The Liquidity Coverage Ratio and Potential Implications for (Small) Business Financing in an Austrian Context – Executive Summary (July 2012)

A study by IHS (Bernhard Felderer, Ines Fortin) and LBMS (Luise Breinlinger) commissioned by the Austrian Federal Ministry of Economy, Family and Youth, the Austrian Ministry of Finance, and the Austrian Federal Economic Chamber

1. Background against which the analysis was undertaken

The regulatory framework of Basel III is mainly aimed at improving the quality and quantity of capital, at increasing liquidity, and at reducing the leverage ratio in banks. Positive effects are expected in terms of higher financial market stability and lower vulnerability to crises. The Basel III liquidity regulations (forming part of the whole Basel III package released in December 2010) as well as the EU liquidity proposals issued by the European Commission in July 2011 establish a short-term liquidity requirement (the Liquidity Coverage Ratio / Requirement: LCR) plus a longer-term stable funding requirement (the Net Stable Funding Ratio / Requirement: NSFR). This study focuses – for reasons of priority – on the short end, the LCR, and its potential implications on business / SME financing. Before final specifications shall become valid, LCR details will still be undergoing evaluation. Thus, some final LCR details will probably differ from the specifications used in this study, and conclusions need to be assessed accordingly.

The LCR is defined as the ratio of High Quality Liquid Assets (HQLA) to Total Net Cash Outflows over the next 30 calendar days. The latter are Total Cash Outflows minus Total Cash Inflows, where Total Cash Inflows are capped at 75% of Total Cash Outflows. The LCR should be at least 100%. Different outflow and inflow categories are weighted by different factors. Retail / SME deposits are assigned relatively low (and therefore beneficial) outflow weightings. With respect to the classification of retail / SME the regulation proposal of the European Commission from 20 July 2011 says in Article 400 (2) that retail deposit means a liability to a natural person or to a small and medium sized enterprise where the aggregate liability to such clients or group of connected clients is less than 1 million EUR. The EU Council General Approach on the regulation proposal from 21 May 2012 adds to this definition an explicit reference to the retail exposure class under the Standardised or IRB approaches for credit risk. The so-called Karas Report of the European Parliament (12 June 2012) proposes to eliminate the 1 million EUR threshold contained in the EC and Council LCR formulations. In addition, it suggests increasing the existing Basel II retail thresholds (for the Standardised approach from 1 million EUR to 2 million EUR and for the IRB approach from 1 million EUR to 5 million EUR). Thereby a larger number of SMEs would be included in the beneficial retail treatment.

In order to elaborate on the details of the liquidity concepts, quantitative impact analyses have been undertaken by BCBS for the global and by CEBS / EBA for the European level. Two sets of analyses

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1 “The Commission is firmly committed to reaching a harmonised Liquidity Coverage Requirement by 2015” (p.13) and “The Commission is firmly committed to reaching a minimum standard on the Net Stable Funding Requirement by 1 January 2018” (p.14) (European Commission, Proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms, Part 1, 20 July 2011).

2 See Basel III: International framework for liquidity risk measurement, standards and monitoring (Basel Committee on Banking Supervision, December 2010), basis of the corresponding EU proposals.
were published, the first is based on data from the end of 2009,\(^3\) the second on data from June 2011.\(^4\) For reasons of data privacy, the results for the group of Austrian banks participating in the evaluations were not available for this report. At the time when this report is being drafted, another monitoring exercise is under progress.

The motivation behind the present analysis is to get an idea of which effects LCR definitions and interpretations might have, first, on Austrian banks in terms of preliminary, indicative LCR results and potential banking policy incentives derived therefrom and, second, on retail and corporate financing (and thereby on SME financing) provided by banks – given that banks are the primary financing source of this business segment in Austria. The analysis is based on recent LCR data plus additional information on the bank specific asset / liability structures, kindly provided by a sample of Austrian banks.

2. Sample based evidence on potential LCR implications for Austrian banks

Based on the information\(^5\) reported by the six participating banks\(^6\) for mid to end 2011, we evaluate LCR fulfilments, the structure of cash inflows and outflows, and the main asset / liability characteristics (see Table 1) – on bank specific levels as well as on an asset-weighted average level. The analysis intends to be a status quo consideration of a significant sample of Austrian banks rather than some sort of national impact study. As such it has to be clearly differentiated from the more comprehensive impact analyses carried out under the auspices of EBA or BCBS. Furthermore, discussions about LCR related regulatory and bank-level implementation and interpretation issues were still in progress at the time when the data for this report were provided. Results based on the definitions and practices applied can therefore not be viewed as final.

The within-sample variation of the LCR is large, underlining the strong effects of sample selection and of the consolidation level applied upon the observed figures. If, for instance, subsamples of 4 banks (out of 6) are formed, the average asset-weighted LCR varies from somewhat below 40% to somewhat below 70%.\(^7\) The waiver option (possibility to form liquidity sub-groups upon approval of competent authorities) is not taken into account in these figures. A consideration thereof would presumably lead to an increase in aggregate LCR. The predominant part of HQLA is made up of Level 1 assets (90%), the Level 2 cap is triggered only once in the sample. The largest part of Level 2 assets are accounted for by covered bonds (8%). Concerning the structure of Total Cash Inflows, the highest inflow position are inflows from financial institutions which amount to about half of total inflows, while

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\(^3\) For global results see: Results of the comprehensive quantitative impact study (Basel Committee on Banking Supervision, December 2010); for the European level see: Results of the comprehensive quantitative impact study (Committee of European Banking Supervisors, 16 December 2010) and Impact Assessment accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms (European Commission, 20 July 2011).

\(^4\) For global results see: Results of the Basel III monitoring exercise as of 30 June 2011 (Basel Committee on Banking Supervision, April 2012); for the European level see: Results of the Basel III monitoring exercise as of 30 June 2011 (European Banking Authority, April 2012).

\(^5\) Basically, provided according to the Basel III option of the EU proposals.

\(^6\) Bank Austria, BAWAG P.S.K., Erste Bank, Raiffeisenlandesbank NÖ Wien, Raiffeisenlandesbank OÖ, and RZB.

\(^7\) The overall asset-weighted average LCR in the observed sample lies at about 50%. In contrast to our results the 2009 CEBS QIS showed a clearly higher LCR for the EU average (67% for Group 1 banks, 87% for Group 2 banks). The mid-2011 monitoring exercise (EBA, April 2012) obtained an average LCR of 71% for Group 1 banks and of 70% for Group 2 banks.
the second largest item are inflows from non-financial corporations (about 30%). Total Cash Outflows are driven by unsecured wholesale funding. Also here, banks account with non-operational deposits for the largest position (approx. 44%), non-financial corporates’ non-operational deposits for somewhat less than 23%. Given their lower outflow weighting, retail / SME deposits induce a less significant fraction of total outflows.

3. Conclusions

One important purpose of this study was to obtain more insight into the question as to whether the new LCR rules might – in addition to the intended positive effects – set incentives potentially interfering with the situation of business financing, or, on a narrower basis, set incentives potentially counterbalancing the preferential capital treatment of SME loans. Results obtained for the analysed sample of Austrian banks indicate (in spite of the restrictions and limitations mentioned before and against which the figures have to be viewed and put into perspective) that there might arise adjustment needs in the funding and / or investment structure in order to fulfil the LCR under the implementation interpretations applied, at least for some Austrian banks.

Obviously, an effective way of closing the gap between required and observed LCR is to extend refinancing maturities – or, in a broader respect, to adjust the liability structure. Another possibility would be to shift assets to HQLA. This shift might take place from loans to HQLA, or from assets other than loans to HQLA (probably it would be a combination thereof). The average asset structure in the sample exhibits total loans accounting for about 55% of assets, approx. 50% of assets fall upon retail and corporate loans. Given their demonstrated stability in creditworthiness, especially the stability of retail loans, asset reallocations from this segment to HQLA would probably not be the optimal solution with respect to financial stability considerations – in addition to c.p. dampening credit growth (for retail stability see Figure 1).

One possibility of mitigating such a potential incentive setting would be, for example, to include further instruments based on high credit quality loans in Level 2 assets. With respect to credit quality of instruments, for instance, this could mean including A- or an equivalent probability of default threshold. As can be seen from Figures 1 and 2, retail and corporate exposures in the internal ratings-based approach (IRB) in Austria exhibit significant volumes from the 3rd best rating category downwards. Such empirical facts should be taken into account when investigating HQLA availability criteria. Requirements concerning tradability and liquidity of these instruments would have to be evaluated against the background of their specific product characteristics and potentially be formulated somewhat less strictly.

Another issue that might be worth analysing in more detail would be the relatively high weighting of outflows from non-operational non-financial corporate deposits. As we have seen above, they account for about one quarter of total outflows in the sample investigated. If the run-off factor for this category was lowered from 75% to 50%, for instance, the average sample LCR would rise by approx. 10 percentage points.
As LCR details are still undergoing evaluation before final specifications shall become valid in 2015, advantage should be taken of this period to thoroughly examine and discuss different LCR aspects at the European level. In these discussions the importance of banks for SME financing should be given sufficiently high emphasis and results of EU impact analyses should receive adequate attention.
Annex

Table 1: Structure of Assets and Liabilities

<table>
<thead>
<tr>
<th>Assets</th>
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</thead>
<tbody>
<tr>
<td>Deposits held at other banks</td>
<td>15,3%</td>
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<tr>
<td>Loans</td>
<td>55,3%</td>
</tr>
<tr>
<td>hereof: Retail</td>
<td>13,6%</td>
</tr>
<tr>
<td>hereof: Corporates</td>
<td>36,5%</td>
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<tr>
<td>Financial assets</td>
<td>16,2%</td>
</tr>
<tr>
<td>Other</td>
<td>13,2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Deposits from banks</td>
<td>19,8%</td>
</tr>
<tr>
<td>Deposits from customers</td>
<td>46,0%</td>
</tr>
<tr>
<td>hereof: Retail</td>
<td>22,0%</td>
</tr>
<tr>
<td>hereof: Corporates</td>
<td>19,1%</td>
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<tr>
<td>Debt securities issued</td>
<td>17,5%</td>
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<tr>
<td>Other</td>
<td>16,7%</td>
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</tbody>
</table>

Notes: All numbers in per cent of total assets.

Source: Sample of Austrian Banks, 2011.
Figure 1: Rating Structure of Retail Exposures in the IRB

IRB Exposure Class Retail (Gross Exposures)

Notes: Rating category classification according to the OeNB master scale
RC1: very good, ..., RC8: default.
Source: OeNB.

Figure 2: Rating Structure of Corporate Exposures in the IRB

IRB Exposure Class Corporates (Gross Exposures)

Notes: Rating category classification according to the OeNB master scale
RC1: very good, ..., RC8: default.
Source: OeNB.