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Michael Grill
Pär Torstensson
Michael Wedow

DG-Macro-Prudential Policy and Financial Stability

An update of regulatory developments and impact on banks' regulatory compliance

Money Market Contact Group – 21 November 2014

ECB-RESTRICTED

Overview

1. **EU Delegated Act on the LCR**
2. **Basel Committee agreement on the NSFR**
3. **Leverage ratio: Latest developments in the U.S. and U.K.**
4. **SFTs: EU SFT draft regulation and FSB work**
5. **EU Bank Recovery and Resolution Directive (BRRD)**

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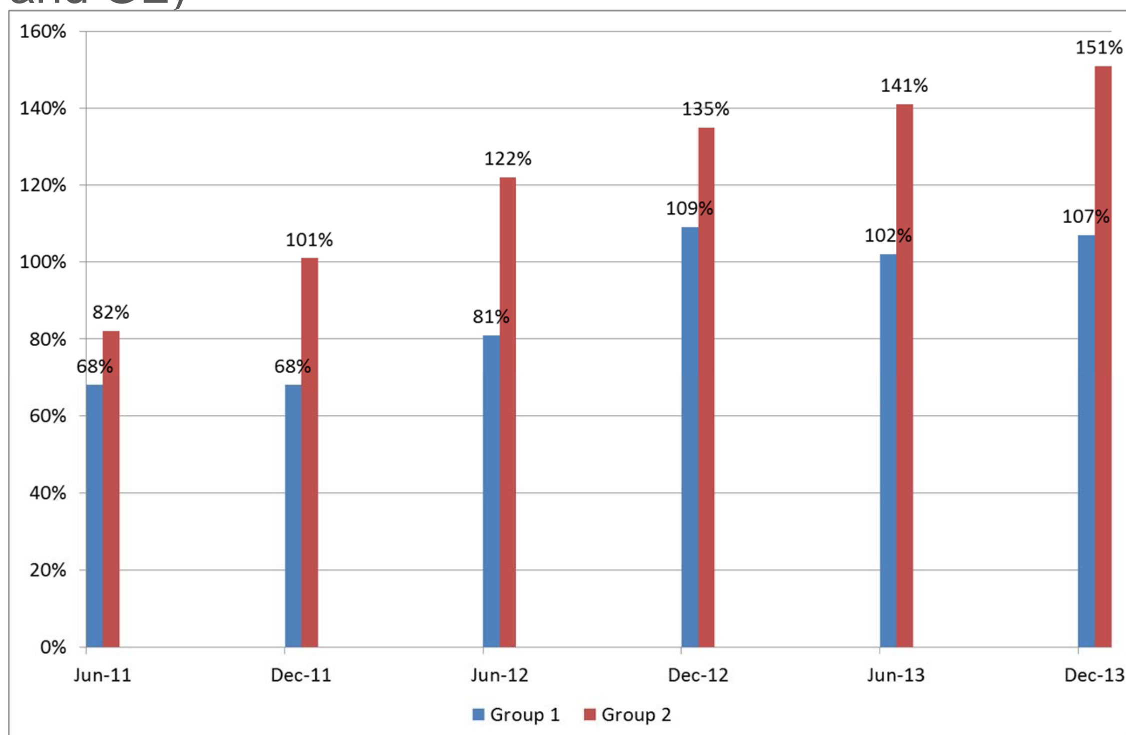
Basel Committee: LCR

$$LCR = \frac{High\ Quality\ Liquid\ Assets}{Outflows - Inflows}$$

where HQLA consists of 3 levels of assets and outflows stem from liabilities and inflows

- State of Play
  - LCR implementation foreseen in January 2015 but likely delayed in EU to October 2015
  - EBA QIS December 2013: LCR 107% and 144% for Group 1 & 2 EU banks
  - Most banks already meet the 60% minimum standard applicable in 2015
  - Few banks account for the majority of LCR shortfall and require adjustment (Group 1 FR and GE)



EU Delegated Act (October 2014): Main Differences

- High Quality Liquid Assets
  - Covered Bonds
    - Level 1: issue size is at least EUR 500mn; Rated at least AA-; 2% over-collateralisation; Haircut 7%, Cap 70%
    - Level 2A: EUR250mn issue size; rated A+ to A-; 15% haircut, Cap 40%
    - Level 2B: if EU regulated and composed of high quality mortgages; EUR250mn issue size; subject to 15% cap and 30% haircut
  - Additional ABS in Level 2B
    - Rated at least AA-; Only the most senior tranche; Backed by residential, commercial, auto and loans to individuals, leases, credit facilities – no re-securitisations or synthetic securitisations; Minimum issuance size at least EUR100 million; Haircuts 25% for residential and auto; 35% for commercial loans and loans to individuals
  - CIUs
    - up to an absolute amount of EUR 500 million; CIUs invests only in liquid assets; higher haircuts applied to underlying assets in CIUs
  - Inflow Caps
    - Specialised (leasing and factoring) credit institutions may be exempted from inflow cap
    - Specialised (consumer and auto loan) credit institutions may apply 90% cap
  - Higher retail deposit outflows: two bands 10-15% and 15-20%; 3% only available in EU from 1 January 2019 subject to approval by COM
  - **Estimated Immediate Impact:** 10-20pp. Improvement in EU banks LCR; reduces LCR shortfall by approximately 40-50%

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2. Liquidity Regulation – Net Stable Funding Ratio

Basel Committee, October 2014

$$NSFR = \frac{Available\ Stable\ Funding}{Required\ Stable\ Funding}$$

where ASF reflects weighted liabilities and RSF weighted assets

- State of Play
  - BCBS published final NSFR calibration in October 2014
  - NSFR implementation Basel III 2018 – CRR not specified
  - EBA QIS December 2013: NSFR 102% and 109% for Group 1 & 2 EU banks
  - BCBS recalibrations may tighten NSFR for some banks with large derivative books
- Revisions:
  - Alignment of SFTs with banks and non-banks: slight increase in RSF from 0% to 10/15% for banks and significant reduction for non-banks 50 to 10/15%
  - More details for treatment of derivatives – but with review clause
  - Possible encumbrance exemption for longer term operations with the central bank ((T)LTRO)
- EU Context
  - NSFR shortfall for Group 1 EU banks: EUR398 bn. requires adjustment
  - NSFR may be adapted for EU context given deviation of EU LCR from Basel III
  - Interaction with phase in of capital standards likely to reduce need for adjustment
  - EBA Project Team to deliver assessment on impact of NSFR by December 2015

3. Leverage Ratio: Latest developments

UK proposal for macro-prudential LR framework

- The Bank of England's Financial Policy Committee (FPC) published its final Leverage Ratio report on 31 October 2014
  - *Sets out recommendations to the U.K. Treasury for the design of the macro-prudential leverage ratio framework*
- The Framework consists of three components:
  i. *a minimum leverage ratio of 3 percent*
  ii. *a supplementary leverage ratio buffer that will apply to G-SIBs and other major domestic UK banks and building societies, including ring-fenced banks;*
  iii. *a countercyclical leverage ratio buffer applied to all banks, and automatically linked to the countercyclical capital buffer in the risk-based framework.*
- Both the supplementary and the countercyclical buffer (CCB) will be set at 35% of the corresponding risk-based requirements
  - *Example: For a bank facing 2% G-SIB buffer, the framework will imply a total LR requirement of between 3.7% (risk-weighted CCB not activated) and 4.6% (when the CCB is set to 2.5%)*
- The LR framework does not reflect binding requirements. Banks breaching the minimum ratio or the buffers will need to agree a capital plan with the supervisor.
- Regarding definition, the exposure measure is based on the CRR that was recently aligned with the latest Basel definition. Role of Additional Tier 1 capital limited in the numerator to 25% of the minimum requirement, with all leverage ratio buffers being met by CET1

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3. Leverage Ratio: Latest developments

U.S. LR developments

- In September 2014 the US banking agencies adopted a final rule modifying the definition of the denominator of the supplementary leverage ratio in a manner consistent with recent changes agreed by the Basel Committee on Banking Supervision.
- As a result, the US require their eight largest bank holding companies to meet a Basel Leverage Ratio of 5 percentage points (a 3% minimum solvency requirement plus a 2% buffer where a breach will trigger restrictions on dividend and bonus payouts)
- This supplementary leverage ratio would be applied in parallel to the already existing generally applicable leverage ratio requirement of 4%, which however differs from the Basel definition.

EU LR developments

- EU Commission adopted on 10 October 2014 the delegated act on the Leverage Ratio, broadly aligning the CRR definition with the Basel definition.

4. SFTs: EU Draft Regulation on Reporting and Transparency

EU Draft Regulation on Reporting and Transparency

- The European Commission's draft proposal was published in January 2014.

- The proposal contains measures aimed at increasing the transparency of securities financing transactions through the obligation to report all SFT transactions to a central database.

- Improves transparency of re-use and re-hypothecation of financial instruments by setting minimum conditions to be met by the parties involved, including written agreement and prior consent.

- The proposed regulation is consistent with the recommendations of the FSB on transparency in SFTs.
  - *In particular, it provides for highly granular and frequent reporting of securities financing transactions to trade repositories*

- The ECB in its legal opinion of 24 June 2014 broadly supports the proposal.

4. SFTs: FSB work on SFTs

FSB WS 5 recommendations on haircuts for SFTs

- Regulatory framework for haircuts on non-centrally cleared securities financing transactions published on 14 October 2014

- Minimum qualitative standards for methodologies used by market participants to calculate haircuts
  - *Haircuts should be based on the market risks of the assets used as collateral and be calibrated at a high confidence level*
  - *Haircuts should capture other risk considerations where relevant*
  - *Additional guidance for methodologies to calculate haircuts on a portfolio basis*

- Numerical floors on haircuts
  - *Scope: non-centrally-cleared securities financing transactions in which financing against collateral other than government securities is provided to non-banks*
  - *New consultative document on potential extension to non-bank to non-bank transactions*

4. SFTs: FSB WS 5 recommendations on haircuts for STFS

Numerical haircuts table:

Table 1: Numerical haircut floors for securities-against-cash transactions[20]

Residual maturity of collateral	Haircut level	
	Corporate and other issuers	Securitised products
$\leq$ 1 year debt securities, and Floating Rate Notes (FRNs)	0.5%	1%
$>$ 1 year, $\leq$ 5 years debt securities	1.5%	4%
$>$ 5 years, $\leq$ 10 years debt securities	3%	6%
$>$ 10 years debt securities	4%	7%
Main index equities	6%	
Other assets within the scope of the framework	10%	

- Apply to non-centrally-cleared securities financing transactions in which financing against collateral other than government securities is provided to non-banks

Bank contributions under the BRRD

- Banks contribute to build up a fund in 10 years
- Target level is 1% of the amount of the aggregate covered deposits
- A bank's contribution will be:
  - *pro rata* to the amount of its liabilities (excl. own funds) less covered deposits, w.r.t. the aggregate liabilities (excl. own funds) less covered deposits of all institutions authorised in the Member State, …
  - …which shall be adjusted in accordance to the risk profile of the bank
- While the BRRD lay out some minima risk criteria to consider, the Commission is empowered to adopt delegated acts on the risk-adjustment
- The Commission adopted a delegated act 21 October 2014, which is subject to a right of objection by Council and Parliament within three months (extendable by a further three months)

The delegated act

- Specifies how to risk-adjust the annual contributions by:
  i. Specifying the fixed part (base) of the contribution;
  ii. Developing the elements which form together the risk indicator against which the riskiness of each institution shall be assessed;
  iii. Providing for the mechanism of adjusting the fixed part of the contribution to the risk indicator
- Bank contribution = basic contribution x risk adjusting multiplier
- Risk adjusting multiplier will range between 0.8 and 1,5
- The risk is assessed on the basis of 4 risk pillars, with specified indicators and different weights:
  a) Risk exposure
  b) Stability and variety of sources of funding
  c) Importance to the stability of the financial system or economy
  d) Additional risk indicators to be determined by the resolution authority

The risk indicators in the delegated act

- ‘Risk exposure’ pillar (50%):
  - Own funds and eligible liabilities held by the institution in excess of MREL
  - Leverage Ratio
  - Common Equity Tier 1 Capital Ratio
  - Total Risk Exposure divided by Total Assets
- ‘Stability and variety of sources of funding’ pillar (20%):
  - Net Stable Funding Ratio
  - LCR
- ‘Importance’ pillar (10%):
  - ‘Share of interbank loans and deposits in the European Union’
- ‘Additional risk indicators’ pillar (20%):
  - Trading activities, off-balance sheet exposures, derivatives, complexity and resolvability (45%)
  - Membership in an Institutional Protection Scheme (45%)
  - Extent of previous extraordinary public financial support (10%)

Special cases

- Special treatment of small institutions:
  - Applies to banks with total liabilities (excl. own funds and covered deposits) less than €300 million and total assets less than €1 billion
  - These banks are allocated to 6 'buckets', which will annually contribute a lump sum in a range €1.000 to €50.000.
  - If any bank would pay more in lump sum than its contribution in the risk-adjusted model, the lowest contribution will apply.
  - Resolution authority can decide that a bank's risk profile is disproportionate to its small size and apply the risk-adjusted model.
- Banks representing 1% of the total assets would pay 0,3% of the total contributions (in the Euro area)
- Also special treatment for specific types of institutions, e.g. mortgage credit institutions financed by covered bonds and which are not allowed to receive deposits, only 50% of the basic annual contribution is applied in the risk-adjusted model.

The Council implementing act

- For the Banking Union, the Commission has drafted a proposal for a Council implementing act to specify the methodology for the calculation of contributions on the basis of the same risk indicators used in the delegated act.
- This act will adapt the methodology to the specificities of a unified system of contributions pooled in the Fund on the basis of a European target level and the eight-year build up period.
- The Board is required to calculate each year the individual contributions to the Fund of the institutions subject to the SRM, by applying the Delegated act and the Council implementing act.
- The act is currently under discussion and will be adopted by the Council by the end of the year.