XIV Convention AIFIRM

Prospettive di evoluzione della strategia di funding delle banche a fronte delle sfide poste dai nuovi requisiti prudenziali in materia di liquidity risk

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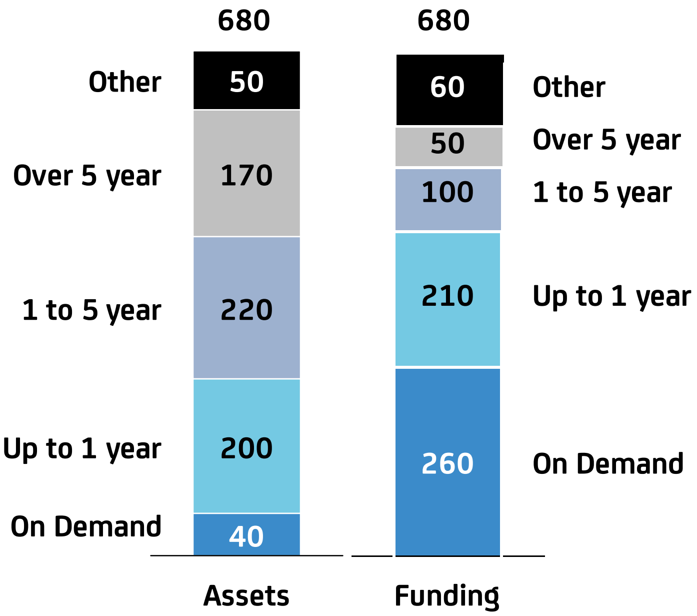
Milan, December 6th 2018

Banking that matters. | UniCredit

What is liquidity Risk?

Bank Balance Sheet
€ bn, contractual maturity distribution



- ILLUSTRATIVE -

- ✓ The main activity of a bank is to gather deposits and grant loans. Typically deposits have short-term maturity (*i.e. sight*), while loans are long-term assets
- ✓ Therefore, the maturity mismatch between asset and liabilities is intrinsic in the banking activity
- ✓ If a bank is not able to renew its maturing liabilities, while at the same time keeps to grant loans it will run in a liquidity crisis
- ✓ If all depositors ask their money back at the same time, the bank cannot instantaneously cash-in all its loans and will run in to a liquidity crisis that could in turn trigger a default

Liquidity risk is the risk that a bank may find itself **unable to fulfill** its **expected or unexpected payment obligations** (by cash or delivery), **current and future**

The financial crisis triggered a profound reshaping of the re regulatory framework with a special focus on the Liquidity Risk Management

The significant liquidity problems faced by many international banks during the crisis led the Basel Committee to the introduction of two new liquidity prudential requirements and a new regulatory framework for banks' resolution

Focus of this presentation

Basel Committee on Banking Supervision (BCBS) - Basel III		Financial Stability Board (FSB)
HIGHER CAPITAL QUANTITY AND QUALITY	**LIQUIDITY REQUIREMENTS**	**BAIL-IN AND ORDERLY RESOLUTION**
✓ **Minimum Capital Ratios[(1)]**: Higher requirements in terms of Common Equity Tier 1 (CET1) and stricter rules (deductions) for prudential capital calculation ✓ **Additional capital buffers:** new capital buffers to be held in addition to minimum CET1 requirement ✓ **Leverage ratio** a non risk-based requirement to work in conjunction with the risk based capital ratios	✓ **Liquidity Coverage Ratio (LCR):** minimum requirement in terms of high quality liquid assets that can be converted into cash to meet the forecast of net cash outflows over a **period of 30 days** given a stress scenario ✓ **Net Stable Funding Ratio (NSFR):** minimum requirement for the **long term resilience to liquidity risk** Time horizon is 1 year	**To address the "Too big to fail"** issue, the Financial Stability Board introduced: ✓ the **Globally Systemically Important Banks** (so called **G-SIB**) concept: Banks subject to stricter regulation and supervision ✓ **Recovery & Resolution Planning**: a new set of requirements for Banks and Authorities to orderly manage crises. It includes additional requirements in terms of **loss absorbing liabilities** to cope with large losses in case of crisis, **without burdening taxpayers** (i.e. Total Loss Absorbing Capacity **TLAC**, for G-SIBs)
EU Legislation: ***Capital Requirement Regulation - CRR, Capital Requirement Directive IV - CRD IV***		**EU Legislation:** ***Bank Recovery and Resolution Directive - BRRD***

[(1)] *The minimum prudential capital requirement is composed of three layers whose sum is the Total Capital. The Common Equity Tier 1 (CET1) is the highest quality component of the Total Capital (it consists mostly of common stock). Additional Tier 1 instruments are hybrid capital instruments, designed to convert to equity in a crisis (e.g. if capital ratios fall below a certain level). Finally, the Tier 2 capital is known as supplementary capital, it comprises mainly subordinated bonds (i.e. bonds with lower priority interest than another securities)*

The Liquidity Coverage Ratio (LCR) has been introduced to face short term liquidity risk

This is a **short term liquidity requirement** and is aimed at ensuring that a bank maintains an adequate level of unencumbered, **high-quality liquid assets** that can be converted into cash **to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario:**

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Net cash outflows over the next 30 days}} \geq 100\%$$

The ratio is monitored since 2012. ***The 100% limit is binding from 2018***

HQLA (high quality liquid assets) – Assets that can be easily and immediately converted into cash at little or no loss of value. To be qualified as such, they need to satisfy five main features:

- ✓ Low credit and market risk;
- ✓ Ease and certainty of valuation;
- ✓ Low correlation with risky asset;
- ✓ Listed on a developed and recognised exchange market;
- ✓ Unencumbered

Net cash outflows – This variable should be computed as the difference between total expected cash outflows and inflows over a stress scenario for the subsequent thirty days

Main Banks' challenges

LCR has a direct balance sheet impact on every bank because it dictates the size and structure of their HQLA portfolio. Main challenges are:

- **Maintain HQLA level**: at the end of 2017 Italian banks had an average liquidity coverage ratio (LCR) of 171%, well above the required 100% (source: Bank of Italy). In a context of **rising interest rates the value of these assets decreases**
- **Sovereign bonds** are a major component of HQLA, on the other side banks are encouraged by supervisors to reduce "home-country" sovereign exposures

The Net Stable Funding Ratio has been introduced to ensure that banks rely on an adequate amount of stable funding to support their lending activity

The **Net Stable Funding Ratio** (NSFR) establishes a **minimum acceptable amount of medium-long term funding.** It aims to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items. This ratio requires a minimum amount of **stable** – i.e. medium and long term - **funding** based on the liquidity characteristics of a bank's assets and activities over a one year horizon. As such, it requires that long term assets are funded with at least a minimum amount of stable liabilities in relation to their liquidity risk profiles:

$$\text{Net Stable Funding Ratio} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

Stable funding is defined as the portion of equity capital and liability financing that is expected to be a reliable source of funds over a 1-year time horizon, **under conditions of stress**, like:

- profitability fall due to a credit, market, operational or other risk event
- a potential downgrade in credit rating
- an event affecting the reputation or the credit quality of the institution

The **minimum threshold for the NSFR is at 100% (under finalization within the CRR2)**

Main Banks' challenges

- **Refinancing**: in mid-2019 Italian banks will have to replace in their stable funding ca. €140 bn in long-term loans that mature in mid-2020 – i.e. **end of TLTRO** (Moody's warned that Italian banks would see **funding costs rise**)
- **Small-medium banks** could face increasing difficulties in **market access** *(..they could become a problem across the sector)*
- Banks will have to **optimize stable liabilities mix**

On top of the new regulatory requirements, also the supervisory approach has become more strict – The New ECB guidance on ILAAP sets ambitious goals

ILAAP (Internal Liquidity Adequacy Assessment Process)

ILAAP plays a key role in the risk management of credit institutions

The ILAAP is…

- **Ongoing process**, not only a document for supervisors
- **Holistic**, it encompasses all material risks
- **Forward-looking**
- **Tailor-made** by each institution who bears full responsibility for it
- To be regularly reviewed and adjusted

A strong ILAAP ensures institutions…

- **Identify and assesses their risk to liquidity**
- **Manage liquidity risk and assess their liquidity needs**
- **Identify and set an action plan to address gaps to regulatory requirements** on risk management framework

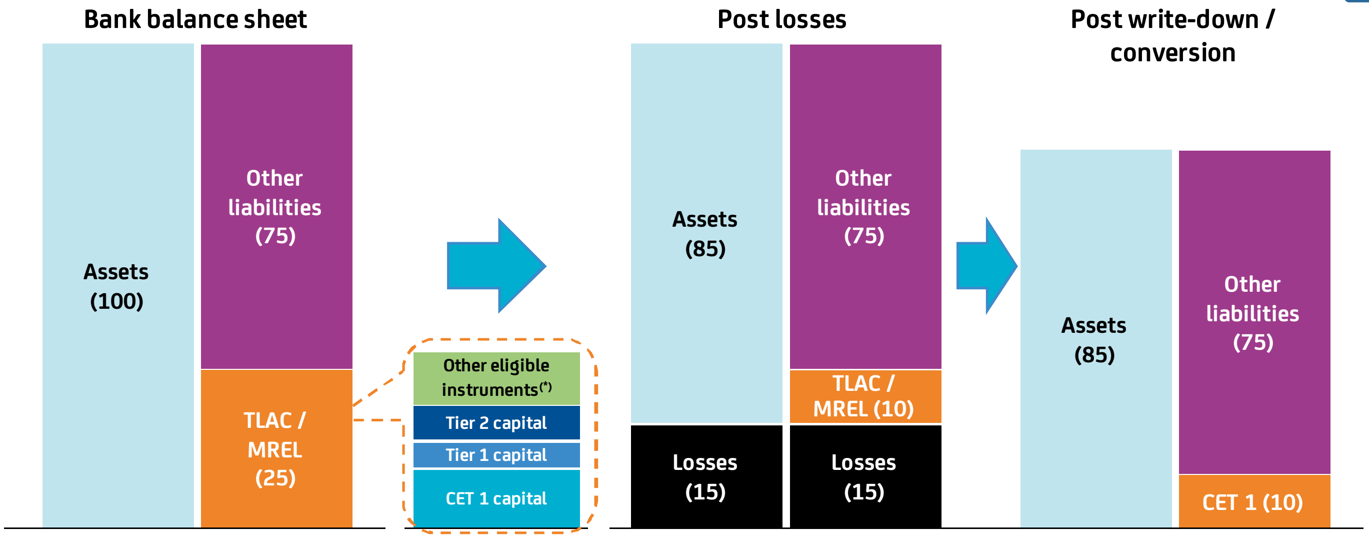
Main Banks' challenges

- Clearly **define and implement short and medium-long term strategies**
- **Risk Appetite Framework** to be consistent with the liquidity strategy
- Thorough **implementation** and monitoring of the strategy and risk appetite truly supported by ILAAP
- **Institutions are expected to define, assess and maintain internal liquidity buffers and stable sources of funding** (also considering stress scenarios)

No more taxpayers' money: MREL & TLAC requirements have been introduced by regulators to ensure an effective resolution framework

- In order to make a Resolution possible, **Regulators have introduced new Loss Absorbing Capacity requirements** (i.e. *Total Loss Absorbing Capacity* – TLAC - as global standard, implemented in Europe through the *Minimum Requirement for Own Funds and Eligible Liabilities* - MREL). Banks shall maintain sufficient financial resources capable to absorb losses and to recapitalize the failing bank (the "Loss Absorbing Capacity") thus **avoiding** a **disordered bankruptcy** which might **affect the stability of the financial system and any recourse to taxpayers' money** (the MREL requirement is **determined and monitored by the Single Resolution Board** during its annual Resolution Planning process)
- Depending on the individual banks' resolution strategy, **TLAC/MREL requirements have implications on banks' funding strategy** and consequently on the type of eligible instruments to be issued on the market

TLAC / MREL: loss absorption and recapitalization in resolution



Key challenges

- **Eligibility criteria** for issuances related to i) Retail Clients ii) Liabilities governed by 3rd country laws iii) Senior Exemption (eligibility of the Senior Bonds for the TLAC)
- **Subordination** requirement
- The **application date**

(*) *Other eligible instruments are composed by other subordinated liabilities, Senior Non Preferred bonds and other senior liabilities, with different criteria between MREL and TLAC eligible instruments*

TLAC & MREL: focus on instruments eligibility and envisaged grandfathering period

Liabilities	Issued by	TLAC eligible	MREL eligible	Eligibility criteria – Specific cases
Own funds (Regulatory Capital)	Consolidated	✓	✓	▪ **In Single Point of Entry (SPE): fully included in EU; excluded from the non-EU subsidiaries** ▪ **In Multiple Point of Entry (MPE): fully included within the resolution perimeter; excluded outside it**
NEW! **Senior Non Preferred (SNP) Other Sub. debt** (maturity >1y)	Resolution Entity (RE) only	✓	✓	▪ The Senior Non Preferred instruments (**SNP**) **already implemented in the Italian legislation**
Senior bond preferred (old style) maturity >1y	RE only	✓ (yellow)	✓	▪ **Senior Preferred bonds** are **eligible for MREL**, while **only 2.5% RWAs** (3.5% from 2022) might be **eligible for TLAC** with the **Resolution Authority's permission** <u>**Bonds issued on Retail networks** can be considered as a **Resolution impediment** due to legal risk in case of a bail-in (e.g. litigation from retail bondholders) and therefore RAs can request to limit such liabilities</u>
Structured Notes (maturity > 1y)	RE only	✗	✓	**Eligible only if**: ▪ **A given amount** of the liability **is known in advance**, is **fixed** & **not affected by a derivative** ▪ The instrument is **not subject to any netting agreement** ▪ Eligibility only up to the amount of the liability that complies with first point
Term Deposits (maturity > 1y; no early withdrawal right)	RE only	✗	✗	▪ **Excluded in Italy due to the depositors preference (from 2019)** ▪ **Without depositor preference, would be eligible only if residual maturity above 1 year**, including the early redemption clause ▪ If the bank cannot identify whether an early redemption clause exists and how long -> **excluded**

Liabilities governed by the law of a third country → Eligible only if bail-in contractually recognized (Art. 55 BRRD); legal opinion required

Key considerations for banks funding strategies

The regulatory framework evolution poses **significant challenges** to banks in order to shape their funding strategies in the future. This is due to the fact the **new regulatory requirements** constraint the **funding structure** and therefore the **balance sheet structure of banks**

- **NSFR**: requires a minimum amount of stable funding (e.g. constraints in terms of maturities and contractual characteristics of funding sources)
- **ILAAP**: stricter supervisory expectations in terms of liquidity steering and liquidity buffer definition (including stress scenario, diversification of funding, etc.)
- **TLAC / MREL:** requires a minimum amount of bail-inable liabilities capable to absorb losses and to recapitalize the failing bank (the "Loss Absorbing Capacity") in case of resolution

Funding strategy in the future requires an optimization between binding regulatory requirements and cost of funding

- ✓ **Balance composition of funding sources in terms of maturity mix** (i.e. minimization of the maturity mismatch)
- ✓ **Optimization of funding sources including new MREL eligible instruments** (i.e. senior non preferred)
- ✓ **Market access to be preserved at sustainable costs**

Glossary (1 of 2)

- **BCBS** – *Banking Committee on Banking Supervision:* international standard setter in the area of banking prudential regulations
- **BRRD** – *Bank Recovery and Resolution Directive:* establishes a common approach within the EU to the recovery and resolution of banks and investment firms
- **CET1 ratio** – *Common Equity Tier 1:* is a measurement of a bank's core equity capital compared with its total risk-weighted assets
- **CRDIV** – *Capital Requirements Directive IV* : is the EU legislative transposition of Basel III
- **CRR** – *Capital Requirement Regulation* : CRR is the EU legislative transposition of Basel III
- **EBA** – *European Banking Authority* : independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European Union banking sector
- **ECB** – *European Central Bank* : the central bank responsible for the monetary system of the EU and the euro currency
- **EDIS** – *European Deposit Insurance Scheme:* is the third pillar of the banking union (not yet implemented)
- **FSB** – *Financial Stability Board:* international standard setter in the area of international financial stability (e.g. G-SIB, TLAC)
- **ICAAP** – *Internal Capital Adequacy Assessment Process:* internal process for the identification, measurement, management and monitoring of capital adequacy
- **ILAAP** – *Internal Liquidity Adequacy Assessment Process:* internal process for the identification, measurement, management and monitoring of liquidity risk
- **IRRBB** – *Interest Rate Risk in Banking Book:* the risk to interest income arising from a mismatch between the duration of assets and liabilities in the normal course of business activities
- **ITS** – *Implementing Technical Standards:* adopted by the EU Commission with an Implementing Act (Level 2 measure), to provide certain details to a broader EU Regulation or Directive (Level 1 measure), where uniform conditions for implementing the relative Level 1 acts are required
- **JST** – *Joint Supervisory Team:* responsible for the day-to-day supervision of a significant institution; comprises staff from both the ECB and the NCAs of the countries in which the credit institution is established
- **LCR** – *Liquidity Coverage Ratio:* measure of the capability to meet short-term obligations - the amount of highly liquid and freely available assets as a ratio of the potential net cash outflows under an acute short-term stress scenario (30 day period)
- **MoU** – *Memorandum of Understanding:* a voluntary cooperation agreement between bank supervisors with common financial stability concerns
- **MREL** – *Minimum Requirement for Own Funds and Eligible Liabilities:* the minimum amount of liabilities that banks have to hold to ensure that a sufficient bail-in can be executed in case of resolution of a bank

Glossary (2 of 2)

- **NCAs** – *National Competent Authority:* the Central/National bank, responsible for bank supervision tasks in its (national) jurisdiction; e.g., the Bank of Italy for Italy
- **NPLs** – *Non performing loans:* Loans classified as past due or unlikely to pay
- **NRA** – *National Resolution Authority:* the national authority with responsibility to plan, monitor, execute the resolution plans of banks, in Italy it is the Bank of Italy
- **NSFR** – *Net Stable Funding Ratio:* ratio between the "available amount of stable funding" and the "required amount of stable funding" that are calculated applying defined weighting factors to on and off-balance sheet items
- **RAF** – *Risk Appetite Framework:* the level of risk that a bank is willing to take in pursuit of its strategic objectives and business plan, taking into account the interest of its stakeholders as well as capital and other regulatory and law requirements
- **RTS** – *Regulatory Technical Standards:* adopted by the EU Commission with a Delegated Act (Level 2 measure), to supplement or amend certain to a broader EU Regulation or Directive (Level 1 measure)
- **SREP** – *Supervisory Review and Evaluation Process:* whose key purpose is to ensure that institutions have adequate arrangements, strategies, processes and mechanisms as well as capital and liquidity to ensure a sound management and coverage of risks. It is the process used to guide the supervisory review of significant and less significant credit institutions and to determine whether (on top of minimum requirements) possible additional requirements should be applied with respect to own funds, liquidity, or whether any other supervisory measures should be applied
- **SRB** – *Single Resolution Board*: the central European authority responsible for the preparation, monitoring and execution of the resolution of the major banks in the EU
- **SRM** – *Single Resolution Mechanism*: the EU-level system for resolving non-viable financial institutions, it comprises the Single Resolution Board (SRB) and National Resolution Authorities of the participating Member States of the Banking Union (NRAs)
- **SSM** – *Single Supervisory Mechanism:* the system of banking supervision in Europe comprising the ECB and the national supervisory authorities of the participating countries with the main aims of ensuring the safety and soundness of the European banking system, increasing financial integration and stability, ensuring consistent supervision
- **TC** – *Total Capital*: The measure of a bank's qualifying capital in the calculation of its risk based capital reserves. It is the sum of Common Equity Tier 1 capital (CET1), Additional Tier 1 capital, and Tier 2 capital
- **TLAC** – *Total Loss-Absorbing Capacity:* the minimum amount of liabilities that a G-SIB bank has to hold to ensure that a sufficient bail-in can be executed in case of a resolution of the bank