FEEDBACK ON RESPONSES TO THE LIQUIDITY DP

DOCUMENT OVERVIEW

This document contains feedback on responses received to the Discussion Paper "*Basel III: Liquidity*" ("**Liquidity DP")** issued jointly on 7 July 2015 by the Jersey Financial Services Commission ("**JFSC**"), the Guernsey Financial Services Commission ("**GFSC**") and the Isle of Man Financial Supervision Commission, which has, through merger, become the Isle of Man Financial Services Authority ("**IoMFSA**") (collectively, the "**Tri-Party Group**").

1 Introduction

1.1 The Liquidity DP raised, and proposed outline solutions to, issues relating to regulatory requirements for liquidity management and reporting in the Crown Dependencies ("**CDs**"). It used as its basis papers issued by the Basel Committee on Banking Supervision ("**Basel Committee**"). In so doing, it addressed the similar EU proposals incorporated in the Capital Requirements Regulation ("**CRR**").

1.2 This paper addresses feedback provided by banks from across the CDs and outlines a general implementation plan. It also focusses on certain key issues in detail, including:

1.2.1 High Quality Liquid Assets ("**HQLA**") definition (Section 3);

1.2.2 Group liquidity (Section 4);

1.2.3 Treatment of stable retail deposits (Section 5);

1.2.4 Treatment of fiduciary deposits (Section 6);

1.2.5 Stress testing and validation (Section 7); and

1.2.6 Other key issues (Section 8).

2 Implementation plan

2.1 The Tri-Party Group has endeavoured to adopt a common approach, wherever feasible. To meet this objective, Tri-Party Group members will individually continue consultation, based on the approach set out in the Liquidity DP and herein, with respect to both the Liquidity Coverage Ratio ("**LCR**") and the Net Stable Funding Ratio ("**NSFR**").

2.2 As part of this consultation a limited number of areas will be identified where treatments may differ across the CDs. In particular, regulatory reporting formats and schemas may differ in order to ensure that information provided meets local needs.

2.3 Plans to address stress testing and validation of assumptions in each island may be shared but it is likely that, in the near term at least, approaches will differ, reflecting differences in the make-up of the banking sectors. This is consistent with the differing approaches to Pillar 2, in respect of similar stress-testing regarding capital (see Section 7 for detail).

3 HQLA definition

3.1 Several respondents suggested changing the components of HQLA. Most requests echoed similar public responses made to the EU Commission regarding its implementation of the LCR (in the CRR). It is understood that some of these were successful, resulting in amendments to the CRR, at variance to the Basel Committee standard. Examples include a better treatment of certain covered bonds and eligibility of investments in collective investment undertakings ("**CIUs**"), where a look-through approach applies under CRR.

3.2 The circumstances in the CDs are different to those in the EU. Critically, the CDs do not have a central bank that would provide liquidity in stressed circumstances and hence the quality of HQLA must be such that in all circumstances marketability would be maintained.

3.3 Relevant banking groups have had extensive opportunities to provide feedback to the Basel Committee and challenge its findings, with no resultant change to the definitions of HQLA. It is therefore not proposed to effect definitional changes to those in the Liquidity DP.

3.4 In particular, it is intended to implement the following, as established in the liquidity DP:

3.4.1 Covered bonds will be eligible, but only as "Tier 2" HQLA; and

3.4.2 Investments in CIUs will not be eligible as HQLA and inflows from CIUs may only be reflected to the extent they are contractually due.

4 Group liquidity

4.1 The Liquidity DP acknowledged that several banks that have operations in the CDs manage liquidity on a group basis, holding HQLA centrally (typically, in the country where the group is headquartered). It proposed an alternative formulation to the LCR, the CD Liquidity Mismatch Ratio or "**LMR**" for such banks. This removed the LCR requirement that HQLA must exceed 25% of gross projected outflows. As this would be likely to result in full reliance on projected inflows to meet projected outflows, the proposal also required that, in effect, such inflows must be predicted to occur before the outflows they offset.

4.2 Respondents were generally supportive of the rationale for the CDLMR but some sought a simpler approach. It has been decided to achieve this by removing the cap on recognition for certain "qualifying group inflows" (so that such inflows are treated similarly to HQLA) i.e. those where:

4.2.1 They are contractually due within one week (5 working days[1]); and

4.2.2 The counterparty is a group bank; and

4.2.3 The counterparty and the local bank are part of a group that is subject to the LCR on a consolidated basis.

4.3 This ensures that qualifying group inflows are locally accessible within a timescale that is similar to the timescale for accessing cash by sale or repo of HQLA (that they would be a substitute for).

4.4 Excepting this change, the CDLMR would be broadly as described in the Liquidity DP, with:

4.4.1 The numerator being (1) HQLA plus (2) qualifying group inflows plus (3) other projected inflows, subject to a limit of 75% of projected outflows; and

4.4.2 The denominator being projected outflows.

4.5 Some also questioned why the CDLMR was described as an option for which regulatory approval would be needed, rather than simply being available in all cases. The rationale is that in certain circumstances it would be either (1) unsafe to rely on inflows from group banks or (2) only safe to rely on inflows if necessary conditions were attached to the approval.

4.6 It is not possible to prescribe grounds for refusal but, as a guideline, refusal might be expected in circumstances where permission has not been granted for exposures to the relevant group counterparties under local Large Exposure rules.

4.7 Conditions imposed on approval might include limiting qualifying group inflows to only those placed with named banks that manage liquidity for the group.

[1] Group inflows that arise later than one week would be treated in the same way as any other inflows.

5 Treatment of stable retail deposits

5.1 Several banks questioned the treatment proposed in the Liquidity DP whereby only retail deposits fully covered by deposit compensation schemes ("**DCSs**") would be eligible for the lowest assumed outflow rate of 5%.

5.2 This was proposed in order to address concerns regarding the stability of larger retail deposits in the CDs in the event of a crisis.

5.3 Alternatives have been reconsidered, including limiting the amount by reference to the parameters of the various local DCSs.

5.4 It is now proposed to instead permit banks to include the amount under the DCS coverage level in all cases. For example, if an individual deposit of £1 million is held by a CD bank then an amount of £50,000 would be eligible for the stable retail treatment.

5.5 Two factors influenced this decision:

5.5.1 Recovery and resolution planning has not been fully developed everywhere but the key principles are now established internationally and hence bank failures leading to losses of insured deposits elsewhere are considered to be less likely to occur. Hence, concerns are less likely to be triggered; and

5.5.2 In the event that unfolding events necessitated a re-appraisal of risks, this could be addressed through the "Pillar 2" stress test based approach set out in Section 7.

6 Treatment of fiduciary deposits

6.1 Some respondents queried the detail of proposals set out in the Liquidity DP for a beneficial treatment of outflows relating to fiduciary deposits received on a "designated" basis. This feedback will be taken into account in developing LCR reporting forms and guidance.

6.2 Some respondents questioned why no similar beneficial treatment was proposed in relation to accounts received on a "pooled" basis, including Swiss fiduciary deposits. The rationale generally asserted for a beneficial treatment was that the underlying customers were retail in nature and therefore sticky.

6.3 The argument for not treating such deposits as retail in nature is that where a single manager is responsible for the placement of funds, it is the manager that makes the relevant decisions over where to do so. Their decisions should not be expected to be similar to those of a retail customer; they can be expected to have greater knowledge and expertise, and be subject to supervision. Moreover, they can be expected to have the capability to readily move large sums to alternative banks in case of need. It is this, rather than the threat of individual customer withdrawals, that is the relevant risk driver.

6.4 Notwithstanding this, the Tri-Party Group has decided that the 100% outflow rate established by the Basel Committee might not be appropriate in all cases. Instead, each supervisor will assess local conditions and determine whether a reduced rate, of at least 50%, should apply in specific circumstances.

7 Stress testing and validation

7.1 Historically, regulation concerning liquidity reporting and management has varied significantly across the CDs. In contrast, capital regulations are more closely aligned, although each Island's approach to Pillar 2 differs.

7.2 In implementing the LCR, it is intended that stress testing and validation will be required to be carried out by all CD banks, with each regulator developing local requirements governing this, ensuring that they are appropriate to local circumstances.

7.3 It is intended that the relevant processes will be similar to the Pillar 2 processes already in place in respect of capital adequacy. Specifically, banks will be required to have a documented process to ensure liquidity is adequate at all times, having regard to both the regulatory minima and liquidity stress testing that they conduct. In similar fashion to Pillar 2, it is intended that the process would be subject to supervisory review, which will be established by local regulations.

7.4 The areas that will be covered by such regulations will include:

7.4.1 **LCR as a minimum.** No adjustments will be permitted under the stress testing approaches that reduce the amount of liquidity required for any category below that established in the local implementation of the LCR.

7.4.2 **LCR monitoring by currency**. The Liquidity DP proposed an approach whereby banks would be required to establish approaches to ensuring assets were available to meet needs on an individual currency basis in their own Liquidity Management Policies. This would be monitored via prudential reporting and subject to supervisory review under the Pillar 2 process.

7.4.3 **Stress testing and validation of predicted outflow rates for deposits and facilities granted to customers.** The Liquidity DP proposed that banks should carry out stress tests. If, as a result of these, deposits were identified where higher outflows were anticipated under a stress scenario than in the LCR, the bank would be expected to hold more HQLA. The European Banking Authority guidelines on deposit outflow rates under the CRR[2] identified risk factors (such as the denomination of a deposit, size of deposit, distribution channel etc) and it is intended to similarly identify relevant factors as and when local guidelines are established.

7.4.4 In the particular case of unconditionally cancellable facilities, for which the Liquidity DP proposed that banks would be required to identify the appropriate

[2] https://www.eba.europa.eu/documents/10180/515704/EBA-GL-2013-01+(Retail+deposits).pdf

outflow rate, banks may: (1) apply a 100% outflow rate in all cases, (2) apply outflow rates as if they were non-cancellable facilities, where this would result in a lower than 100% outflow rate or (3) seek to establish that specific lower rates are appropriate (no minimum is established in the LCR).

8 Other key issues.

8.1 **NSFR reporting.** No respondents raised objections to the proposal to require NSFR reporting and this will be developed alongside LCR reporting. Concerns were raised regarding the consequences of introducing a minimum for the NSFR and will be taken into account in any future work on this subject.

8.2 Feedback received on details of the proposals will be taken into account in the drawing up of reporting schemas and drafting guidance for the LCR and NSFR.

8.3 **Treatment of inflows from third party banks.** It was suggested that all inflows from banks should be permitted to fully offset outflows. This would not be compliant with the Basel III LCR standard and we do not consider that there is any basis for a general deviation. The particular issue of up-streaming within a banking group that complies with the LCR on a consolidated basis is addressed in Section 4 and does not conflict with the Basel III LCR standard, which does not address intra-group flows.

8.4 **Central bank eligibility of HQLA.** There were also questions regarding HQLA and central bank eligibility, as set out in Appendix D of the Liquidity DP. The following is intended to clarify what was set out in paragraphs D.1.3 and D.1.4 and will be used as the basis for implementation:

8.4.1 Paragraph D.1.3 stated that "*HQLA should ideally be eligible at central banks…*". The Basel III LCR standard contains this wording and this reflects a presumption that markets in ineligible assets are more likely to dry up in a crisis. This does not mean that an ineligible asset cannot be HQLA but rather that eligibility should be considered by local banks alongside the other relevant characteristics (those listed in Appendix D of the Liquidity DP); and

8.4.2 Paragraph D.1.4 draws a further distinction between assets that can only be sold/repo'd to the market and those that can be (directly or indirectly) repo'd with central banks (possibly via group counterparties). This reflects a presumption that group banks would be likely to be willing and able to utilise such assets to seek and on-lend central bank funding during a crisis, were this to be necessary. This is a relevant consideration and should be assessed alongside other operational considerations (those set out in Appendix E of the Liquidity DP).

8.5 **Cash-backed loans**. The Liquidity DP did not address the situation where a deposit is pledged as security for a loan. In such circumstances, outflows relating to the pledged deposit may be excluded from the LCR calculation but only if the following conditions are met:

8.5.1 The loan will not mature or be settled in the next 30 days; and

8.5.2 The pledge arrangement is subject to a legally enforceable contract disallowing withdrawal of the deposit before the loan is fully settled or repaid; and

8.5.3 The amount of deposit to be excluded does not exceed the outstanding balance of the loan.

8.6 The above treatment does not apply to a deposit which is pledged against an undrawn facility, in which case the higher of the outflow rate applicable to the undrawn facility or the pledged deposit applies.

8.7 **(Net) Inflow rate for claims on sovereigns, MDBs and PSEs.** In paragraph 18.5.2 of the Liquidity DP, it was proposed that the predicted inflow rate (for the purpose of the LCR) for such claims should be 50% of the amount contractually due. For the avoidance of doubt, it is confirmed that where the inflows relate to an asset that qualifies as HQLA, the double-counting rule means that no inflow would be reflected (See Appendix C of the Liquidity DP). Hence, this treatment would only apply in the case of a loan or a bond held that did not meet the criteria to be classed as HQLA.

8.8 **Treatment of branches**. As stated in the Liquidity DP, it is not intended to make branches subject to these proposals. However, for the avoidance of doubt, branch reporting might, at some point, be aligned by replacing the various mismatch reports used with reports based on those for banks incorporated in the CDs.