Institutional and Regulatory Strategic Advisory
Group Finance – Treasury – Asset Liability Management & Financial Planning - Strategic Funding - Group Finance Reporting and Operations
Group Risk Management – Liquidity Risk portfolio – Treasury and Credit Treasury Risks

UniCredit Group's reply to the Basel Committee on Banking Supervision's Consultative Document on "International Framework for Liquidity Risk Measurement, Standards and Monitoring"

1. General remarks

UniCredit supports the efforts of Basel Committee on Banking Supervision (BCBS) to address under a common harmonized framework the major themes regarding safe liquidity management in banking groups.

Setting up a general framework is of paramount importance to prevent different home country regulatory approaches that, if not harmonized, could generate un-level playing field effects with undesired potential bottlenecks in liquidity and balance sheet management of international banking groups.

At the same time, however, it is of crucial importance that peculiarities of different financial systems (bank-oriented vs market-oriented) across the world are taken into account when defining the new regulatory framework. Otherwise, despite the intention to promote a level playing field, there is a risk of discriminating against one financial system and in favor of another one.

On the basis of current Basel proposal on liquidity, stock of highly quality liquid assets should first of all be highly "marketable". This definition of liquidity does not necessarily reflect the eligibility criteria for monetary operations with the Central Banks. From that perspective, we deem the concept of liquidity as first of all "marketability" more suited to the US market-based financial system and not "adequate" to properly address the specificities of the European (Euro area) banking system.

Some assets can be "liquefied" if they are eligible for Central Banks credit operations in the sense that can be "transformed" into Central Bank money, regardless the marketability of the assets. This is particularly the case under stress conditions where both an idiosyncratic as well as a market disruption is occurring. In such circumstances the marketability of an asset becomes quite unpredictable. In fact the market-risk aversion sharply increases whereas the Central Bank risk aversion may decrease (e.g. temporary extension of eligible assets, liquidity allotment policy), counterbalancing the change in market behavior.

For instance, the broad range of ECB eligible assets has proved to be a crucial feature in ensuring banks' resilience during the recent crisis, even more important than the market-liquidity under normal conditions. Such a feature is not fully reflected by the BCBS, which in our opinion should foster a higher degree of convergence among Central Banks themselves and between Central Banks and banking Supervisors.

The rationale of the equation liquidity = eligibility is based on the main feature of the Euro area financial system. The prominent role of Euro area banking loans to finance private sector (households and non financial corporate sector) and the lower recourse to external capital markets by banks is one of the factors which explains why the Eurosystem accepts a wide range of collaterals[1]. In addition, the existence of differences in the characteristics of governments bonds in the Euro-area from a liquidity as well as a risk perspective, together with the need to ensure a level playing field, contributes to explain a "wider" eligibility criteria compared to US. Last but not least, EU Treaty, banning monetary financing to the public sector, makes even more compelling the need to recourse to a wide range of collateral for the implementation of monetary policy.

Furthermore, the alignment of the Basel III criteria for liquid assets with those of Central Banks would also allow a broader portfolio risk diversification, thus avoiding possible concentration risk from government bond investment. An extension of the criteria for liquid assets including also asset backed securities (such as RMBS), however mitigated by a threshold limit, would be, under this perspective, advisable.

All the above mentioned features, together with the current set up of ECB operational framework, should be taken into account in the definition of new Basel criteria for liquidity. Otherwise there is a risk of un-level playing field and incentive to distorted behaviors by market participants due to inconsistencies in regulatory framework (for instance: new liquidity rules introduced by BSCS *vis a vis* ECB eligibility criteria). Finally, full standardization may impact on banking business models potentially creating herding effects, with undesired systemic effects.

In the design of the new rules a close cooperation between Supervisors and Central Banks is desirable to assess the relevant market implications according to the banking peculiarities of specific geographic areas and to proposed stress scenarios. This harmonized approach should define shareable safe standards leaving the door open to internal advanced liquidity management approaches, to be approved by Supervisors to grant peers' comparability.

[1] Since beginning of 2007 banks loans responding to specific criteria are eligible for ECB facilities in all Euro Area.

Moreover, the optimal design of prudential regulation on market and liquidity risks should reflect a comprehensive and consistent approach. This requires that the new regulatory framework adopt an integrated view for trading book items both under a capital requirement perspective (market risk) and a liquidity risk perspective (time to liquidate).

The fixed percentages do not really take into account the peculiarities of the business model and the markets in which the bank is operating. The percentages, especially on the SME and Retail liability side, should be risk based on the liquidity sensitivity of the client. It goes without saying that through fixed percentages an institution will loose the capability to sets in own liquidity risk appetite, especially if the ratios are being disclosed.

A careful attention should also be paid to the need for banks to properly allocate the price of liquidity to each balance sheet item via a consistent fund transfer pricing system. More in particular, the new metrics could make it more difficult for internal systems to track funding activities to liquidity needs.

The quantitative study, currently being executed, will help us to assess the impact on the balance sheet due to this regulation. Nevertheless initial estimates show *(i)* an increased need in the prescribed liquid assets, due to the emphasis on marketability and *(ii)* an increased amount of medium-long term issues not easily absorbable by markets.

Finally, if Basel III liquidity related <u>rules were adopted "as is"</u>, the major economic/financial effects would be *(i)* increased customer spreads due to systematically funding of short term assets with longer term liabilities and *(ii)* possible reduction of banks' lending activity or adjustment of clients' product pricing with evident consequences on the financial system and the "real" economy.

2. Technical Considerations

With regards to time horizon in an on-going concern framework, the need for indicators referring to short and medium-long term ("structural") liquidity is in line with the general approach of the industry; further discussion is needed regarding the proposed short (LCR) and structural (NSFR) ratios to assess if the "standardized stress scenario analysis" is in line with the "current approach of bank's stress test analysis".

The correlation between LCR and NSFR is acceptable in order to limit the impact of "cliff-effects". However, particular attention should be given to possible metrics already in place within the industry regarding on-going concern structural liquidity ratios, in order to avoid inconsistency and/or improper

additional pressure on the banks' medium-long term funding sources. With reference to this point, the definition of the NSFR under the hypothesis of one year stress scenario seems to merge concepts pertaining to structural liquidity funding needs under an on-going concern scenario (usually addressed via an ordinary funding plan consistent with budget goals) with metrics adopted when working out contingency funding plans (usually foreseen for short term horizon).

This very conservative approach could lead banks *(i)* to overweight long term liabilities, preventing banks from performing their core maturity transformation role and *(ii)* to reduce their lending activity or adjust client's products pricing with evident consequence on the financial system and the "real" economy.

From a methodological viewpoint the NSFR needs to take into account those balance-sheet items that can be considered manageable within a year timeframe. The assumption that Financial Institutions will not be able to manage their balance sheet over this period of time is unrealistic, especially given the severe scenario that is being proposed. In order to get a more suitable NSFR, it is strongly suggested that the scenario at the basis of the NSFR is less severe, e.g. an idiosyncratic crisis. Such a scenario will allow the institution to exit certain business models, which are not commensurate with a 3 notch downgrade.

Further considerations on the available unencumbered collateral showed in LCR numerator should be performed to define "Fundamental characteristics" and "Market-related characteristics" possibly under a two-layer approach: (one week and one month) to better define marketability criteria including Central Banks eligibility assessment.

Both the ratios consider marketable securities representing claims on sovereigns, among other kind of issuers, as liquid assets only if they are highly rated (0% risk-weight under the Basel II standardized approach). In the case of LCR, government or Central Bank debt issued in domestic currencies by the country in which the liquidity risk is being taken or the bank's home country are also considered. The inconsistency between the two ratios in the treatment of central government debt issued by the country in which the liquidity risk is being taken or the bank's home country should be solved. There is also a clear arbitrage issue relative to the choice between different rating agencies. No clear guidelines are given in case of split rating.

The requirement to limit over-reliance on wholesale and repo funding during stress time looks too rigid and less realistic also in light of last crisis where these reference markets were operative even though with short term maturity.

A careful assessment for the calculation of the two ratios should be worked out with regards to *(ii)* the segmentation and calibration for deposits in the LCR, especially on corporate and financials, depending on

the kind of activity they run with the bank and *(ii)* the segmentation of the single components of the NSFR in order to mitigate requirements of medium-long term funding for the financing of short term positions (including also trading book items).

An introduction of an internal model validated by the Regulator could be more appropriate to manage differences in typologies of clients, products and countries. If internal model is not applicable, possible usage of different standardized factors for each country could be introduced.

A trade-off between "frequency" and "granularity" should be considered in order to allow *(i)* the Supervisors to achieve their targets of monitoring and *(ii)* the banks to generate the relevant information with adequate frequency, reporting more aggregate managerial data to replace accounting data that can not be produced with high frequency.

The effects of public disclosure of the two liquidity ratios should be deeply analyzed, in order *(i)* to verify the capability to reconcile regulatory metrics and disclosure based on accounting/managerial contribution and *(ii)* to avoid negative market consequences in case of stressed situation, especially with regards to the communication of the LCR.

2.1. Specific Technical Considerations in relation to main points of the Consultative Paper ("International framework for liquidity risk, measurement, standards and monitoring")

The two liquidity ratios should be applied primarily at <u>Group level</u> or to the major international subsidiaries of a banking group.

While the Liquidity Coverage Ratio could be calculated at least monthly also on **managerial data**, the Net Stable Funding Ratio should be calculated at least quarterly **on accounting data** (trade-off between "frequency" and "granularity").

a. Liquidity Coverage Ratio

- **Points 20/29**: in order to properly address the specificities of the European banking system, a concept of **<u>eligibility should be more suited instead of the one of marketability</u>**.
  As far as the portfolio of eligible assets is concerned, the metrics should be developed considering a two-layer approach (first, one week and second, one month).
  In <u>the first layer</u> and at least up to reserve requirements fulfillment, eligible assets (not only highly liquid) should be included on the basis of an on-going concern scenario access to Central Bank

(calculation of the maximum amount to be allowed could be worked out taking into consideration the individual percentage on overall reserve requirements with respect to the total amount of Central Bank's refinancing of the system).

In the second layer the rest of eligible assets should be considered.

In this way the systemic institutional role of the Central Bank could be clearly identified.

All the government bonds up to 20% risk-weight (not only 0%) should be included, in order to prevent a potential sell-off of bonds in case of country downgrading with considerable economic and market impacts artificially triggered by the regulation.

- **Points 22/34/35/36/37**: attention should be paid to the combined effects of liquidity shortage and idiosyncratic impacts on the capability of the bank to fund itself under a stress scenario: as matter of fact, recent experience has shown that a counterparty affected by worsening in its creditworthiness was not able to raise secured funding in the market independently of the quality of the collateral. Therefore central bank eligibility is a more important characteristic, independent of its marketability under stressed conditions, in a severe 3 notched downgrade scenario as stipulated.

  The exclusion of securities issued by financial firms in the liquidity buffer is not aligned with eligibility criteria and may cause restrictions to the access to long-term funding necessary to balance medium and long term assets profile.
- **Point 36/ 37:** the corporate and the covered bond market should not be treated under the same assumption. Covered bonds should instead receive a lower haircut than the envisaged 20% for AA and 40% for A- based upon *(a)* a substantially larger market volume, *(b)* the high portion of AAA and no significant default in the last years, *(c)* the close historic correlation of covered bond spreads with government bonds expressing the high credit quality, *(d)* the broad market liquidity not only for liquid benchmark deals, but also in registered/bearer bonds based on broad and loyal customer base.
- **Points from 41 to 70**: in general, the rules provided for the estimation of "Cash outflows" look too prescriptive and detailed. We would suggest a review of the proposed segmentation and calibration for deposits, especially on corporate and financials, depending on the kind of activity they run with the bank.

  The introduction of an internal model validated by the Regulator could be more appropriate to manage expected outflows in a stressed situation and related to differences in typologies of clients, products and countries.

  The 7.5% assigned minimum run-off factor for stable deposits is highly questionable, as behaviors vary significantly across jurisdictions. For term deposit, a jurisdiction based assessment is necessary.

  Excluding the potential even partial roll over of funding sources (money market borrowing, certificate of deposits, commercial paper and debt) may shrink interbank money market transactions with significant distortions even under an on-going concern market scenario.

  Libor/Euribor rates could be affected and become less informative and robust.

- **Point 66 (d)**: what kind of companies is included in the broad definition of "Financials"? We would envisage only a strict definition (i.e. banks, excluding, for example, financial holdings of industrial groups and investments funds).
- **Point 69**: a drawdown on "Unconditionally revocable uncommitted credit and liquidity facilities" can be avoided in a stress scenario since the bank is supposed to be able to manage them.
- **Point 76**: liquidity facilities (inflows) are assumed not to be drawn. This treatment looks in contrast with **Point 66**, whereas liquidity facilities (outflows) will remain outstanding throughout the duration of the stress test.

b. Net Stable Funding Ratio

- **Points 38/59:** the definition of NSFR is made to reflect the economic nature of liabilities rather than focusing on the pure legal maturity. Under this perspective, a partial renewal of covered bond issuance, similarly to the unsecured wholesale funding, could be acknowledge using at least 50% stable funding contribution for maturing covered bonds.
- **Point 82**: with particular reference to the Available Stable Funding (ASF) components, the calibration between "Stable" and "Less Stable" retail deposits is very sensitive and based on the following criteria:
  1) Deposits covered by an insurance scheme;
  2) Depositors have other established relationships with the bank;
  3) Deposits booked in transactional accounts (i.e. salaries automatically credited).

  As far as the above requirements are concerned, an introduction of an internal model validated by the Regulator could be more appropriate to manage differences in typologies of clients, products and countries.

  If internal model is not applicable, possible usage of different ASF factor for each country could be introduced.
- **Point 86 (table 1)**: regarding the total amount of capital to be included as a component of ASF category, doubts have risen about the elements not considered as permanent funding (regulatory vs accounting criteria). More in general, other permanent sources of funding, like provisions and "quasi permanent funds", are excluded. A more explicit definition of what should be included among all other liabilities and equity categories should be provided, considering the downside risk of excluding important sources of stable funding *via* a zero percentage weighting factor.
- **Point 89 (table 2)**: with particular reference to the Required Stable Funding (RSF) components, some doubts could arise regarding: 1) the rating classification (in case of discrepancy between two rating agencies, which rating should be taken as reference), 2) as for the sight assets, which is their classification in terms of RSF, 3) much more disclosure should be given to "All other assets".

The required amounts of stable funding related to loans to non financials and retails loans, with a maturity <1 year, respectively weighted on 50% and 85% is too severe and prescriptive, increasing systematically funding of short term assets with longer term liabilities.

The proposed weights seem overstated, especially considering specific product typologies (eg. consumer finance). Similar considerations can be made in relation to liquid trading instruments as listed equity securities (current weight 50%).

- **Point 91 (table 3)**: the RSF category concerning the "Conditionally revocable and irrevocable credit liquidity facilities" should be clarified, in connection with the IAS financial statement.

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