

EBA/Op/2017/15

13 December 2017

Opinion of the European Banking Authority on the draft national measures that the Republic of Cyprus intends to adopt in accordance with Article 458 Regulation (EU) No 575/2013

Introduction and legal basis

1. On 21 November 2017, the EBA received notification from the Central Bank of Cyprus (CBC) of its intention to adopt draft national measures as referred to in Article 458(2)(d)(v) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation – CRR)¹ to apply stricter liquidity requirements than those laid down in Part Six of the CRR in order to address changes in the intensity of macroprudential or systemic risk that could pose a threat to financial stability in Cyprus.
2. The EBA's competence to deliver an opinion is based on subparagraph (2) of Article 458(4) of the CRR. Article 458(2) of the CRR requires designated or competent authorities entrusted with the national application of that provision to notify the EBA where the authority identifies changes in the intensity of macroprudential or systemic risk in the financial system with the potential to have serious negative consequences for the financial system and the real economy in a specific Member State and which that authority considers would better be addressed by means of stricter national measures. Article 458(2)(d) specifically refers to stricter national measures concerning the level of own funds, requirements for large exposures, public disclosure requirements, the level of the capital conservation buffer, liquidity requirements (as laid down in Part Six of the CRR), risk weights for targeting asset bubbles in the residential property and commercial immovable property sector, or intra-financial sector exposures.

¹ 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) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

3. Within one month of receiving such a notification, the EBA is required to provide its opinion on the points referred to in Article 458(2) of the CRR to the Council, the Commission and the Member State concerned.
4. In accordance with Article 14(5) of the rules of procedure of the EBA, the Board of Supervisors has adopted this opinion.

Background on the measure

5. The proposed measure includes tightening some elements of the calculation of the liquidity coverage ratio (LCR) by setting stricter inflow and outflow rates than those defined in Commission Delegated Regulation (EU) 2015/61 (the LCR Delegated Regulation, adopted pursuant to Articles 412 and 460 of the CRR), resulting in stricter liquidity requirements in the form of an add-on. Those stricter requirements will supplement the fully phased-in LCR requirements over a one-year period.
6. The stricter measure is intended to be implemented in two stages. The first stage defines higher rates for the LCR calculation applicable from 1 January 2018 until 30 June 2018. The second stage defines higher rates applicable from 1 July 2018 until 31 December 2018.
7. The specific parameters for the calculation of the add-on are set out in the annex to this opinion. These imply stricter liquidity outflow and inflow rates than those applicable under Chapters 2 and 3, respectively, of Title III of the LCR Delegated Regulation. In particular, lower inflow rates are prescribed for assets with an undefined contractual end date and higher outflow rates for retail and other deposits. Other general requirements for items that are not subject to the rates prescribed in the Regulation are also included.
8. The measure applies to all but one domestically authorised credit institutions in Cyprus. One credit institution is exempted from the proposed measure because the fully phased-in LCR already imposes stricter liquidity requirements on it than the national measures previously in place in Cyprus.

Economic rationale for the measure

9. In accordance with Article 460(2) of the CRR and Article 38(1) of the LCR Delegated Regulation, the LCR will be fully phased in at 100% from 1 January 2018. National liquidity requirements therefore have to be phased out at that time, as provided for in the second sentence of Article 412(5) of the CRR.
10. In Cyprus, the fully phased-in LCR will result in significantly lower liquidity requirements than under the national liquidity requirements currently in force. The CBC estimates that approximately EUR 4 billion in excess liquidity would be made available to credit institutions. The CBC notes that EUR 4 billion is 22% of the annual GDP of Cyprus.

11. In the notification, the CBC observes that the credit institutions in Cyprus are funded mainly by deposits from both domestic and foreign depositors and that they are mainly dependent on short-term funding. The CBC states that the immediate release of this excess liquidity could increase liquidity risk and credit risk for credit institutions by increased risk-taking in their lending and investment decisions and that such behaviour could undermine the resilience of the Cypriot financial system.
12. The objective of the measure is therefore to ensure the gradual release of this excess liquidity, i.e. approximately EUR 2 billion on 30 June 2018 and EUR 2 billion on 31 December 2018. This would enable the CBC to closely monitor excess liquidity as well as macroprudential risks and vulnerabilities related to liquidity risks. During the 12-month period over which the measure will be phased out, the CBC intends to closely monitor the sustainability of the business models and strategic plans of credit institutions and assess any areas of concern, with particular attention to business models that are characterised by an imbalance between their short-term liabilities and assets, as over-reliance on short-term funding increases liquidity risks. This period, will therefore, as also stated by the CBC, enable any necessary microprudential or macroprudential action to be taken as required, including, if needed, requesting the extension of the proposed measure for one additional year each time, as permitted under Article 458(9) of the CRR.

Rationale for not using alternative measures

13. The CRR and Directive 2013/36/EU (the CRD)² offer various different options for addressing credit institutions' vulnerabilities: Points (c) and (e) of Article 458(2) of the CRR require the designated authority to justify, respectively, why other possible measures (i.e. the application of Articles 124 and 164 of the same Regulation and Articles 101, 103, 104, 105, 133 and 136 of the CRD) cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures, and why the stricter national measures are deemed by the authority to be suitable, effective and proportionate to address the situation.
14. The only measures set out in the CRR or CRD that could be used as macroprudential tools to address systemic liquidity risks are defined in Articles 103, 104 and 105 of the CRD. Article 103 permits the application of the supervisory review and evaluation process (SREP) to institutions in a similar or identical manner where the competent authorities determine that institutions with similar risk profiles are or might be exposed to similar risks or pose similar risks to the financial system. Article 104(1)(k) grants competent authorities the power to impose specific liquidity requirements. Article 105 specifies that, for the purposes of determining the appropriate level of liquidity requirements on the basis of SREP, the competent authorities are to assess whether any imposition of a specific liquidity requirement is necessary to capture

² Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

liquidity risks to which an institution is or might be exposed, taking into account, among other considerations, systemic liquidity risk that threatens the integrity of the financial markets of the Member State concerned.

15. As justification for the CBC's decision to apply Article 458 of the CRR, instead of Article 103, 104 or 105 of the CRD, the notification states the following:

- The current SREP framework does not include additional general liquidity charges.
- Articles 103 and 104 of the CRD are less transparent than Article 458(2)(d)(v) of the CRR. The application of the proposed measure under Article 458(2)(d)(v) of the CRR would achieve transparency and signal to credit institutions the need for sound liquidity risk management and more prudent lending and investment decisions, by providing an incentive to credit institutions to maintain a balance between their short-term liabilities and short-term assets, and by discouraging investments in risky financial instruments. The application of measures under Article 103 or 104 of the CRD would not address the risks that could arise from vulnerable funding and risky management strategies, which could threaten the solvency and liquidity position of a credit institution and the stability of the financial system as a whole.
- Article 105 of the CRD cannot be used to address the issue of excess liquidity. In particular, the issue of excess liquidity was not created as a result of any actions undertaken by credit institutions, on which specific liquidity requirements or administrative sanctions could be imposed. The issue of excess liquidity arises as a result of the differences between the stricter current national prudential liquidity requirements, which will be abolished on 31 December 2017 in accordance with Article 412(5) of the CRR, and which currently apply to all credit institutions that are incorporated in Cyprus, and the fully phased-in LCR. As the issue to be addressed is not institution-specific, a macroprudential measure that can be applied across the board (i.e. a system-wide formula that is identical for all credit institutions) is considered to be the most appropriate measure.
- Furthermore, under Council Regulation (EU) No 1024/2013, the competent authority that may make use of Articles 103, 104 and 105 of the CRD for significant institutions is the ECB.

Assessment and conclusions

16. Based on the evidence provided by the CBC, the EBA acknowledges the changes in the intensity of macroprudential or systemic risk in the Cypriot economy, as well as the potential threat to financial stability that could result from a sudden release of excess liquidity. The EBA welcomes the intention of the CBC to closely monitor the gradual release of liquidity and the liquidity positions of Cypriot banks and to take actions as required, and deems this gradual release a suitable and effective way of addressing the situation. In this context, the EBA observes that the proposed measure addresses only the sudden release of excess liquidity and

not the general risk described by the CBC in relation to reliance on short-term funding after the 12-month period. Given the transitory nature of the measure, any negative impact on the internal market is seen as limited. The EBA therefore does not object to the measure.

17. Based on the information provided in the notification, it is not possible to assess how the specific parameters given in the annex were calibrated. Here the question is if the same release of excess liquidity could have been achieved with a different and potentially simpler measure.

18. Paragraph 4 of Article 458 of the CRR requires the EBA to assess the points mentioned in paragraph 2. In particular, this includes, based on Article 458(2)(c), an assessment of the justification of why other measures, including Pillar 2 measures, cannot adequately address the systemic risk identified. In principle, the focus of Pillar 2 should be to address bank-specific risks based on SREP results. However, given the requirement to assess whether using Pillar 2 as an alternative would achieve the same result, the EBA has the following remarks to make regarding the choice of measure:

- While the application of Pillar 2 measures can be seen as less transparent, since those measures are generally not published, the use of Article 458 of the CRR for setting stricter liquidity requirements may also have negative effects on transparency, since LCR values across EU banks are no longer comparable if some banks are subject to a different calculation other banks. In addition, a signalling effect to institutions can also be achieved through the clear communication of SREP decisions to institutions or by publishing the macroprudential measures taken under Pillar 2.
- The applicability of Articles 103, 104 and 105 of the CRD cannot be rejected solely by referring to the distribution of responsibilities set out in Council Regulation (EU) No 1024/2013. The CBC could have requested the ECB to address its macroprudential concerns in SREP decisions. It is, however, acknowledged that this might not be possible in a very short timeframe and that it seems to be critical to implement the measure at the beginning of 2018. The process of assessing the application of different macroprudential tools should have been started earlier. The objective pursued by the CBC, i.e. the gradual release of excess liquidity, could have been achieved by applying measures under Article 103, 104 and 105 with the necessary lead-in time before the full phasing in of the LCR in January 2018.

19. In this regard, the EBA also notes that the same result described in this proposal could have been achieved by applying an earlier phasing out of the national legislation in anticipation of Article 412(5) of the CRR.

20. Finally, the notification from the CBC is the first case in which a designated authority has made use of Article 458 of the CRR to set stricter liquidity requirements. The EBA observes that there are uncertainties regarding the nature of Article 458(d)(v) that need to be clarified in the

future. This opinion therefore does not preclude a different assessment of any other measures taken by the designated authority of a Member State in the future.

21. This opinion will be published on the EBA's website.

Done at London, 08 December 2017

Andrea Enria

Chairperson

For the Board of Supervisors

Annex: Calibration of LCR add-on

Table 1: Calibration of LCR add-on ³

	Add-on rate	
	Stage 1 (1 January 2018)	Stage 2 (1 July 2018)
LCR INFLOWS		
Assets with an undefined contractual end date (i.e. the 20% standard default inflow rate is reduced to the rate referred at each stage)	0%	10%
LCR OUTFLOWS		
Retail deposits		
Deposits subject to higher outflows	20%	10%
Stable deposits	5%	2.5%
Other retail deposits	5%	2.5%
Other than retail deposits		
Operational deposits maintained for clearing, custody, cash management or other comparable services in the context of an established operational relationship	15%	7.5%
Non-operational deposits by other customers	5%	2.5%
Retail deposits exempted from the calculation of LCR outflows	5%	2.5%
ADDITIONAL GENERAL ADD-ONS		
Financial companies deposits with maturity over 30 days	15%	7.5%
Non-financial companies deposits with maturity up to 30 days	10%	5%
Non-financial companies deposits with maturity over 30 days	10%	5%

³ The following items may be used to cover the LCR add-on requirements:

- (a) Liquid assets as defined and calculated for purposes of the LCR, and
- (b) Surplus inflows that exist, but are exempted in the LCR calculation due to being over the 75% cap as per Article 33(1) of the LCR Delegated Regulation.

It should be noted that under the national liquidity requirements currently applied, credit institutions are allowed to include 100% of their interbank placements (with maturity up to 30 days) in the liquidity requirement calculation. As the current national liquidity requirements do not factor in any restriction on the level of inflows used in the computation of the liquidity requirements, the LCR add-on will also allow credit institutions to include, as far as applicable, any inflows exempted on account of being over the 75% cap applied in the LCR calculation.