1i) Implementation of Basel III in the euro area

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Outline

1. **Recap: The Basel III Liquidity Framework**
2. **Transposition into binding EU legislation (CRD IV)**
3. **Potential divergence from the Basel III liquidity framework**
4. **Wrap-up/next steps**

1. The Basel III Liquidity Framework

- **New capital and liquidity standards (Dec. 2010/June 2011):**
  - Two sets of standards: capital and liquidity
  - Objective: improve the banking sector's ability to absorb shocks arising from stress, thus reducing the risk of spill-over from the financial sector to the real economy
  - Why **liquidity standards**? The crisis clearly revealed how quickly liquidity can evaporate as a consequence of changes in market conditions
  - Bank management was apparently "caught off guard" by those developments
  - Regulatory response was twofold:
    - Basel Committee's *Principles for Sound Liquidity Risk Management* (2008)
    - Two minimum standards for liquidity: *Liquidity Coverage Ratio (LCR)* and *Net Stable Funding Ratio (NSFR)*

1. The Basel III Liquidity Framework

- **Basel III introduces 2 minimum standards for liquidity:**
  - **Liquidity Coverage Ratio (LCR):** Short-term measure, to enable banks to survive 1-month stress scenario

$$\text{LCR} = \frac{\text{Stock of highly liquid assets}}{\text{Expected net cash outflow in 30 days}} \geq 100\%$$

  - **Net Stable Funding Ratio (NSFR):** Longer-term measure, to create incentives for more stable funding

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

2. Transposition into binding EU legislation

- **CRD IV (proposal of 20 July 2011):**
  - Proposed CRD IV follows “spirit” of Basel III. However, no simple copy and paste.
  - Basel III: not a law, rather a set of internationally agreed principles.
  - Different scope of application: Basel III (internationally active banks) vs. CRD (all banks as well as investment firms)
  - Single rule book: **Regulation** shall ensure uniform application
  - **Directive**: Not directly applicable. Contains e.g. Pillar 2 measures and capital buffer regimes

3. Potential divergence from Basel III

- **Definition of liquid assets for the LCR requirement:**
  - CRR: Definition of liquid assets is not as precise. Provisions aim at specifying reporting obligations to facilitate further analysis (to be conducted by the EBA) on the liquidity eligibility criteria
  - Shares in Collective Investment Units (CIUs) also eligible, up to a threshold and under certain conditions
- **Net Stable Funding Ratio: Implementation**
  - CRR: The Commission will use the longer Basel observation period to prepare a legislative proposal. The implementation language is somewhat ambiguous, e.g. using words as “will consider” and “if appropriate”. However, the Commission has been very vocal on its commitment to follow Basel III

3. Potential divergence from Basel III

- **What could be done?**
  - **Definition of liquid assets:**
    - ➢ Clarify the precise interaction with the reporting requirements in Art. 404 of the CRR and the list of eligible liquid assets as stipulated in Annex III.
  - **Implementation of new liquidity standards:**
    - ➢ Use consistent implementation language for all elements subject to observation period (leverage ratio and liquidity framework)
    - ➢ Adjust text to adequately reflect COM's commitment to introduce requirements after observation period (avoid "ambiguous" terms)
    - ➢ LCR/NSFR: References in the text should clearly convey that ratios will become effective on 1 January 2015 and 1 January 2018, respectively

4. Wrap-up/next steps

- **Divergence from Basel III:**
  - On liquidity, it seems to be more a problem of “potential discretion” and “inconsistent language” which could easily be solved
  - It is key to not leave any doubt at this stage that the LCR as well as the NSFR will indeed become binding requirements, after appropriate review and subject to recalibration

- **Further ECB assessment of the proposed CRD IV:**
  - ECB will provide its Opinion on the proposed CRD IV, by November 2011
  - Thus, the above recommendations are without prejudice to the content of this legal opinion
  - Joint FSC/MOC Task Force to analyse the impact of the Liquidity Regulation on the recourse of banks to Eurosystem monetary policy operations and related effects on financial markets

Thank you for your attention!