

# ALLEN & OVERY



## Capital Requirements Directive IV Framework *Liquidity Requirements*

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# CRD IV Framework: *Liquidity Requirements*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV<sup>1</sup> (**CRD IV**) and the Capital Requirements Regulation<sup>2</sup> (**CRR**), replacing the Banking Consolidation Directive<sup>3</sup> and the Capital Adequacy Directive.<sup>4</sup> The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be

relevant to the in-house lawyer. This briefing is for general guidance only and does not constitute definitive advice.

**NOTE: In relation to the topics discussed in this briefing, the CRR contains a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects.**

**This briefing paper is based on information available as of 17 January 2014.**

<sup>1</sup> 2013/36/EU.

<sup>2</sup> Regulation 575/2013.

<sup>3</sup> 2006/48/EU.

<sup>4</sup> 2006/49/EU.

## Background and scope

CRD IV and the CRR apply from 1 January 2014. CRD IV and the CRR (together the **CRD IV Framework**) primarily represent the European Commission's implementation of the revision to the **Basel Accord** known as **Basel III**.

In line with Basel III, the CRD IV Framework introduces a new liquidity coverage requirement for credit institutions and investment firms, which is meant to ensure that firms have enough liquid funds to meet outflows, including in stressed circumstances. In the UK, this will replace existing liquidity regulatory requirements from 2015. The CRR also provides for net stable funding reporting, pending agreement of substantive rules for a net stable funding ratio.

## Sources

Policy impetus and rationale: CRR (*Regulation 575/2013*): Recitals 100 -112; CRD IV (*Directive 2013/36/EU*): Recitals 76 and 77.

Competence and duties of home and host Member States: CRD IV (*Directive 2013/36/EU*): Articles 49-52.

Liquidity – Definitions and Liquidity Coverage Requirement: CRR (*Regulation 575/2013*): Articles 411-428.

Delegated and Implemented Acts: CRR (*Regulation 575/2013*): Articles 460 and 461.

Reports and Reviews – Liquidity Requirements: CRR (*Regulation 575/2013*): Article 509.

[UK Financial Conduct Authority \(FCA\) Policy Statement \(PS13/10\) CRD IV for Investment Firms \(December 2013\)](#).

[UK Prudential Regulation Authority \(PRA\) Policy Statement \(PS7/13\) Strengthening capital standards: implementing CRD IV, feedback and final rules \(December 2013\)](#).

# Introduction

The Basel III reforms introduce for the first time quantitative liquidity requirements for credit institutions and investment firms. These quantitative liquidity requirements are split into two:

- the Liquidity Coverage Requirement (the **LCR**) which aims to ensure that institutions hold a buffer of unencumbered high quality liquid assets (**HQLA**) to meet net liquidity outflows under a

30-day stress scenario in order to meet short-term liquidity needs; and

- the Net Stable Funding Requirement (the **NSFR**) which addresses long-term liquidity mismatches by incentivising institutions to use stable sources of long-term funding.

# Application

The CRD IV Framework applies to credit institutions and investment firms and the new liquidity requirements apply to both types of entities. However, only investment firms which carry out the MiFID<sup>5</sup> activities of dealing on own account, and

underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis, will have to comply with the liquidity requirements.

<sup>5</sup> The Markets in Financial Instruments Directive (2004/39/EC).

# Liquidity requirements

As discussed above, the two new liquidity requirements are:

- the LCR, which aims to improve short-term resilience of the liquidity risk profile of firms by requiring a buffer of high quality liquid assets to be held; and
- the NSFR, which aims to ensure that a firm has an acceptable amount of stable funding to support its assets and activities over the long term.

The LCR is designed to measure whether firms hold an adequate level of unencumbered HQLA to meet net cash outflows under a stress scenario lasting for 30 days. The LCR measures the available

liquid assets against net cash outflows arising in the 30-day stress scenario period. Credit institutions are expected to maintain an LCR providing at least full coverage of projected liquidity outflows minus projected liquidity inflows under stressed conditions. This is to ensure that institutions maintain adequate levels of liquidity buffers to face any possible imbalance between liquidity inflows and outflows under severely stressed conditions. Much of the detail of the LCR is still to be specified in technical standards.

The LCR will be phased in over a number of years, with credit institutions obliged to hold 60% of their full LCR in 2015, 70% in 2016, 80% in 2017 and 100% in 2018.

The CRR contains interim reporting requirements on stable funding but does not include substantive provisions relating to the NSFR. The European Commission intends to develop the NSFR, with the aim of introducing it from 1 January 2018. The NSFR will measure the amount of stable funding available to a firm against the required amount of stable funding (defined as those types and amounts

of equity and liability financing expected to be reliable sources of funds over a one-year time period under conditions of extended stress). The required amount of stable funding will be measured on the basis of the broad characteristics of the liquidity risk profiles of a firm's assets, off-balance sheet exposures and other selected activities.

## Reporting requirements

Until the LCR is in force, firms must report liquid assets as set out in the CRR on not less than a monthly basis. Stable funding must be reported on not less than a quarterly basis.

Firms will be obliged to report their holdings of liquid assets to the competent authorities in their home states regularly and, should they fail to meet or expect to fail to meet either the LCR or the NSFR, they must report to the relevant competent authorities daily until instructed otherwise.

For firms with branches in other member states which are supervised on a consolidated basis, the

information provided will be shared with all national regulators and central banks in its host states, with the national regulators in jurisdictions where the firms' parent entities have authorised subsidiaries, the European Banking Authority (**EBA**) and the European Central Bank (**ECB**).

However, until these reporting obligations regarding the LCR are in place, firms may be required to continue to report to their home and host state regulators as they do currently. In the UK, the PRA and FCA have continued pre-CRD IV liquidity requirements pending implementation of the LCR.

## Valuation

The value of liquid assets to be reported is that asset's market value, subject to appropriate haircuts. Those haircuts must reflect the duration, credit and liquidity risk as well as typical repo haircuts in periods of general market stress. For transferable assets of high liquidity and credit quality, the minimum haircut is 15% and, if the price risk of an asset is hedged, the cash flows resulting from a potential close-out of the hedge need to be taken into account in the valuation of the asset.

Additionally, shares or units in collective investment undertakings are subject to haircuts on a look-through basis to the underlying assets. In situations where the institution holding the shares or units in the collective investment undertaking is not aware of the underlying exposures, it must assume that the collective investment undertaking invests to the maximum extent allowed under its mandate, in descending order, in (i) cash and central bank exposures which can be easily withdrawn in times of stress, (ii) other transferable assets that are of extremely high liquidity and credit quality, and (iii) government bonds and other transferable assets that are of high liquidity and credit quality, until the maximum total investment limit is reached.

# Operational requirements

Not all assets that meet the basic definition of liquid assets can be counted as part of an institution's LCR. Assets meeting the definition can only count towards the reportable LCR if:

- (a) they are appropriately diversified;<sup>6</sup>
- (b) they are legally and practically readily available at any time during the next 30 days;
- (c) the liquid assets are controlled by the institution's liquidity management function;
- (d) a portion of the liquid assets are sold periodically and at least annually to test the market access, the effectiveness of the liquidation process, the usability of the assets and to minimise the risk of negative signalling during a period of stress;
- (e) price risk can be hedged, but only if the illiquid assets remain readily available to the treasury when needed and are not used in other ongoing operations such as hedging or trading strategies, providing credit enhancements in structured transactions or covering operational costs; and
- (f) the denomination of the liquid assets is consistent with the distribution of projected outflows after the deduction of inflows.

<sup>6</sup> Instruments set out in Article 416(1)(a)-(c) CRR are not affected.

## Conclusion

The substance of the CRR's liquidity requirements remains to be finalised over 2014. The detailed reporting and operational requirements in combination with the identification and valuation of liquid assets will increase institutions' regulatory burdens beyond the obvious additional costs of holding the necessary liquid assets for the LCR and (in due course) the NSFR.

As the liquid assets held to meet these requirements must be unencumbered HQLA, the new requirements may, together with the other regulatory requirements requiring HQLA (such as the increased collateralisation requirements under the new rules for derivatives), lead to a 'collateral crunch', as there is a limit on the total value of assets that can be used to fulfil these new requirements.



# EBA technical standards and guidelines

CRD IV and the CRR mandate that various technical standards and guidelines shall be produced. In connection with liquidity requirements, the following technical standards and guidelines shall be produced:

CRD IV/CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
Article 415(3)(a) CRR ( <i>Reporting obligation and reporting format</i> )	Implementing technical standards on uniform formats and IT solutions with associated instructions for frequencies, reference and remittance dates for the reporting obligation.	CRR deadline states 1 February 2015.  Submitted 28 July 2013 (amended by corrigendum).	Consultation on draft implementing technical standards on supervisory reporting requirements for liquidity coverage and stable funding (June 2012) ( <a href="#">EBA/CP/2012/05</a> ).
Article 415(3)(b) CRR ( <i>Reporting obligation and reporting format</i> )	Implementing technical standards on additional liquidity monitoring metrics.	1 January 2014.	Final draft implementing technical standards on additional liquidity monitoring metrics (December 2013) ( <a href="#">EBA/ITS/2013/11</a> ).  Final draft implementing technical standards on supervisory reporting (July 2013) ( <a href="#">EBA/ITS/2013/02</a> ).
Article 415(3)(b) CRR ( <i>Reporting obligation and reporting format</i> )	Implementing technical standards on provision of information for reporting for the purposes of additional liquidity monitoring.	1 January 2014.	<a href="#">European Commission draft implementing technical standards with regard to supervisory reporting of institutions (January 2014)</a> .
Article 416(5) CRR ( <i>Reporting on liquid assets</i> )	Implementing technical standards on listing the currencies which meet the conditions referred to in the third sub-paragraph of paragraph 3).	31 March 2014.	Consultation on draft implementing technical standards on currencies with an extremely narrow definition of central bank eligibility (October 2013) ( <a href="#">EBA/CP/2013/37</a> ).
Article 419(4) and Article 419(5) CRR ( <i>Currencies with constraints on the availability of liquid assets</i> )	Technical standards on currencies for which the justified demand for liquid assets exceeds their availability; derogations for eligible currencies; and the currencies with an extremely narrow definition of central bank eligibility.	31 March 2014.	Consultation on draft implementing technical standards on currencies for which the justified demand for liquid assets exceeds the availability of those assets (October 2013) ( <a href="#">EBA/CP/2013/38</a> ).  Consultation on draft regulatory technical standards on derogations from currencies with constraints on the availability of liquid assets (October 2013)

CRD IV/CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
			<a href="#">(EBA/CP/2013/39)</a> .
Article 421(3) CRR ( <i>Outflows on retail deposits</i> )	Guidelines regarding the outflow of retail deposits.	1 January 2014.	Consultation on guidelines on retail deposits subject to different outflows for purposes of liquidity reporting (August 2013) <a href="#">(EBA/CP/2013/34)</a> .  Guidelines on retail deposits subject to different outflows for purposes of liquidity reporting (December 2013) <a href="#">(EBA/GL/2013/01)</a> .
Article 422(10) CRR ( <i>Outflows on other liabilities</i> )	Regulatory technical standards to specify the local regulator's ability to apply a lower retail deposit outflow rate.	1 January 2015.	None to date.
Article 423(3) CRR ( <i>Additional outflows</i> )	Regulatory technical standards on the conditions of application of the additional outflow corresponding to collateral needs in relation to the notion of materiality and methods for the measurement of this additional outflow.	31 March 2014.	Consultation on draft regulatory technical standards on additional liquidity outflows (May 2013) <a href="#">(EBA/CP/2013/19)</a> .
Article 425(6) CRR ( <i>Inflows</i> )	Regulatory technical standards on conditions under which the local regulator may apply a higher inflow rate.	1 January 2015.	None to date.
Article 426 CRR ( <i>Updating future liquidity requirements</i> )	Implementing technical standards to specify the conditions set out in Article 421(1), Article 422, with the exception of paragraphs 8, 9 and 10 of that Article, and Article 424 to take account of international standards.	No date specified.	None to date.
Article 50(6) CRD IV ( <i>Collaboration concerning supervision</i> )	Regulatory technical standards to specify the information referred to in Article 50.	1 January 2014.	Final draft regulatory technical standards on collaboration concerning supervision between the competent authorities of home and host Member States specifying the information to be shared (December 2013) <a href="#">(EBA/RTS/2013/10)</a> .
Article 50(7) CRD IV ( <i>Collaboration concerning supervision</i> )	Implementing technical standards to establish standard forms, templates and procedures for the information sharing requirements which are likely to facilitate the monitoring of institutions.	1 January 2014.	Final draft implementing technical standards on collaboration concerning supervision between home and host Member States regarding sharing of information (December 2013)

CRD IV/CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
			<a href="#">(EBA/ITS/2013/07)</a> .
Article 51(4) CRD IV ( <i>Significant branches</i> )	Regulatory technical standards to specify general conditions for the functioning of colleges of supervisors.	31 December 2014.	None to date.
Article 51(5) CRD IV ( <i>Significant branches</i> )	Implementing technical standards to determine the operational functioning of colleges of supervisors.	31 December 2014.	None to date.

The consultations and other documents relating to these RTS and ITS are available here: <http://www.eba.europa.eu/regulation-and-policy/liquidity-risk>.

## National discretions and UK implementation

The CRR provides competent authorities with certain discretions:

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA PROPOSAL TO EXERCISE DISCRETION
Article 6(4) ( <i>General principles</i> )	Pending a further report by the European Commission into the application of liquidity requirements to investment firms which carry out the MiFID activities of dealing on own account, and underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis by the end of 2015, competent authorities can exempt these investment firms from the liquidity requirements, 'taking into account the nature, scale and complexity of the investment firm's activities'.	In respect of FCA authorised firms, the FCA has indicated that it intends to exercise this discretion. The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).  In respect of PRA authorised firms, the PRA has indicated that it does not intend to exercise this discretion.
Article 11(3) ( <i>General treatment</i> )	Competent authorities may exempt investment firms from the liquidity requirements on a consolidated basis, 'taking into account the nature, scale and complexity of the investment firm's activities'.	In respect of FCA authorised firms, the FCA has indicated that it intends to exercise this discretion. The FCA has set out whether it intends to exercise these discretions in Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013).  In respect of PRA authorised firms, the PRA has indicated that it does not intend to exercise this discretion.



# Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

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