recognising RMBS as Level 2 assets. In our view, this does not constitute an appropriate reflection of the liquidity offered by other ABS featuring simplicity and a high degree of granularity. Particularly automotive-ABS proved a high degree of liquidity and stable value even during the crisis. The EBA report is based on MiFID data which, however, fail to reflect the liquidity of automotive-ABS. Also auto-ABS should therefore be recognised as Level 2 assets.

Fiduciary structures

Deposits by natural persons should be treated as retail deposits even if and when the nature of the deposit is not consistent with the current retail deposit definition. More often than not, retail deposits are collected in trust and fiduciary structures or in family offices before they are subsequently invested. Hence, at this juncture the call rates should be based on the beneficiary and not on the structure.