Explanatory memorandum on the Regulation on the liquidity of institutions (Liquidity Regulation; *Liquiditätsverordnung*)

General part

Pursuant to section 11 (1) sentence 2 of the German Banking Act (*Gesetz über das Kreditwesen*), the Federal Ministry of Finance is authorised to issue a legal regulation in consultation with the Deutsche Bundesbank. This regulation gives concrete shape to the statutory requirement under section 11 (1) sentence 1 of the Banking Act, under which institutions must ensure sufficient liquidity at all time. In addition, section 9 of the Liquidity Regulation translates Articles 5 and 6 of Directive 2000/46/EC into German law.

Special part

Regarding section 1

This provision defines the group of institutions to which this regulation applies. Subsection 1 requires those institutions to which section 11 of the Banking Act is applicable to apply the Liquidity Regulation. E-money institutions are explicitly required to comply only with section 9 of the Liquidity Regulation.

Subsection 2 defines the conditions under which the application of the regulation to branches within the meaning of section 53b (1) of the Banking Act can be waived. If certain conditions are fulfilled, domestic branches of a credit institution domiciled in another country of the European Economic Area (EEA) can be exempted from applying the regulation. Until liquidity supervision has been harmonised at the European level, the host member state, in cooperation with the competent authority of the home member state, shall remain responsible for monitoring the liquidity of the branch of a credit institution domiciled in the EEA (Article 41 sentence 1 of Directive 2006/48/EC).

Regarding section 2

Institutions' ability to meet their payment obligations at all times is a *sine qua non* for a financial market to function effectively. Institutions must accordingly have sufficient liquidity at all times. Owing to the many options for holding or obtaining liquidity within certain time periods, there is a standardised procedure for calculating a liquidity ratio as well as observation ratios. The liquidity ratio is used to assess whether an institution's liquidity is adequate under normal circumstances. This reflects the critical time horizon of a period of up to one calendar month (maturity band 1). Moreover, the time period of over one month to up to one year is also of interest to supervisors, as any liquidity problems that occur within this time band could point to structurally induced refinancing difficulties. The liquidity recording framework therefore covers a total period of up to 12 months, divided into four maturity bands. The data on liquidity in the areas between one month and one year (maturity bands 2 to 4) are intended only for information purposes.

Regarding section 3

Section 3 (1) and (2) lists the specific items that are to be regarded as payment assets within the meaning of the regulation. The recognisable payment assets pursuant to subsection 1 include the liquidity components that, irrespective of the contractually agreed (residual) maturities, may be regarded as items that can readily be liquidated at all times (first-class liquidity). These liquidity components are always to be assigned to maturity band 1. Pursuant to subsection 2, these are joined by items maturing in the next 12 months and causing inflows of assets to the institution. These items are to be assigned to the relevant maturity band depending on their respective maturities (second-class liquidity). For the sake of clarity, subsection 3 lists the items that do not count as liquid assets.

Regarding section 4

The purpose of recording payment obligations pursuant to section 4 is to determine an institution’s available liquidity in each respective maturity band.

Subsection 1 lists the payment obligations without any fixed maturities or periods of notice. These are liabilities and performance obligations that an institution must expect to be requested at any time. They therefore need to be recorded in the first maturity band up to the amount of the respective call risk contained in the weights of the respective liability items.

Subsection 2 lists the liability items that need to be recorded as payment obligations in maturity bands 1 to 4 depending on their residual maturities.

Regarding section 5

Owing to the wide variety of ways of structuring contracts on the pledging and lending of securities (securities repurchase and lending agreements) with respect to liquidity flows, disbursement and netting, it is necessary, within the framework of the Liquidity Regulation, to assign the relevant securities and/or claims arising from the contracts to the appropriate institution. This is intended to resolve the question of who is required to classify the relevant securities as liquid assets or payment obligations, with the corresponding impact on the affected institution’s liquidity calculation.

Regarding section 6

The basis on which liquid assets and payment obligations are to be weighted is laid down by defining the basis of assessment. The basis of assessment for central bank money holdings pursuant to section 3 (1) numbers 1 and 2 is the amount of the central bank money holdings. For liquid assets pursuant to section 3 (1) numbers 3 to 8, the basis of assessment reflects the amount the institution may regularly expect if the relevant liquid assets are converted into central bank money. Subsection 2 describes the procedures for treating value adjustments which cannot be assigned to the relevant assets. Subsection 3 regulates the conversion of foreign-currency-denominated asset and liability items into euro.

Regarding section 7

Since, over time, an institution’s liquidity depends to a major degree on the maturity of liabilities incurred and the concomitant inflow or outflow of liquid assets, it is necessary to calculate the residual maturities. To this end, a starting point (here, the respective reporting date) and the time of each maturity (depending on the respective contractual circumstances) are chosen.

Regarding section 8

With respect to building and loan associations, it is necessary to count 10% of the book value of the difference between deposits under savings and loan contracts and loans under savings and loan contracts towards payment obligations pursuant to section 4 (1) in maturity band 1 in order to create the basis for sufficient liquidity provisioning to cover the expected outflows from building and loan association business (collective business) (sentence 1). This also takes account of the fact that no fixed residual maturities can be assigned to the individual assets and liabilities from collective business. The other assets and liabilities of building and loan associations are comparable to those of other institutions; the general provisions of this regulation can therefore be applied accordingly.

Regarding section 9

Section 9 transposes the provisions of Article 5 (1), (2), (5) and (6) of Directive 2000/46/EC into German law. The Directive requires liabilities related to outstanding electronic money to be backed by certain liquid assets. It also stipulates that certain investments are not permitted to exceed 20 times the own funds of an e-money institution. This provision is addressed in subsection 1 sentence 4. The reporting requirement introduced in sentence 5 – in the event such an overshoot occurs – exceeds the scope of the Directive. However, given the importance of the above-mentioned limitation of an e-money institution’s investments, this reporting requirement is appropriate and does not cause institutions undue hardship.
The verification of the specific requirements called for by Article 6 of the Electronic Money Directive is implemented in subsection 3.

Regarding section 10

The liberalisation clause is an innovation which permits an institution to use an internal procedure for measuring and managing liquidity risk. An institution’s liquidity risk measurement and management system is understood to mean the sum total of all procedures used by that institution to measure or manage its liquidity risk. If an internal procedure is used, the provisions of sections 2 to 8 of the Liquidity Regulation regarding the calculation of the liquidity and observation ratios defined therein shall not apply. Correspondingly, the operative costs for applying sections 2 to 8 are also waived. This contrasts, however, with direct and indirect costs of inspections by supervisors and of ongoing compliance with the requirements for utilisation.

The possibility of using internal procedures helps to strengthen the risk management framework of institutions and groups of institutions or financial holding groups in the area of their liquidity management above and beyond the mandatory minimal requirements of section 25a of the Banking Act. Institutions should avoid uneconomic operations or investment decisions even though adequate liquidity is guaranteed.

Subsection 1 makes the use of an internal liquidity risk measurement and management system subject to supervisory approval. To maintain adequate control of the use of internal procedures, BaFin (the Federal Financial Supervisory Authority) may render its approval contingent upon collateral clauses and conditions. In particular, BaFin can require the submission of documentation and material corrective adjustments. If the conditions are no longer fulfilled, BaFin can revoke its approval.

Subsection 2 ensures that supervisors must examine an internal procedure prior to approval, as well as perform routine follow-up examinations.

This subsection together with the conditions pursuant to subsection 3 ensure that internal liquidity risk measurement and management systems are not used until BaFin has determined that the requirements for utilisation are being observed. If approval is granted, sections 2 to 8 do not need to be applied. Subsection 3 makes the existence of defined benchmarks for assessing the risk of insufficient liquidity a requirement for utilisation. The internal specification-based reporting requirement gives BaFin the possibility to provide a nuanced response to the risk of insufficient liquidity on the part of the institution. Focusing on an institution’s specific benchmarks minimises the prudentially-related additional costs which the institution incurs through using the liberalisation clause.

Subsection 4 transfers the “waiver rule” for institutions belonging to a group pursuant to section 2a of the Banking Act to the use of an internal liquidity risk measurement and management procedure. As in subsection 1, the possibility of using an internal procedure is given to single entities, not to groups of institutions or financial holding groups. This approach is due to the fact that section 11 of the Banking Act is targeted only at single-entity institutions and not groups. Logically, the scope of application of the Liquidity Regulation laid down in section 1 (1) also lists only institutions and not groups. As subsection 4 sentence 2 requires compliance with “group-related requirements for utilisation” in order to waive the application of the provisions pursuant to sections 2 to 8, BaFin can also determine whether the requirements for utilisation pursuant to subsection 3 are fulfilled with regard to an entire group of institutions or a financial holding group. In this case, subsection 4 sentence 1 provides for waiving application of the provisions pursuant to sections 2 to 8 for all institutions within a group of institutions or a financial holding group. In this way, the exemptions for institutions belonging to a group according to section 2a of the Banking Act have been integrated into the liberalisation clause of the Liquidity Regulation.

Regarding section 11

This section defines the reporting deadlines for ratios, as well as the reporting procedure, more precisely. The ratios have to be calculated by the institutions in each case by the end-of-month reporting date; in the case of guarantee banks and credit guarantee associations, the respective dates are at the end of May and end of November.

Regarding section 12

Institutions continuing to apply Principle I temporarily in 2007 instead of the new provisions of the Solvency Regulation (*Solvabilitätsverordnung*) will also be able to apply Principle II in place of the Liquidity Regulation over the same transitional period. This eases the burden for institutions.

Regarding section 13

The regulation shall come effect on 1 January 2007. The power to issue a regulation pursuant to section 11 (1) sentence 2 of the Banking Act and the power to issue a regulation pursuant to section 10 (1) sentence 9 of the Banking Act shall thus be implemented simultaneously.