HARMONISATION OF BANK LIQUIDITY RISK REGULATIONS. A STATE OF PLAY

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Abstract: This article deals with an issue of bank liquidity risk regulations. The legal framework for banks concerning the liquidity risk management has been evolving since 2008, when the global financial crisis hit and revealed plenty of unintended consequences, including system-wide ones. Since then, there have been global as well as European initiatives undertaken to address the liquidity risk management deficiencies. The European regulatory framework for liquidity risk management by banks is still evolving – many of these regulations have not been introduced yet, whereas the existing provisions are mainly transitional. The article describes and analyses the regulatory initiatives concerning the liquidity risk management both at the global and European level, and it draws conclusions with reference to the issue of the liquidity risk harmonisation within the European Union.

Keywords: liquidity risk regulations, liquidity risk management, harmonisation of regulations.

1 Introduction

Harmonization of liquidity risk regulations is a new concept, which has evolved on the grounds of the recent financial crisis. European regulations concerning the liquidity risk management draw from the relevant Basel standards, which constitute a globally recognized framework for internationally active banks. The liquidity regulations were introduced in the European Union (EU) throughout the single rulebook, which means that all banks must comply with them.

The single rulebook was established in the EU with the aim to provide a set of harmonised prudential regulations for credit institutions and investment firms in order to ensure a uniform application of the Basel rules in all member states and finalise the creation of the single financial market within the EU. It was also expected that the single rulebook would be helpful in minimising the divergences in national rules and regulations, leading to a more resilient, transparent and efficient banking sector.

The purpose of this paper is to assess the current level of harmonisation of the liquidity risk regulations and draw conclusions from its introduction for banks and supervisory authorities. The article briefly describes the Basel standards regarding the liquidity risk management by banks. Secondly, it explains the way the liquidity risk regulations were transposed to the EU legal framework and gives an overview of the remaining work. Main conclusions are presented in the summary.

2 Harmonisation of liquidity risk regulations at the global level

In 2008, as a global financial crisis emerged, it turned out that the liquidity risk management practices of banks were largely deficient. Prior to the crisis, liquidity was readily accessible and relatively cheap. However, under stressed conditions it occurred that banks lacked sufficiently high quality liquid assets, they did not use adequate stress tests, neither had robust liquidity contingency plans in place. What is more, a considerable loss of trust between banks made it even more difficult to raise funding. Hence, in many cases, central bank liquidity assistance or even public support were needed. In response, the BCBS published a framework for liquidity risk management in 2008[1] in order to address the lapses identified in basic principles of liquidity risk management[2]. The framework highlighted the importance of maintaining a buffer of unencumbered, highly liquid assets, which would enable banks to withstand a range of stress events[3]. It referred also to liquidity risk governance, including defining clear responsibilities of senior management, setting an adequate liquidity risk tolerance, and incorporating liquidity cost in the internal transfer pricing systems (LTP – *liquidity transfer pricing*)[4]. The BCBS standard shed light on liquidity risk identification, measurement, monitoring and control systems. Banks should actively monitor and control liquidity risk positions, available collateral and funding needs within and across legal entities, business lines and currencies. Banks should also diversify tenor and sources of funding and maintain presence in the markets where they can regularly sell assets and obtain funds. Intraday liquidity management is equally important for a sound liquidity risk management[5], whereas public disclosure strengthens banks' resilience to stress.

In order to complement the liquidity risk management framework, the BCBS introduced two quantitative liquidity standards, namely a liquidity coverage ratio (LCR)[6], which was revised soon after its publication[7], and a net stable funding ratio (NSFR)[8]. In addition, the BCBS assisted supervisors in determining of how to assign liquid assets to a proper category of high quality liquid assets, based on certain assets characteristics, market structure characteristics and market liquidity indicators[9].

The LCR requires banks to maintain a buffer of high quality liquid assets in order to ensure that banks withstand a liquidity crisis lasting for 30 calendar days. A size of liquidity buffer should be adequate, taking into account a banks' net liquidity position (i.e. liquidity inflows over a 30-day horizon less liquidity outflows over a 30-day horizon, both under the assumption of idiosyncratic, systemic-wide, and combined stress scenarios)[10]. On the other hand, the NSFR aims at improving a structural, long term liquidity position of banks by requiring them to extend stable sources of funding. Available stable funding (ASF) should be commensurate with the amount of assets requiring stable funding (RSF)[11].

The BCBS also requires banks to disclose quantitative and qualitative information about the ratios – LCR[12] and NSFR[13]. The disclosure requirements are expected to improve banks' transparency, enhance market discipline and reduce uncertainty in the markets from the date of first reporting period relevant for each regulatory ratio.

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1 BCBS, *Principles for sound liquidity risk management and supervision*, Bank for International Settlements, September 2008.

2 The Basel principles of 2008 were not entirely new. In 1992 Basel Committee on Banking Supervision (BCBS) issued a first set of sound liquidity risk management practices for banks, which constituted a model approach in the early 90's (see: BCBS, *A Framework for Measuring and Managing Liquidity*, Basel, September 1992). In 2000 the BCBS published a new standard regarding liquidity risk management for banks: BCBS, *Sound Practices for Managing Liquidity in Banking Organisations*, Basel, February 2000.

3 More information on liquidity stress testing can be found: BCBS, *Liquidity stress testing: a survey of theory, empirics and current industry and supervisory practices*, Working Paper No 24, Bank for International Settlements, October 2013; BCBS, *Literature review of factors relating to liquidity stress – extended version*, Bank for International Settlements, Working Paper No 25, Bank for International Settlements, October 2013.

4 The principles were discussed more thoroughly in: J. Grant, *Liquidity transfer pricing: a guide to better practice*, Occasional Paper, no. 10, Financial Stability Institute, Bank for International Settlements, December 2011.

5 See more: BCBS, *Monitoring tools for intraday liquidity management*, Bank for International Settlements, April 2013.

6 BCBS, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, Bank for International Settlements, January 2013.

7 BCBS, *Revisions to Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, Annex, Bank for International Settlements, January 2013.

8 BCBS, *Basel III: the net stable funding ratio*, Bank for International Settlements, October 2014.

9 BCBS, *Guidance for Supervisors on Market-Based Indicators of Liquidity*, Bank for International Settlements, January 2014.

10 The LCR came into force in January 2015, while the minimum requirement was set at 60% with a view to be further increased by 10 p.p. per year to reach 100% in 2019.

11 The NSFR shall become a minimum standard by 1 January 2018.

12 BCBS, *Liquidity coverage ratio disclosure standards*, Bank for International Settlements, January 2014 (rev. March 2014).

13 BCBS, *Net Stable Funding Ratio disclosure standards*, Bank for International Settlements, June 2015.

3 Harmonisation of liquidity risk regulations at the European level

The liquidity risk had not been in the centre of attention until the global financial crisis materialized in 2008. Some studies[14] suggested different reasons for the late harmonization of liquidity regulations, such as the lack of supervisory momentum, or the view that capital addresses liquidity risks. The reason might be as well that the liquidity risk management does not usually pose problems under normal circumstances, when liquidity is abundant and relatively cheap. The recent financial crisis gave supervisory momentum and made the liquidity regulations for banks more pronounced and uniform.

A transposition of the Basel principles into the European Union (EU) legal framework takes place in the form of directives, resolutions and technical standards or guidelines. While implementing these principles, the European legislators take into account the EU and national specificities. There are currently in force two main legislative acts, which refer to liquidity risk management by banks (investment firms as well, although the scope of this paper is limited to banks only).

The directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (CRD IV)[15] requires banks to develop robust policies, strategies, processes and systems for the identification, measurement, management and monitoring of liquidity risk over a set of different time horizons, including intraday. These policies, strategies, processes and systems should be proportionate to complexity, risk profile, scope of operations, risk tolerance and a bank's importance in each Member State, in which it conducts business. They should also take into account core business lines, currencies, branches and legal entities. It is equally important that banks develop methodologies for the identification, measurement, management and monitoring of funding positions, which should include the current and projected material cash-flows arising from assets, liabilities, off-balance-sheet items and the possible impact of reputational risk. In addition, the management body of each bank is assigned with the responsibility to set appropriate liquidity risk tolerance, which should be communicated to all relevant business lines in order to increase the awareness of the liquidity risk incurred in operations, which they carry out. What is more, banks should be able to actively manage available collateral, i.e. to distinguish between pledged and unencumbered assets, as well as to monitor a physical location of the assets and assess the potential to use them in emergency situations. Article 86 of the directive 2013/36/EU also requires banks to include allocation mechanism of liquidity costs, benefits and risks. Moreover, banks are obliged to maintain a buffer of liquid assets, which should enable them to withstand a wide range of stress events. Other risk mitigation tools should include a system of limits, well diversified funding structure and access to funding sources, all of which need to be reviewed regularly. Alternative scenario analyses are critical for decisions underlying the composition of liquidity risk mitigants and funding positions of banks. They need to be conducted at least on an annual basis and address, in particular, off-balance sheet items and other contingent liabilities, including those of Securitisation Special Purpose Entities or other special purpose entities, in relation to which the bank is expected to deliver material liquidity support either because it acts as a sponsor or people believe it is otherwise related. The analyses should be comprehensive enough to capture the institution-specific, market-wide and combined scenarios of different lengths and severity. The outcomes of the alternative scenario analyses should form a basis for contingency planning. Last but not least, banks shall assess how developments such as product design and volumes, risk management, funding policies and funding concentrations affect their liquidity risk profiles.

The Regulation (EU) No 575/2013 (the CRR)[16] applies to banks directly in the EU Member States. It imposes two quantitative liquidity requirements, namely the LCR and the NSFR, as in the Basel accord.

The short term liquidity requirement has already become binding since 1 October 2015[17] and its minimum required level is 60% (the minimum requirement will be 70% in 2016, 80% in 2017, and 100% in 2018). The European Commission (the EC) may alter the phase-in periods and decide to postpone a full introduction of the LCR until 2019[18]. It is important to note also that competent authorities have been given a mandate to set the minimum liquidity coverage requirement at a higher level of up to 100% before 2018[19]. What is more, Member States are allowed to maintain or introduce new binding short term liquidity standards until the liquidity coverage requirement is fully introduced in the Union[20].

By the end of 2015, the European Banking Authority (the EBA) is expected to submit a report to the European Commission (the EC) on whether and how it would appropriate to introduce the stable funding requirement. While making this assessment, the EBA should take into account possible consequences for the economy, business and risk profiles of institutions established in the EU, financial markets and bank lending, with a particular focus on lending to certain business sectors[21]. Within the same timeframe, the EBA should also, after consulting the European Systemic Risk Board (the ESRB), report on methodologies for determining the weights applicable to assets, liabilities and off-balance sheet items in order to assess the amounts of required and available stable funding[22]. Similarly to the LCR, Member States are allowed to maintain or introduce new stable funding requirements until the NSFR is specified and introduced in the Union[23].

It should be noted that the provisions referring to the liquidity requirements as set out in the CRR serve solely for the purpose of specifying reporting obligations until detailed delegated acts become introduced[24]. With regard to the LCR, the delegated act specifying the requirement came into force on 10 October 2014 and became binding from 1 October 2015. The detailed delegated act concerning the NSFR is still pending. The EC shall adopt this act, if it considers it appropriate, by 31 December 2016[25].

In order to complement the delegated act concerning the liquidity coverage requirement and ensure a level playing field, the EC should adopt several detailed technical standards. So far, the EC has adopted the ITS on currencies with an extremely narrow definition of central bank eligibility[26], according to which the condition for liquid assets to be eligible collateral for standard liquidity operations of a central bank in a Member State or the central bank of a third country should be waived for liquid assets held to meet liquidity outflows denominated in Bulgarian levs (in Bulgaria, the central bank does not extend liquidity to

[14] C. Bonner, P. Hilbers, *Global liquidity regulation - Why did it take so long?*, DNB Working Paper, Working Paper No. 455, January 2015, p. 8.

[15] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176/338, 26.7.2013.

[16] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013.

[17] Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions, OJ L 11, 17.1.2015.

[18] Article 461(2) of the CRR. While assessing the necessity of deferral the Commission shall take into account the report and assessment, which is to be prepared by the European Banking Authority by 30 June 2016.

[19] Article 416(5) of the CRR.

[20] Ibidem.

[21] Article 510(1) of the CRR.

[22] Article 510(2) of the CRR.

[23] See Article 413(3) of the CRR.

[24] See Articles 412(4) and 413(2) of the CRR. A more detailed assessment and comparison between the requirement specified under the delegated act and the Basel standard can be found in: K. Patora, *Liquidity Coverage Requirement under the Delegated Regulation of the European Commission and Basel III Rules – a Comparative Study*, „Bezpieczny Bank/Safe Bank" Nr 2(59) 2015, p. 25-46.

[25] Article 510(3) of the CRR.

[26] Commission Implementing Regulation (EU) 2015/233 of 13 February 2015 laying down implementing technical standards with regard to currencies in which there is an extremely narrow definition of central bank eligibility pursuant to Regulation (EU) No 575/2013 of the European Parliament and of the Council, OJ L 39, 14.2.2015.

institutions except in extreme circumstances)[27]. The Commission has also adopted the ITS on supervisory reporting[28], which aims at implementing uniform reporting requirements in order to ensure comparability between institutions and enable the supervisory assessment of fulfilling the requirements. It has to be noted that this ITS requires a substantial revision, since current templates and instructions are based on the CRR provisions, whereas the delegated act on liquidity coverage ratio is far more detailed and it differs from the initial reporting requirements specified under the CRR. The EBA has already proposed a draft ITS amending the Commission's implementing regulation[29], however the EC is delaying its adoption[30]. The Commission's negligence brings serious consequences for a sound and uniform application of the LCR within the EU Member States, as it cannot even be properly calculated, even though the requirement is already in force. There are several more technical standards, which await adoption by the EC, of which there are draft ITS on currencies with liquid assets shortage[31] and draft Regulatory Technical Standard (RTS) on derogations for currencies with constraints[32]. The draft ITS on currencies with liquid assets shortage is aimed at listing the currencies, for which the availability of liquid assets is constrained. In cases where the demand for liquid assets resulting from the liquidity coverage requirement exceeds the availability of such assets, banks may, on condition that all necessary measures have been taken to reduce the shortage of liquid assets in a domestic currency, opt for one or more deregations specified under the RTS on derogations for currencies with constraints, that is:

- banks may use liquid assets denominated in a foreign currency (derogation A), provided that they apply a general additional 8% haircut to foreign currency liquid assets held to meet domestic currency net outflows to adjust for currency risk,
- banks may use credit lines committed by the relevant central bank as liquid assets (derogation B), provided that they apply a minimum 15% haircut to collateral posted at a central bank and that the associated fees to be paid by banks offset the higher yield earned on the assets pledged to secure the credit lines.

In May 2015 the EC expressed its intention to amend these draft technical standards mentioned above. In Commission's opinion the derogation should apply to the Norwegian Krone only (the draft ITS submitted by EBA also included the Danish Krone). The EC proposed to remove the requirement to apply the minimum 15% haircut to assets pledged as collateral under derogation B. Certain other changes were proposed as regards the notification process and a number of smaller drafting changes were provided. The EBA, in its opinions[33], accepted the proposal to remove the Danish Krone from the scope of the ITS on currencies with liquid assets shortage. However, it disagreed with the proposed removal of the minimum 15% haircut to the assets securing the credit lines, as this condition was envisaged to create disincentives for banks to excessively rely on the derogation.

In order to ensure that the LCR is fully operational, the EC should also adopt a final draft RTS on additional liquidity outflows corresponding to collateral needs connected with derivative transactions under adverse market scenario[34]. According to this draft RTS all banks will be required to use the Historical Look Back Approach (HLBA) to determine additional collateral outflows. In addition, banks (especially those with large derivative portfolios, provided that they already have Internal Model Method for counterparty credit risk approved) may choose to use an internal model-based method, i.e. the Advanced Method for Additional Outflows (AMAO), which is to be applied on top of the HLBA.

For the purpose of supplementing the quantitative liquidity standards and enabling a comprehensive view of a bank's liquidity risk profile, certain additional monitoring metrics are expected to be reported by banks in the near future. The EBA submitted to the Commission a final draft ITS on additional liquidity monitoring metrics (AMM)[35], which is principally based on the BCBS' document[36]. The metrics proposed to be covered by the ITS are as follows:

- maturity ladder consisting of time buckets of up to 10 years, based on contractual maturities of assets, liabilities and off-balance positions,
- concentration of funding obtained from the 10 largest counterparties, which exceed a threshold of 1% of total bank liabilities, along with information on the counterparties names, types and location, product type, amounts received, weighted average and residual maturities,
- concentration by product type (wholesale or retail funding), where the value of a particular product category exceeds 1% of total bank liabilities,
- concentration of counterbalancing capacity by the 10 largest holdings of assets or liquidity lines granted to the bank for this purpose,
- average transaction volumes and prices related to these transactions with maturities ranging from overnight to 10 years,
- rollover of funding on a daily basis over a monthly time horizon.

The EC proposed to delay the application date of the ITS on AMM to 1 January 2016. Some minor drafting changes were suggested as well. The EBA agreed to implement the proposed amendments, however it opposed to remove the maturity ladder from the ITS[37]. The rationale for maintaining the maturity ladder within the scope of the additional monitoring metrics is connected with its importance for the supervisors in making justified judgments of the banks' liquidity risk profiles and funding needs over various time horizons. Since the date of the EBA's opinion of September 2015, the EC has not adopted the ITS on AMM.

In addition to the abovementioned draft technical standards, the EBA is entitled to develop guidelines in order to elaborate further on certain issues, which require explenation. In the area

[27] EBA FINAL draft implementing technical standards on currencies with an extremely narrow definition of central bank eligibility under Article 416(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR), EBA/ITS/2014/02, 28 March 2014. This ITS is no longer needed under the provisions of the delegated act no. 2015/61 EC.

[28] Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council, OJ L 191, 28.6.2014.

[29] EBA FINAL draft Implementing Technical Standards amending Commission Implementing Regulation (EU) No 680/2014 (ITS on supervisory reporting) with regard to the Liquidity Coverage Ratio (LCR) following the EC's Delegated Act specifying the LCR, EBA/ITS/2015/04, 23 June 2015.

[30] It is important to note that will take 6 months to introduce the provisions of the ITS from the date of its publication in the Official Journal, which makes it even longer to wait for a proper and uniform application of the LCR.

[31] EBA FINAL draft implementing technical standards on currencies for which the justified demand for liquid assets exceeds the availability of those assets under Article 419(4) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR), EBA/ITS/2014/01, 28 March 2014.

[32] EBA FINAL draft regulatory technical standards on derogations for currencies with constraints on the availability of liquid assets under Article 419(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR), EBA/RTS/2014/04, 28 March 2014.

[33] EBA, *Opinion of the European Banking Authority on the Commission intention to amend draft Implementing Technical Standards with regard to currencies with constraints on the availability of liquid assets*, EBA/Op/2015/12; EBA, *Opinion of the European Banking Authority on the Commission intention to amend draft Regulatory Technical Standards specifying the derogations concerning currencies with constraints on the availability of liquid assets according to Article 419(5) CRR*, EBA/Op/2015/13.

[34] EBA FINAL draft Regulatory Technical Standards on additional liquidity outflows corresponding to collateral needs resulting from the impact of an adverse market scenario on the institution's derivatives transactions, financing transactions and other contracts for liquidity reporting under Article 423(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation CRR), EBA/RTS/2014/05, 28 March 2014.

[35] EBA FINAL draft implementing technical standards on additional liquidity monitoring metrics under Article 415(3)(b) of Regulation (EU) No 575/2013, EBA/ITS/2013/11/rev1, 24/07/2014.

[36] BCBS, *Basel III: The Liquidity Coverage Ratio (...)*, op. cit.

[37] EBA, *Opinion of the European Banking Authority on the Commission intention to amend draft Implementing Technical Standards on additional liquidity monitoring metrics under Article 415(3)(b) of Regulation (EU) No 575/2013*, EBA/Op/2015/16, 23 September 2015.

of liquidity risk, the EBA issued guidelines relating to the allocation of liquidity costs[38], definitions of liquidity buffers and counterbalancing capacity[39], harmonized definitions and templates for funding plans[40], and –more directly connected with the LCR – retail deposits subject to different outflows[41]. The latter, however, serve solely for the purpose of identification of such deposits under the delegated act on liquidity coverage requirement, as these different outflow rates have already been determined by the legislator[42]. It is worth to mention that according to the CRR, the EBA in cooperation with the ESRB should develop guidance on the principles for use of liquid assets in stress situations[43].

4 Conclusions

The harmonization of liquidity risk regulations in the European Union was broadly aimed at providing greater transparency and improved efficiency of banks as a result of introduction of a set of uniform practices and regulations in the area of liquidity risk. The idea, however right, does not work so well in practice. First of all, there are significant delays in the legislative process, which bring inconsistencies in the way of application of the regulations throughout the Union, or even restrain banks from meeting the requirements. What is more, an introduction of every single amendment to the regulations (even those concerning reporting obligations) is a very complex process, which requires plenty of time, and as such creates impediments to a smooth application of the requirements. Moreover, there are many doubts as regards the correct interpretation of the legal acts' provisions, which cannot be clarified at the national level, as it is the EBA, which is allowed to provide interpretations, although it takes around 6 months to prepare and publish an answer.

From the analysis provided herein, it can be concluded that the establishment of the single rulebook has made the process of application of the regulatory provisions very prolonged and complicated, which creates uncertainty among banks. The harmonization of liquidity risk regulations is progressing gradually at the European level, although it requires years to transform into a truly uniform and comprehensive regulatory framework. Hopefully, however, this new regulatory framework will prevent any possible future crises stemming from the significant deficiencies in the liquidity risk management strategies of banks.

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