



European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Brussels, 22 October 2013

EACB Contribution to EBA Workshop on Proportionality

October 22, 2013

Liquidity risk regulation and small co-operative banks' network

Rapporteur: Andrea Pezzotta



Contents

1. General remarks	3
2. Proportionality, small co-operative banks and liquidity risk regulation	3
3. Specific aspects for which the principle of proportionality is relevant.....	6
3.1. RETAIL DEPOSITS	6
3.1.1. <i>Stable and less stable deposits</i>	6
3.1.2. <i>Deposits subject to different outflows</i>	7
3.1.3. <i>Retail markets bonds</i>	7
3.2. WHOLESALE DEPOSITS	8
3.2.1. <i>Operational deposits held by local banks with the central institutions</i>	8
3.2.2. <i>Intra-network liquidity flows</i>	8
3.3. SECURED FUNDING	9
3.4. DEFINITION OF LIQUIDITY ASSETS	9
3.5. CAPPED LIQUIDITY INFLOWS	10
3.6. ADDITIONAL LIQUIDITY METRICS.....	10
3.7. INTRADAY LIQUIDITY RISK	12
4. Conclusions	12



1. General remarks

The financial crisis and its spillover effects on the real economy once again demonstrated that no banking model in particular is the best suited to take on the financial intermediation function in all circumstances. Thus the coexistence of various bank models plays a key role for the overall economic efficiency and stability. Regulatory (over)reaction to a financial crisis is always accompanied by the risk that the burden of regulations falls disproportionately on non-joint stock and smaller banks which perform traditional retail financial intermediation. If this risk were to materialise, diversity in banking sector would be jeopardised. Strict compliance with the principle of proportionality by all levels of regulation (Level 1 text, Delegated and Implementing Act, Regulatory and Implementing Technical Standards) is the fundamental prerequisite for maintaining diversity in the European banking sector. Thus the proportionality principle has to be considered of the utmost importance, especially if regulation is aimed at maximising harmonization and addressing systemic risk.

Implementing the principle of proportionality is a demanding task. There are several complex regulatory areas in which the translation of this principle is not straightforward. Some basis criteria might help in achieving this objective in a balanced manner. The assumption that for small institutions, with fewer resources, the new compliance costs are comparatively and proportionally lower (e.g. in producing new reports to authorities) than for large and complex institutions (so called **'implicit' proportionality**) should not entail automatically that there is no need for **'explicit' proportionality**. Where a simplified approach has been developed for smaller and less complex institutions (e.g. the EBA proposal to calculate additional valuation adjustment) an assessment on potential 'cliff effects' should be performed in order to prevent those simplified solutions becoming a disproportionate burden for those institutions. There can be specific situations in which abiding by proportionality principle might entail exemptions from common rules for smaller and/or co-operative banks without implying deviation from Single Rulebook and generating *de facto* barriers to entry in local markets. Therefore, it should not be excluded aprioristically that the principle of proportionality could entail exemptions from common rules for certain categories of intermediaries. Reflecting appropriately the specificities of different business models into the rules also implies that a distinction - in particular amongst small banks - should be made between banks which are members of a network (where the central institutions and mutual solidarity systems play important roles) and the ones that are not.

Finally, we appreciate that the EBA has consulted small banks' associations while crafting some draft technical standards (i.e. before publishing them for consultation) in order to ascertain that it does not affect them adversely. Nevertheless it is important to extend and intensify this dialogue. In particular, the impact of the new rules on the viability of small banks' business models should be analysed before enforcement and the possibility of adapting the requirements to the actual risk profile of such banks should be considered. For instance, this could be achieved by putting in place formal special processes for taking into account specificities and limited compliance resources of smaller banks the same way that the Federal Reserve acted in the US by establishing, *inter alia*, a special subcommittee of its regulatory and supervisory committee that reviews all regulatory proposal with an eye to their effect on community banks¹.

2. Proportionality, small co-operative banks and liquidity risk regulation

Theoretic and empirical researches provide evidence that different liquidity risk profiles correspond to different bank's business models. Generally, a more traditional (deposit-taking and loan supply, merely in the retail markets) business model is associated with sources and processes of liquidity creation clearly identified in the

¹ See D. K. Tarullo (2013), *Dodd-Frank Implementation*, speech before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., July 11. For supervisory purposes, community banks are generally defined as those with less than \$10 billion in assets.



bank's balance sheets², a liquidity management strategies more focused on matching cash flows of assets and liabilities instead of relying intensively on financial markets³ and a lower level of liquid assets to optimize profits⁴. In order to take account of institutions' different liquidity risk profile and to avoid that the burden of regulation may fall disproportionately on traditional smaller banks, the legislator had two main options when it was drafting new liquidity standards:

- (a) recognising that it may not be appropriate to impose the same requirements to all banks and thus allowing small institutions which operate a relatively simple business model to apply a simplified approach (akin the "simplified buffer requirements" required by the UK prudential regulation framework⁵);
- (b) applying the same standards to all banks, hence following a 'one-size-fits-all' approach, and operating a calibration of the standards which reflects different bank business models.

As we all know the legislator chose the second solution, although from the beginning has emerged clearly the difficulties of liquidity standards in reflecting appropriately different bank practices/business approaches and that the calculation of the liquidity standards could be burdensome for smaller institutions.

Therefore, it is extremely important that during the monitoring phase of the new liquidity standards the dominant features of the small banks' business model are taken into account. In this regard we would like to draw the attention to the following features of small co-operative banks which could be relevant for liquidity risk regulation.

- **Small size and relatively small market shares:** in many European countries co-operative banks represent the smallest category of banks⁶.
- **Local ownership by member-customers:** the ownership of small co-operative banks is generally at the local (regional or even smaller) level and their members are generally also customers, although a cooperative bank may have customers who are not members.
- **Focus on traditional retail banking and local economy:** small co-operative banks perform traditional intermediation activities (deposit-taking and loan supply), based on the originate-to-hold model and on long-lasting fiduciary relationships with retail customers (households and SMEs). Furthermore, they operate at a local level in close proximity to their members and customers; in some countries this is established in the banking law⁷.
- **Non-complex activities and focus on limited product range, not-for-profit business and no cross-border activity:** although for all banks profits earning is needed for the viability of the business, a key characteristic of co-operative banks is that they seek to maximise consumer surplus and the interests of their members. Small co-operative banks are not involved in international activity and they do not enter into composite and structured products like exotic derivatives with complicated underlying contracts. As stated above, their core business is collecting savings and lending to the real economy through a traditional, relationship-based intermediation. In some

² See A. Bervas, (2008), *Financial innovation and the liquidity frontier*, Banque de France, Financial Stability Review – Special issue on liquidity, n.11, February.

³ See A. Schertler (2010), *Insights on Banks' Liquidity Management: Evidence from Regulatory Liquidity Data*, Beiträge zur Jahrestagung des Vereins für Socialpolitik: Ökonomie der Familie - Session: Banking Regulation: Liquidity and Regulatory Capital, No. A7-V2.

⁴ See E. Bordelau and C. Graham (2010), *The impact of liquidity on bank Profitability*, Bank of Canada, WP.

⁵ See <http://media.fshandbook.info/content/PRA/BIPRU/12.pdf>.

⁶ For example in Austria many local banks only have a balance sheet total around €50 million and less than 10 employees. In Italy 341 out of 400 local co-operative banks - the Banche di Credito Cooperativo (BCC) – have a balance sheet total less than €1 billion and no one of them have a balance sheet total higher than €10 billion.

⁷ For example according to the Italian Banking Law the BCC must carry out at least 50% of their lending activity in favour of members/shareholders (who must have their domicile and continuative business within the competence territory of the bank) and no-less than 95% of that activity must be performed within the territory of competence.



countries, like Italy, specific operational restrictions to the scope of small co-operatives activity are provided for by the law⁸.

- **Funding structure:** the bulk of their total liabilities is raised from non-financial entities and the vast majority of this consists in retail deposits (funding provided by natural persons and SMEs) and bonds and other securities issued in the retail markets. Funding from financial entities is almost exclusively provided by their central institutions (see below).
- **Membership to a national network with an integrated structure where:**
 - **the central institutions perform the role of a wholesale products and services provider for local co-operative banks and an intra-network inter-bank market.** Co-operative banks became more integrated by creating their own central institutions. Generally, co-operative banks are the exclusive or majority shareholders of the central institutions and do not behave like external investors; as shown by the history, they fund and recapitalise the central institutions if needed. Due to robust division-of-labour arrangements, the central institutions play a primary role within the network as a wholesale products and services provider for local co-operative banks which in this way are able to offer customers a complete range of banking/financial products. In particular, the central institutions offer products specifically designed for local banks (such as repo, time deposits, etc.) which can be used for investing liquidity surplus – *i.e.* amount of money estimated in excess to the above operational functions. Thus central institutions take deposits and other extension of funding from financial institutions, the vast majority of which are from local co-operative banks; the related funds collected may be either transferred to other local banks which needs funding, used for their own lending activities or placed on financial/money markets at better conditions than the latter individually could obtain.
 - **the mutual solidarity systems play an important role in the recovery and resolution phase of local co-operative banks.** In general small co-operative banks have their own sectorial Deposit Guarantee Scheme (DGS) that, unlike the classical one, carries out also early intervention and helps resolving ailing banks. In addition to the DGS, these banks have adopted several institutional arrangements which make them more effective in coping with liquidity or solvency problems without external intervention or taxpayer aids. The most important one is the Institutional Protection Scheme (IPS) which is defined by article 113(7)⁹ as a “*contractual or statutory liability arrangement [between credit institutions] which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary*”. Currently, Austrian and German co-operative banks have already established an IPS. In Italy, Credit Co-operative Banks are in the process of setting up the same scheme (its statute was approved by Bank of Italy at the end of 2011). It is worth mentioning that these mutual solidarity systems may provide members and non-member customers with an explicit greater protection than the one provided by the DGS and/or provide explicit guarantee to deposits and other extensions of funding non-covered by the latter¹⁰.
- **Indirect participant to the payment and settlement systems:** Small co-operative banks generally do not have a deposit with the relevant central bank and do not have access to payment and

⁸ This is the case of the Italian Banking Law, allowing the BCC to enter into derivative contracts only for hedging purposes.

⁹ See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU), OJ L 176, 27.6.2013). As of 1 January 2013, article 113(7) of the CRR will replace article 80(8) of the Capital Requirement Directive (CRD) which introduced the IPS.

¹⁰ For example, In Italy in 2004 the BCC introduced the Bondholders' Guarantee Fund (FGO) which protects bonds issued solely by BCC up to an amount of €103,000 per bondholder. BCC which participate to the FGO, inter alia, must hold minimum capital requirements for the related off-balance sheet commitments (100% conversion factor and risk weight).



settlement systems. They use the services of their central institutions, which act as correspondent bank, to settle their payments.

- **No adoption of any advanced model for calculating supervisory capital requirements for Pillar 1 risks.**
- **Shares of small co-operative banks are not listed on a stock exchange.**
- **The almost exclusive source of capital is their retained profits.**

A review of the key characteristics of small co-operative banks emphasises, *inter alia*, the institutions risk profile, the traditional retail banking model, the localism and mutual ownership and the role of mutual solidarity systems and network central institutions. As we argue in the next paragraph those specificities of small co-operative banks' business model could be taken into account more appropriately in the bank liquidity risk regulation while still achieving safety-and-soundness aims. For example, by virtue of those specificities, different treatments could be provided both for Liquidity Coverage Requirements (LCR) and Stable Fundings (SF).

3. Specific aspects for which the principle of proportionality is relevant

3.1. Retail deposits

3.1.1. Stable and less stable deposits

A recent survey conducted by a professional services firm from a pool of 59 European banks and banking groups point out that "with respect to the calculation methodology, banks have highlighted that the first main challenge in calculating the LCR [and thus also the NSFR] is represented by the deposit treatment¹¹." In particular, the differentiation between stable and less stable deposits can be very difficult to handle in practice. In the case of small retail banks this could require highly burdensome assessments. Therefore, in some circumstances operational simplifications/practical expedients may be introduced while still reflecting the related bank's liquidity risk. For example, this could be the case of a small co-operative bank's liabilities to member and/or employee-customers. As already said, the typical co-operative bank seeks to maximise the benefit/surplus of its members, who typically maintain long-term relationship with their bank. Unlike joint stock companies "*value added in a cooperative bank is generally distributed to [member]-customers **ex ante** in the pricing of deposits and loans and/or the quality of the services*"¹² rather than in the form of either dividends or a higher share price. Therefore, in our view the EBA Technical Standards or Guidelines on this topic should clearly recognise that deposits and other extensions of funding raised from co-operative banks' employees and members are considered to be part of "*an established relationship making withdrawal highly unlikely*" **without any need to perform further assessments**.

In our view the perceived creditworthiness of the institution acts as the decisive factor leading depositors to withdraw their funds under a stress scenario. Therefore, we think that the EBA during the observation period might gauge the application of a specific treatment to deposits which benefit of an explicit protection by a co-operative banks' mutual solidarity system larger than the one provided by the DGS. For example let us consider a deposit with a €275,000 nominal value, covered up to €100,000 by a local DGS and up to an additional amount of €100,000 by a co-operative banks' mutual solidarity system. Provided that all conditions to be considered as stable deposit are met the following run-off rates might be applied: 5% up to €100,000, 7,5% for an additional €100,000 and 10% for the remaining part.

¹¹ See Deloitte (2013), *EU Bank's halfway to Basel III adoption – Current state and main impacts of the new liquidity regulation*.

¹² Ayady et al. (2010), *Investigating Diversity in the Banking Sector in Europe - Key developments, performance and role of cooperative banks*, Centre for European Policy Studies, Brussels.



A specific treatment which takes into account the aforementioned characteristics of small co-operative banks (special relation with their members which are generally also customers and the explicit guarantee of a mutual solidarity system) might also be evaluated by the EBA during the observation period.

3.1.2. Deposits subject to different outflows

The collection and the assessment of the relevant data and the proposed categorization, requested in the EBA Consultation Paper on Draft Guidelines “*On retail deposit subject to different outflows*” (hereinafter Draft GL), will result overly complex and costly to be implemented in IT systems. Therefore, especially in the case of small institutions, the costs of the methodology proposed are likely to outweigh the benefits. Given the costs and the complexity of implementing the proposed methodology, there might be the case of banks not being able to fully apply those guidelines. Small banks should be allowed to classify all relevant deposits within one only bucket (e.g. the third bucket described in the Draft GL); furthermore, an appropriate minimum outflow rate for that bucket could be provided by the EBA or assigned to national discretion.

This being said we strongly underline that higher risk factors should not be considered for retail deposits:

- placed by a co-operative bank with its members, setting aside very high value deposits which represent a significant part of the retail deposit base; or
- covered by a significant amount of their nominal value by the DGS *and* a co-operative banks’ mutual solidarity system.

Moreover it has to be taken into account that in the case of small co-operative banks some of the risk factors identified by the Draft GL cannot be regarded as factors affecting the stability of retail deposit products. For instance, as already mentioned membership in a co-operative bank is generally remunerate through the pricing of deposits and loans. Thus comparing the rate that a co-operative bank applies to each deposit placed with its members to the average paid by their peers for similar products does not make any sense. On the other hand, identifying a suitable average rate of peers could be really difficult to obtain since there might not exist other co-operative banks in the markets in which the former operate.

3.1.3. Retail markets bonds

As already mentioned in the previous paragraph small co-operative banks operate in merely local markets both for lending and funding purposes. In some countries, in addition to retail deposits they issue bonds (hereinafter retail bonds) which are not of sizable amount, have a plain-vanilla profile and are held by unsophisticated retail investors (households and SMEs). Paragraph 110 of *Basel III: International framework for liquidity risk measurement, standards and monitoring* (January 2013) rightly lays down that “*all notes, bonds and other debt securities issued by the bank are included in this category [i.e. unsecured wholesale funding provided by other legal entity customers with a 100% run-off factor] regardless of the holder, unless the bond is sold exclusively in the retail market and held in retail accounts (including small business customer accounts treated as retail per paragraphs 89-91), in which case the instruments can be treated in the appropriate retail or small business customer deposit category*”.

Therefore, in order to not penalize banks, especially the small ones, which issue ‘retail bonds’ it is of outstanding importance that the identical treatment applies in the context of the CRR both for the determination of LCR and SF.

Furthermore, a preferential run-off rate should be recognised to the retail bonds which benefit of an explicit guarantee by a co-operative bank’s mutual solidarity system.



3.2. Wholesale deposits

3.2.1. Operational deposits held by local banks with the central institutions

Within the network, the central institutions provide local banks with clearing, custody and cash management services. Such services are provided under a legally-binding agreement. For these operational functions each local bank holds a specifically designated account at the central institutions and place deposits into this account. Therefore, these deposits are by-products of the underlying services provided by the central institutions. Article 422(3) of the CRR provides a run-off rate of 25%, instead of 100%, for this operational deposits. Nevertheless, funds qualifying for this preferential treatment should be net of excess balances which do not relate to a specific operational function since the institution is required to *“have evidence that the client is unable to withdraw amounts legally due over a 30 day horizon without compromising its operational functioning”*.

In a network in which the central institutions offer a wide range of services (such as clearing, custody and cash management services, indirect fulfillment of the minimum reserve requirement) and products specifically designed for local co-operative banks, distinguishing money that is addressed for operational functions is almost impossible. Moreover, the underlying rationale for keeping extra money in each operational deposit resides with a local bank's behaviour, leaving the central institutions without any practical means to identify the portion of the deposit balance not related to operational functions. The effort and cost of estimating excess balances on an account-by-account basis (and the cost of potential inaccuracies in such estimates) will far outweigh the benefit of determining the specific amount of funds specifically needed for operational purposes. Furthermore, as historical evidences suggest, including periods of financial strains, a 25% run-off rate is above the central institutions' experience of volatility in such accounts, especially on a portfolio basis, so it should also provide an adequate buffer against any withdrawal of excess balances. In the light of the considerations above a simple and efficient approach could consist in using the difference, only if positive, between the end-of-month balances and the monthly averages to determine the excess balances.

3.2.2. Intra-network liquidity flows

As stated in paragraph 2, within the network the central institutions are in charge of pooling and managing the network's excess liquidity and providing centralised services. By virtue of internal arrangements the central institutions are able to ensure the balancing of liquidity within the network, and local co-operative banks which need funding are able to continue to supply loans to the local economy. Thus the central institutions are at the heart of the liquidity management of the co-operative banking network. However, the nature of the liquidity systems of the small co-operative banks' networks may differ in practice. In some countries small co-operative banks has implemented an IPS which, according to article 113(7) of the CRR, ensures member banks' *“liquidity and solvency to avoid bankruptcy where necessary”*. In other countries small co-operative banks and their central institutions constitute 'liquidity systems' to ensure group-wide liquidity; such 'liquidity systems' may include statutory elements, specifically with regard to liquidity or minimum reserves by the central institutions and contractual elements with regard to cash-clearing services and the placement of free liquidity, moreover they may be associated with specific guarantee or protection schemes, not fully compliant with the requirements laid down in article 113(7) of the CRR.

We welcome that the CRR rules on liquidity risk recognise the case of the IPS (see artt. 8(4), 416(1)(f), 422(3), 425(4)). At the same time we note that the EBA has been explicitly mandated by the CRR (art. 509(2)(d)) to assess *“the provision of specific lower outflow and/or higher inflow rates for intragroup flows, specifying under which conditions such specific in- or outflow rates would be justified from a prudential point of view (...)”*. On this point we strongly advocate that this assessment should also be carried out with respect to the liquidity flows between the central institutions and local co-operative banks which are members of the same IPS or banking network not fully compliant with the requirements laid down in article 113(7) of the CRR, for the following reasons. First the central institutions' business model is based on inter-bank transactions, namely **relationship-based**



transactions with local co-operative banks which are at the same time their shareholders. Therefore we wonder if the application of the general outflow and inflow rates to these transactions is well put. Secondly, as already described, the central institutions allow liquidity to be easily transferred from local banks with a surplus to banks with a deficit. Several studies¹³ point to that quantitative liquidity rules are likely to affect the inter-bank money markets (in particular during stress): activities at the short end of the money market will decline and the increased demand for longer-term financing is expected to increase interests from maturities longer than 30 days, thereby determining a steeper money market yield curve. A similar effect has to be expected in the intra-network inter-bank markets due to an impaired role of the central institutions as a treasurer within the co-operative banking networks. While reducing the banks' dependence on volatile money market is an intended effect we wonder if the related positive effects might outweigh its potential negative implications associated with a shrinking of the intra-network inter-bank market alongside with skewed interest rates. Therefore it is worthwhile to report separately the liquidity flows between the central institutions and local co-operative banks during the observation period.

Furthermore, we believe this role of the central institutions should be considered in setting appropriate rules governing how and when they may use their liquidity buffer, thereby falling below the minimum level required.

3.3. Secured funding

As outlined by the European Systemic Risk Board *“the most notable development [in the banks' funding structure] has been the increase in the relative importance of secured funding as a consequence of investors' risk aversion and of regulatory developments, notably the Basel frameworks for capital and liquidity and Solvency II.”* In order to avoid generating an unlevel playing field between large and small institutions the methods and channels by which the latter access to the secured funding market should be taken into account. Small co-operative banks generally do not have a deposit with the relevant central bank and do not have access to payment and settlement systems and capital/money markets. Therefore, they perform central bank refinancing operations and secured funding transactions in the wholesale markets through their central institutions. To this end they pre-position at their central institutions financial assets which are stand available within a collateral pool to be used for obtaining funding.

In our view abiding by the proportionality and level playing field principles should lead to recognise that small co-operative banks may apply, under article 422(3)(e) of the CRR, a 0% run-off factor to liabilities resulting from secured lending and capital market-driven transactions performed with the relevant central bank through their central institutions. This treatment shall be recognised provided that the competent authorities are satisfied that the level of integrated management, risk management and internal control mechanisms are adequate for the purposes of managing, monitoring, reporting and recording those operations.

3.4. Definition of liquidity assets

In the light of the remarks set out in the previous paragraph, abiding by the principles mentioned above should also entail that under article 416(3)(a) of the CRR small co-operative banks may include in the stock of liquidity assets the ones that have been pre-positioned at their central institutions but have not been used to generate liquidity, provided that they qualify as liquid assets.

Another area of concern for small banks refers to the link between LCR-eligibility and central bank eligibility for a twofold consideration.

¹³ See for example M. Bech and T. Keister (2012), *On the liquidity coverage ratio and monetary policy implementation*, BIS Quarterly Review, December; C. Bonner and S. Eijffinger (2012), *The impact of the LCR on the interbank money market*, European Banking Center Discussion Paper, No. 2012-019.



First, the definition of liquid assets and the rule on central banks eligible assets cannot be regarded as two separate issues. Recognising central bank eligibility as a decisive element for the LCR-eligibility is crucial for small banks in many European countries.

Secondly, the EBA has also been mandated (art. 509(3) of the CRR) to report to the European Commission (by 31 December 2013) on appropriate uniform definitions of high and of extremely high liquidity and credit quality of transferable assets and related appropriate haircuts. In this regard the EBA consulted the banking industry by publishing a discussion paper which sets out the suggested methodology it intends to follow in performing this analysis. The proposed methodology will be too complex to be implemented and carried out in practice by banks, especially the smaller ones¹⁴. We strongly believe that the EBA and the national supervisory authorities could substantially benefit from using what is already in place and well tested in terms of the liquidity categories for marketable assets for the Eurosystem credit operations¹⁵. The list of the European Central Bank (ECB) eligible assets – which does not include gold, equities and commodities – is sufficiently broad in terms of issuer location (EEA plus G10), issuer type (all), asset type (all relevant), currency denomination (most relevant currencies) and creditworthiness. This implies that there should be sufficient information for the EBA to make use of the Eurosystem classification for most of the relevant assets to be included in the LCR. The EBA could focus its efforts on those asset categories not included in the broad list of the ECB eligible assets or on minor countries and less relevant currencies or major non EU currencies.

3.5. Capped liquidity inflows

Requiring institutions to always hold a predetermined percentage of their stressed cash outflows can be considered reasonable from a prudential perspective, provided that the cap on liquidity inflow is drawn without penalizing more conservative liquidity management strategies and creating wrong incentives. Indeed, the cap on inflows as provided by article 425 of the CRR could penalise small banks with a traditional business model since:

- their liquidity management strategies are more focused on matching cash flows of assets and liabilities instead of relying intensively on financial markets¹⁶;
- it freezes unduly liquidity that will not be available for lending to the real economy;
- it creates wrong incentives since banks which are close to minimum ratio are further spurred to purchase liquid assets instead of making loans to the real economy.

Therefore, we think the EBA should take into account this potential unintended consequences under the mandate given by article 509(2)(a)) of the CRR.

3.6. Additional liquidity metrics

In general small institutions should be fully exempted from reporting information which are not relevant to obtaining a comprehensive view of their liquidity risk profile. In particular, those institutions should be exempted from reporting the additional monitoring tools aimed at capturing elements/dimensions of liquidity risk which are not material for them. For instance, small institutions which perform traditional retail financial intermediation might

¹⁴ We note that it is not the EBA intention to require banks to run this assessment methodology but only to apply resulting assets classes to their assets. Nevertheless, banks will need to be able to duplicate the EBA classification process. As the latter will need to be updated over time for changes in market environment, banks will try to anticipate changes in regulatory asset classes to avoid any 'cliff-effects'. Moreover, a consistent approach should be applied for assets which will not be covered by the EBA methodology.

¹⁵ Several other benefits can be associated to the adoption of this approach. In this regard see ABI (2013), *Response to EBA Discussion Paper On retail deposits subject to higher outflows for the purposes of liquidity reporting under the draft Capital Requirements Regulation (CRR)*, www.eba.europa.eu/documents/10180/42030/%7BABI%7D-Italian-Banking-Association.pdf.

¹⁶ A. Shelter (2010), *op. cit.*, finds evidence that in Germany commercial banks rely more intensively on markets when managing their regulatory liquidity, while savings and cooperative banks focus more on matching cash flows of assets and liabilities. Furthermore, results of the Basel III monitoring exercises have always indicated that almost all banks which reported inflows that exceeded the 75% cap were the smaller ones. For example according to the last monitoring exercise based on data of European banks as of 31 December 2012 two Group 1 banks and 17 Group 2 banks reported inflows that exceeded the 75% cap.



be exempted from reporting the additional monitoring tools related to prices for various lengths of funding and to rollover of funding since these types of reporting should be based on wholesale funding. Moreover, since generally the wholesale funding of small co-operative banks stems mostly from their central institutions, these data could be obtained directly from the latter. Along the same lines, provided that certain conditions are met, they should be exempted from reporting monitoring tools for intraday liquidity risk management (see paragraph below), which are currently under development.

Moreover, in order to simplify and reduce the burden of the reporting framework, the EBA might consider incorporating some of the additional templates in the reviews of the Internal Liquidity Adequacy Assessment Processes (ILAAP) whenever their periodic reporting during the year is likely to generate (significant) additional costs without creating much added value for banking supervision. This taking also into account that the competent authorities are entitled to increase the reporting frequency in a distressed liquidity environment or in any other circumstances which is relevant from liquidity risk standpoint. For instance, this may be the case of the behavioural flows maturity ladder. As outlined by paragraph 186 of *Basel III: International framework for liquidity risk measurement, standards and monitoring* (January 2013), “banks should also conduct their own maturity mismatch analyses, based on going-concern behavioural assumptions of the inflows and outflows of funds in both normal situations and under stress. These analyses should be based on strategic and business plans and **should be shared and discussed with supervisors**, and the data provided in the contractual maturity mismatch should be utilised as a basis of comparison.” Therefore, under a business as usual situations, at least in the case of small institutions, the review of the ILAAP is the most appropriate place to carry out an assessment on how institutions manage internally and strategically the liquidity risk and fund themselves. Should material changes to bank’s business model occur, then it becomes “crucial for supervisors to request projected mismatch reports as part of an assessment of impact of such changes to prudential supervision” (e.g. in the case of acquisitions or mergers) and banks could be required to report specific information in the form of behavioural flow maturity ladder. Alternatively, since even performing simple analyses and using simplified methods could be burdensome for small banks, a standardised behavioural flows maturity ladder could be introduced by the EBA.

As regards to compliance costs, the related analysis should not be limited to ‘one-off’ expenses but should also include the ‘ongoing’ ones since considerable resources have to be spent on creating and updating new templates, definitions, and instructions and new staff have to be recruited to collect and examine figures and perform internal controls of the new data flows. We agree with the EBA’s assumptions that “the costs will be driven by the size and complexity of the balance sheet and of the activities undertaken by institutions”. At the same time we think it should not be taken for granted that the expected scale of compliance costs will be directly proportionate to the factors above (i.e. size and complexity) since they might fall disproportionately on small institutions.

In the light of the above considerations we think that proportionality, simplifications and phase-in implementation are necessary. Focusing on proportionality¹⁷, it might be more adequately applied by adopting a more flexible and granular approach (that the one provided by the EBA) while still achieving the objective to obtain a comprehensive view of banks’ liquidity risk profile.

Small institutions not engaged in any cross-border activities and where the ratio of individual balance sheet total to the sum of individual balance sheet totals of all institutions under the supervision of its competent authority is below 1% should be exempted from reporting the behavioural flows maturity ladder and the additional monitoring tools related to prices for various lengths of funding and to rollover of funding. Under normal business conditions they should be required to report semi-annually (ideally) or quarterly (alternatively) the:

- contractual flows maturity ladder in order to capture information to the extent to which the bank relies on maturity transformation under its current contracts, which is essential to get to an appropriate assessment of the liquidity risk profile of all banks;

¹⁷ With respect to the other points, simplifications and phase-in implementation see EBF (2013), *Response to EBA Consultation on Draft Implementing Technical Standards On Additional Liquidity Monitoring Metrics under Article 403(2) of the draft Capital Requirements Regulation (CRR)* (EBA/CP/2013/18), [www.eba.europa.eu/documents/10180/204373/European+Banking+Federation+\(EBF\).pdf](http://www.eba.europa.eu/documents/10180/204373/European+Banking+Federation+(EBF).pdf).



- additional monitoring tools on concentration of funding by counterparty and product type since concentration risk, both on asset and liability side, could be a significant risk factor especially for small institutions which operate at a local level.

In our opinion a threshold that takes also account of the wholesale funding activity of banks is better to determine if small banks shall be exempted from reporting the additional monitoring tools related to prices for various lengths of funding and to rollover of funding. However in order to avoid complexity and keep the regulation simple the proposed '1% threshold' seems adequate since it is very low.

Under normal business conditions, institutions not engaged in any cross-border activities, where the individual balance sheet total is below a certain percentage (e.g. 5%) of the sum of individual balance sheet totals of all institutions under the supervision of its competent authority or is lower than an absolute value (e.g. €30 billion) and whose level of the LCR exceeds some minimum level should be allowed to report quarterly the contractual maturity ladder and the additional liquidity metrics.

In both the above cases a higher reporting frequency could be introduced in exceptional stressed conditions provided that competent authorities are entitled to impose it.

Finally, we noticed that, for many items, the maturity ladder template includes a separate detail for intra-group flows (including flows between the members of an IPS). On this point we think that the intra-network transactions should also be reported as a separate detail since, as already pointed out, this transactions generally have different liquidity risk characteristics than other interbank transactions which are conducted at arm's length basis.

3.7. Intraday liquidity risk

As already said small co-operative banks generally do not have a deposit with the relevant central bank and do not access directly to payment and settlement systems and capital/money markets. Therefore, within the network the central institutions provide correspondent banking services on behalf of local co-operative banks and grant them (collateralized) intraday credit facilities. In April 2013 the Basel Committee on Banking Supervision (BCBS) published *monitoring tools for intraday liquidity management* which sets out a set of quantitative tools to enable banking supervisors to monitor banks' intraday liquidity risk and their ability to meet payment and settlement obligations on a timely basis under both normal and stress conditions. Not all of the tools are relevant to all reporting banks since banks which are direct participant and/or provide correspondent banking services are required to report more information. In the light of the work conducted by the BCBS, the EBA stated that it can consider amendments to its proposal on additional liquidity monitoring metrics in order to be able to monitor banks' intraday liquidity management.

We would like to underline that significant resources will already be deployed to prepare IT systems for the LCR, NSFR, asset encumbrance and additional liquidity metrics. Therefore monitoring tools or further reporting on intraday liquidity risk will be burdensome for small co-operative banks since setting up the reporting systems will be costly. It is thus essential to strike the right balance between useful reporting and related costs. Appropriate exemptions in connection with liquidity systems of small co-operative banks could be provided. This could be the case for small co-operative banks (indirect participants) where formal internal control arrangements have been put in place with their central institutions (which act as a correspondent bank) that substantially reduce their intraday liquidity risk and provided that the competent authorities are satisfied that these arrangements are adequate to this aim.

4. Conclusions

Implementing the principle of proportionality is a demanding task. Some basis criteria might help in achieving this objective in a balanced manner. The assumption of 'implicit' proportionality should not entail automatically that there is no need for 'explicit' proportionality'. Performing an assessment on potential 'cliff effects' stemming from



the development and adoption of simplified approaches is necessary in order to prevent those simplified solutions from becoming a disproportionate burden for smaller and less complex institutions. It should not be excluded aprioristically that the principle of proportionality could entail exemptions from common rules for certain categories of intermediaries.

Reflecting appropriately the specificities of different business models into the rules also implies that a distinction - in particular amongst small banks - should be made between banks which are members of a network (where the central institutions and mutual solidarity systems play important roles) and the ones that are not. Indeed, liquidity risk of small institutions which are member of a mutual solidarity network (IPS, guarantee systems) is different, from that of the standalone small institution, as the solidarity system neutralises to a great extent the effects of an idiosyncratic liquidity shock for a small institution which has also a positive impact on financial stability. Therefore common liquidity management of network systems should be stimulated by the regulations and any details which might disintegrate the systems should be avoided.

During the observation period of the new liquidity standards it is worth reporting separately some types of liabilities/transactions which reflect the co-operative small banks' business model (e.g. deposits which benefit of an explicit protection by a bank's co-operative mutual solidarity system, intra-network liquidity flows, etc.) in order to assess if the classification can be made more granular by introducing new items and specific treatments in terms of in-outflow rates. The fact that small banks generally are indirect participant to the payment and settlement systems should be taken into account.

Operational simplifications/practical expedients should be sought out and introduced if they do not imply a deviation from achieving safety-and-soundness aims. The 'materiality principle' in the measurement methodologies and reporting systems areas should obtain explicitly greater emphasis, provided that a more conservative treatment is applied.

Dialogue between small banks' associations and the EBA should be extended and intensified.