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 (Text with EEA relevance)

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

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012[(1)], and in particular Article 460 thereof,

Whereas:

(1) During the early 'liquidity phase' of the financial crisis that began in 2007, many credit institutions, despite maintaining adequate capital levels, experienced significant difficulties because they had failed to manage their liquidity risk prudently. Some credit institutions became overly dependent on short term financing which rapidly dried up at the onset of the crisis. Such credit institutions then became vulnerable to liquidity demands because they were not holding a sufficient volume of liquid assets to meet demands to withdraw funds (outflows) during the stressed period. Credit institutions were then forced to liquidate assets in a fire-sale which created a self-reinforcing downward price spiral and lack of market confidence triggering a solvency crisis. Ultimately many credit institutions became excessively dependent on liquidity provision by the central banks and had to be bailed out by the injection of massive amount of funds from the public purse. Thus it became apparent that it was necessary to develop a detailed liquidity coverage requirement whose aim should be to avoid this risk by making credit institutions less dependent on short-term financing and central bank liquidity provision and more resilient to sudden liquidity shocks.

(2) Article 412(1) of Regulation (EU) No 575/2013 imposes a liquidity coverage requirement on credit institutions formulated in general terms as an obligation to hold 'liquid assets, the sum of the values of which covers the liquidity outflows less the liquidity inflows under stressed conditions'. Pursuant to Article 460 of Regulation (EU) No 575/2013, the Commission is empowered to specify in detail that liquidity coverage requirement and the circumstances under which competent authorities have to impose specific in- and outflow levels on credit institutions in order to capture specific risks to which they are exposed. In accordance with Recital 101 of Regulation

Changes to legislation: *There are outstanding changes not yet made to Commission Delegated Regulation (EU) 2015/61. Any changes that have already been made to the legislation appear in the content and are referenced with annotations. (See end of Document for details) View outstanding changes*

(EU) No 575/2013, the rules should be comparable to the liquidity coverage ratio set out in the international framework for liquidity risk measurement, standards and monitoring of the Basel Committee on Banking Supervision ('BCBS'), taking into account Union and national specificities. Until the full implementation of the liquidity coverage requirement from 1 January 2018, Member States should be able to apply a liquidity coverage requirement up to 100 % for credit institutions in accordance with national law.

(3) Consistent with BCBS liquidity standards, rules should be adopted to define the liquidity coverage requirement as a ratio of a credit institution's buffer of 'liquid assets' to its 'net liquidity outflows' over a 30 calendar day stress period. 'Net liquidity outflows' should be calculated by deducting the credit institution's liquidity inflows from its liquidity outflows. The liquidity coverage ratio should be expressed as a percentage and set at a minimum level of 100 %, when fully implemented, which indicates that a credit institution holds sufficient liquid assets to meet its net liquidity outflows during a 30-day stress period. During such a period, a credit institution should be able to convert quickly its liquid assets into cash without recourse to central bank liquidity or public funds, which may result in its liquidity coverage ratio falling temporarily below the 100 % level. Should that occur or be expected to occur at any time, credit institutions should comply with the specific requirements laid down in Article 414 of Regulation (EU) No 575/2013 for a timely restoration of their liquidity coverage ratio to the minimum level.

(4) Only freely transferable assets that can be converted quickly into cash in private markets within a short timeframe and without significant loss in value should be defined as 'liquid assets' for the purposes of credit institutions' liquidity buffers. Consistent with Part Six of Regulation (EU) No 575/2013 and the BCBS classification of liquid assets, appropriate rules should differentiate between assets of extremely high liquidity and credit quality or level 1 assets, and assets of high liquidity and credit quality or level 2 assets. The latter should be further divided into level 2A and 2B assets. Credit institutions should hold an adequately diversified buffer of liquid assets, having regard to their relative liquidity and credit quality. Accordingly, each level and sub-level should be subject to specific requirements on haircuts and limits of the overall buffer and, where appropriate, differentiated requirements should be applied between levels or sub-levels and between categories of liquid assets in the same level or sub-level, which should be more stringent the lower their liquidity classification.

(5) Certain general and operational requirements should be applied to liquid assets to ensure they can be converted into cash within a short timeframe, subject to some exceptions for specified level 1 assets where appropriate. These requirements should specify that liquid assets should be held free from any obstacle preventing their disposal, easy to value and listed on recognised exchanges or tradable on active sale or repurchase markets. They should also ensure that the credit institution's liquidity management function has access to and control of its liquid assets at all times and that the assets comprising the liquidity buffer are appropriately diversified. Diversification is important to ensure that a credit institution's ability to rapidly liquidate liquid assets without a significant loss in value is not compromised by those assets being vulnerable to a common risk factor. Credit

***Changes to legislation:** There are outstanding changes not yet made to Commission Delegated Regulation (EU) 2015/61. Any changes that have already been made to the legislation appear in the content and are referenced with annotations. (See end of Document for details) View outstanding changes*

institutions should also be required to ensure consistency of the currency denomination of their liquid assets and their net liquidity outflows, to prevent an excessive currency mismatch from compromising their ability to use their liquidity buffer to meet liquidity outflows in a specific currency in a stress period.

(6) In accordance with the recommendations made by the European Banking Authority (EBA) in its report of 20 December 2013, prepared pursuant to Article 509(3) and (5) of Regulation (EU) No 575/2013, all types of bonds issued or guaranteed by Member States' central governments and central banks as well as those issued or guaranteed by supranational institutions should be given level 1 status. As the EBA noted, there are strong supervisory arguments for not discriminating between various Member States because the exclusion of some sovereign bonds from level 1 would create incentives to invest in other sovereign bonds within the Union, which would result in the fragmentation of the internal market and increase the risk of mutual contagion in a crisis between credit institutions and their sovereigns (the 'bank-sovereign nexus'). As regards third countries, level 1 status should be given to exposures to central banks and sovereigns which are assigned a 0 % risk weight under the credit risk rules in Title II of Part 3 of Regulation (EU) No 575/2013, as is provided for in the BCBS standard. Exposures to regional governments, local authorities and public sector entities should be given level 1 status only where they are treated as exposures to their central government and the latter benefits from a 0 % risk weight in accordance with the same credit risk rules. The same status should apply to exposures to 0 % risk-weighted multilateral development banks and international organisations. Given the extremely high liquidity and credit quality demonstrated by those assets, credit institutions should be allowed to hold them in their buffers without limit and they should not be subject to a haircut or a diversification requirement.

(7) Assets issued by credit institutions should generally not be recognised as liquid assets, but level 1 treatment should be conferred upon bank assets supported by Member States governments, such as promotional and government-owned lenders as well as private bank assets with an explicit State guarantee. The latter constitute a legacy from the financial crisis that should be phased-out and, accordingly, only bank assets with a government guarantee granted or committed to prior to 30 June 2014 should be eligible as liquid assets. Similarly, senior bonds issued by certain specified asset management agencies of certain Member States should be treated as level 1 assets subject to the same requirements applicable to exposures to the central government of their respective Member State but only with a time-limited effect.

(8) Covered bonds are debt instruments issued by credit institutions and secured by a cover pool of assets which typically consist of mortgage loans or public sector debt to which investors have a preferential claim in the event of default. Their secured nature and certain additional safety features, such as the requirement on the issuer to replace non-performing assets in the cover pool and maintain the cover pool at a value exceeding the par value of the bonds ('asset coverage requirement'), have contributed to make covered bonds relatively low-risk, yield-bearing instruments with a key funding role in mortgage markets of most Member States. In certain Member States outstanding covered bond issuance exceeds the pool of outstanding government bonds. Certain covered bonds of

Changes to legislation: *There are outstanding changes not yet made to Commission Delegated Regulation (EU) 2015/61. Any changes that have already been made to the legislation appear in the content and are referenced with annotations. (See end of Document for details) View outstanding changes*

credit quality step 1, in particular, exhibited an excellent liquidity performance during the period from 1 January 2008 to 30 June 2012 analysed by the EBA in its report. Nevertheless the EBA recommended treating these covered bonds as level 2A assets to align with BCBS standards. However, in the light of the considerations made above about their credit quality, liquidity performance and role in the funding markets of the Union, it is appropriate for these credit quality step 1 covered bonds to be treated as level 1 assets. In order to avoid excessive concentration risks and unlike other level 1 assets, the holdings of credit quality step 1 covered bonds in the liquidity buffer should be subject to a 70 % cap of the overall buffer, a minimum 7 % haircut and to the diversification requirement.

(9) Covered bonds of credit quality step 2 should be recognised as level 2A assets subject to the same cap (40 %) and haircut (15 %) applicable to other liquid assets of this level. This can be justified on the basis of available market data which indicate that credit quality step 2 covered bonds exhibited greater liquidity than other comparable level 2A and 2B assets, such as residential mortgage-backed securities ('RMBSs') of credit quality step 1. Furthermore, permitting these covered bonds to qualify for the purposes of the liquidity buffer would contribute to diversifying the pool of available assets within the buffer and prevent an undue discrimination or a cliff effect between them and covered bonds of credit quality step 1. It should be noted, however, that a significant proportion of these covered bonds became credit quality step 2 as a result of the downgrade in the rating of the Member State's central government where their issuer was established. This reflected the country ceiling typically included in the methodologies of rating agencies which determines that financial instruments may not be rated over a certain level relative to their respective sovereign rating. Hence, country ceilings precluded the covered bonds issued in those Member States from reaching credit quality step 1, irrespective of their credit quality, which in turn reduced their liquidity compared with covered bonds of similar quality issued in Member States that were not downgraded. Funding markets within the Union have become greatly fragmented as a result, which highlights the need to find an appropriate alternative to external ratings as one of criteria in prudential regulation to classify the liquidity and credit risk of covered bonds and other categories of assets. In accordance with Article 39b(1) of Regulation (EU) No 1060/2009 of the European Parliament and of the Council[(2)], the Commission must report by 31 December 2015 on alternative tools to credit ratings, with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020.

(10) In relation to asset-backed securities ('ABS'), the EBA had recommended, consistent with its own empirical findings and with the BCBS standard, that only RMBSs of credit quality step 1 be recognised as level 2B assets, subject to a 25 % haircut. It is also appropriate to deviate from this recommendation and expand level 2B eligibility to certain ABSs backed by other assets. A broader range of eligible subcategories of assets would increase diversification within the liquidity buffer and facilitate the financing of the real economy. Furthermore, as available market data points to a low correlation between ABSs and other liquid assets such as government bonds, the bank-sovereign nexus would be weakened and fragmentation in the internal market would be

***Changes to legislation:** There are outstanding changes not yet made to Commission Delegated Regulation (EU) 2015/61. Any changes that have already been made to the legislation appear in the content and are referenced with annotations. (See end of Document for details) View outstanding changes*

mitigated. In addition, there is evidence that investors tend to hoard high quality ABSs with short weighted-average life and high prepayments during periods of financial instability, as these convert into cash quickly and can be relied upon as a safe source of liquidity. This is particularly the case of ABSs backed by loans and leases for the financing of motor vehicles ('auto loan ABSs'), which exhibited price volatility and average spreads comparable to RMBSs during the 2007-2012 period. Certain sections of consumer credit ABSs, such as credit cards, also showed comparable good levels of liquidity. Lastly, allowing ABSs backed by real economy assets, such as those mentioned already and loans to SMEs, could contribute to economic growth as it would send a positive signal to investors in relation to these assets. Appropriate rules should therefore recognise ABSs backed not just by residential mortgage loans, but also by auto loans, consumer credit and SME loans as level 2B assets. However to preserve the integrity and functionality of the liquidity buffer, their eligibility should be subject to certain high quality requirements consistent with the criteria to be applied to simple, transparent and standardised securitisations in other financial sectorial legislation. For RMBSs in particular, high quality requirements should include complying with certain ratios on loan-to-value or loan-to-income, but those ratios should not apply to RMBS issued before the starting date of application of the liquidity coverage requirement. To account for the less high liquidity observed in consumer credit and SME loan ABSs relative to RMBSs and auto loan ABSs, the former should be subject to a higher haircut (35 %). All ABSs should be subject, like other level 2B assets, to the overall 15 % cap of the liquidity buffer and to the diversification requirement.

(11) The rules in relation to the classification, requirements, caps and haircuts for the remaining level 2A and 2B assets should align closely with the BCBS's and the EBA's recommendations. Shares and units in collective investment undertakings ('CIU'), on the other hand, should be treated as liquid assets of the same level and category as the assets underlying the collective undertaking.

(12) It is also appropriate in determining the liquidity coverage ratio to take into account the centralised management of liquidity in cooperative and institutional protection scheme networks where the central institution or body plays a role akin to a central bank because the members of the network do not typically have direct access to the latter. Appropriate rules should, therefore, recognise as liquid assets the sight deposits which are made by the members of the network with the central institution and other liquidity funding available to those from the central institution. Deposits which do not qualify as liquid assets should benefit from the preferential outflow rates allowed for operational deposits.

(13) The outflow rate for stable retail deposits should be set at a default rate of 5 %, but a preferential outflow rate of 3 % should be allowed to all credit institutions affiliated to a deposit guarantee scheme in a Member State that meets certain stringent criteria. First, account should be taken of the implementation of the Deposit Guarantee Scheme Directive 2014/49/EU of the European Parliament and of the Council[3] by Member States. Second, the scheme of a Member State should comply with specific requirements relating to the repayment period, *ex-ante* funding and access to additional financial means in the event of a large call on its reserves. Last, the application of the preferential