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Basel III Liquidity Standards:
The Implications for Credit Union Investments

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This document is intended to provide a summary of the potential impact of certain aspects of the Basel III liquidity standards on credit unions. It is provided for information and discussion purposes only and is not intended to be comprehensive. Readers may wish to supplement the content by reading the source materials referred to throughout and form their own view. Statements and other assumptions contained in this document are based on the current expectations, opinions and/or beliefs of Davy at the time of publishing. These assumptions and statements may or may not prove to be correct and actual outcomes may differ.

Executive Summary

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- Basel III is a comprehensive set of global banking measures which introduces two new liquidity ratios that are intended to ensure that banks hold sufficient liquidity aside for crisis situations. These ratios have important implications for the credit union sector.
- For the purposes of liquidity, banks will be required to classify deposits according to their perceived stability.
- Under Basel III, funds from credit unions are likely to be classified as Non-bank Financial Institutions ('NBFIs'). This classification means that it is assumed that credit union deposits may be withdrawn from banks in a period of market stress, and therefore will be viewed as a relatively unstable source of funding.
- As a result, deposits from credit unions may no longer be as attractive to banks, especially those deposits with maturities of less than one year.
- The main implication of the lower deposit rates resulting from the NBFI classification is a potential reduction in credit union investment income. Davy estimates that, based on a number of assumptions, this could result in a reduction of investment income of approximately €58 million per annum across the credit union movement in Ireland.
- Although implementation of Basel III will be introduced on a phased basis from 2015, Davy understands that certain deposit rates available to credit unions are already negatively reflecting Basel III measures.
- As the impact is significant, credit unions may wish to consider collectively lobbying at national and at European level to have funds reclassified to a more stable category, although there is no guarantee that this would be successful.
- In the event that credit unions proceed with an application to have their funds reclassified, representative bodies should inform and educate their members. The Central Bank of Ireland and the Department of Finance should also be informed of the movement's issues and intentions.
- The above steps should be conducted in a relatively swift manner so that discretion may be exercised prior to finalisation of proposals and full implementation by banks.

PLEASE NOTE: Until Basel III is finalised and fully implemented, there is no assurance that the assumptions referred to above will materialise. Actual outcomes may differ.

Section 1: Introduction & Background

Introduction

Basel III is a comprehensive set of global measures intended to '*strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector*'[1]. Much of the commentary on Basel III tends to be focused on the more stringent capital requirements that the world's banks must hold in order to protect themselves against losses, but in addition Basel III introduces entirely new liquidity requirements.

The purpose of this paper is to give an overview of the new liquidity framework and its consequences for the credit union movement, in addition to highlighting the important implications that Basel III is likely to have for credit union investment portfolios in Ireland.

Background

During the 2007 financial crisis, several banks, such as Northern Rock and Bear Sterns, suffered from a liquidity crisis due to their over reliance on short-term wholesale funding from the interbank lending market. These institutions were unable to roll over short-term financing which resulted in a major liquidity event and their subsequent collapse which, among other factors, had a detrimental effect on the global economy. Basel III measures have therefore been introduced with the aim of improving liquidity regulation with the ultimate objective of protecting the global banking system thus averting the possibility of a similar crisis in the future.

Section 2: Liquidity Ratios under Basel III

Liquidity Ratios

Basel III introduces two new liquidity ratios which are intended to ensure that banks hold sufficient liquidity aside for crisis situations in the event that wholesale funding markets shut down. It encourages a structural shift away from reliance on wholesale funding towards a longer term and potentially more robust funding strategy. The ratios include a Liquidity Coverage Ratio ('LCR') which addresses short-term funding requirements in a time of stress, and the Net Stable Funding Ratio ('NSFR') which concerns longer term funding requirements.

i. Liquidity Coverage Ratio ('LCR')

$$\textbf{LCR:}\quad \frac{\text{Stock of high quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}} \geq 100\%$$

- The LCR is designed to strengthen the ability of banks to withstand adverse shocks in the short run.
- It requires banks to hold sufficient high quality liquid assets (cash, certain government bonds and other liquid securities) to meet cash outflows over a period of 30 days.
- It assumes that during a stressed scenario, a proportion of retail deposits are withdrawn, that there is limited access to wholesale funding and it incorporates the impact of a number of other liquidity risk scenarios such as a ratings downgrade.
- It is designed with the intention that liquid assets cover the deficit between cumulative cash inflows and outflows over the 30-day stressed period.

ii. Net Stable Funding Ratio ('NSFR')

$$\textbf{NSFR:}\quad \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

[1] Source: www.bis.org/publ/bcbs189.pdf

- Complementary to the LCR is the NSFR, which is a more structural measure and concerns long-term funding. It looks beyond the 30-day timeframe of the LCR and aims to reduce the use of short-term funding to finance less liquid assets.
- It encourages banks to have stable funding in place to support operations during a stressed period of one year on a rolling basis. Stable funding sources would include capital and long-term debt instruments, retail deposits and maturity wholesale funding of greater than one year, to match their medium and long-term lending.
- It establishes a minimum acceptable amount of stable funding (including long-term debt instruments, retail deposits and term deposits greater than one year in maturity) based on the liquidity characteristics of an institution's assets and activities over a one-year horizon. It requires the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress. NSFR requires banks to fund long-term, illiquid assets with long-term, stable funding.

Classification of Deposits & Relevance to Credit Unions

Heretofore, banks have broadly treated credit union funds as stable deposits which have attracted competitive rates of return. Under Basel III a number of different classes or funding sources are identified which are summarised in Table 1 (please refer to Appendix 1 for further detail). Classes can largely be divided into retail (placed by a natural person) and wholesale (placed by a legal entity). Based on Basel III criteria, deposits from credit unions fall into the wholesale category Non-Bank Financial Institutions (NBFIs), as highlighted in Table 1. The implications of this reclassification are:

- **LCR**: *The LCR assigns a specific run-off rate to each source of funding. A run-off rate reflects the amount of funding due to mature in next 30 days which is not rolled over and therefore is withdrawn from the bank. The NBFI class attracts a run-off rate of 100%.*
- **NSFR**: *In order to establish the available amount of stable funding of a bank, the NSFR assigns a factor to each source of funding, called the availability factor. This factor represents the proportion of the balance today that is expected to be available to the bank in one year in order to fund longer term assets. Accordingly, certain behavioural assumptions are built into the availability factor relating to expectations regarding funding withdrawal. The NBFI class has been assigned an availability factor of 0%.*

TABLE 1: The Treatment of Different Funding Sources under Basel III Liquidity Ratios

	Deposit	LCR *Run-off rate*	NSFR *Available for NSFR (assuming maturity less than 12 months)*
Retail	Stable Retail	3%	90%
	Less Stable Retail	10%	80%
	Retail Fixed Term Deposits	0%	90%
Wholesale	Small Business Customer:		
	▸ Stable	3%	90%
	▸ Less Stable	10%	80%
	Operational Relationships	25%	
	Deposits in an institutional network of co-op banks	25%	Maximum of 75%
	Non-financial corporates, Public sector enterprises	40%	50%
	All other legal entities, including NBFIs, banks, insurance companies	100%	0%
Secured Funding		100%	

Decreaseing attractiveness of bank deposits leading to lower deposit rates

Source: Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010 and Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013

The most valuable sources of funding are those regarded as most stable and sticky, i.e. those that are unlikely to be withdrawn from the bank. Those funds will therefore have lower run-off rates in calculating outflows for the purposes of the LCR and high availability factors in calculating available amounts of stable funding under the NSFR. Stable retail funding is perceived as the most valuable source of funding to a bank and is likely to attract the highest deposit rates. Conversely, less stable wholesale funds, perceived as less valuable to banks, will attract lower deposit rates.

The implications of the above classification is that deposits from credit unions will no longer be as attractive to the banks, especially those deposits with maturities of less than one year.

The LCR is being introduced on a phased basis from 1st January 2015, with full implementation scheduled for 2018. While the NSFR is to be introduced in 2018, the proposal is still to be finalised. Despite this timeframe for implementation, Davy understands that credit unions have already been classified as NBFIs by some Irish banks; as a result, certain deposit rates available to credit unions have started to reflect this classification.

Section 3: The Impact on Credit Unions

i. Potential Reduction in Investment Income

In the current environment of ultra-low interest rates, one of the biggest challenges that credit unions face over the coming years is the ability to generate meaningful income from investment portfolios.

Portfolio returns will vary from credit union to credit union depending on a number of factors, including asset allocation and the maturity profile of the portfolio. In order to assess the impact of the NBFI classification, it is useful to contrast the current deposit rates available to credit unions against retail deposit rates. Table 2 illustrates that the divergence in rates may be in excess of 1% in certain maturities. We expect that this discrepancy may continue to grow and that, in general, rates available to credit unions may decline towards the ECB rate (currently 0.75%).

TABLE 2: Comparison of Sample of Deposit Rates available to Credit Unions versus a Sample of Retail Deposit Rates as at 25th April 2013

	Credit Union Deposit Rate (AER)[2]	Retail Deposit Rate (AER)[2]
On demand	0.50%	1.97%
3 months	1.25%	2.02%
1 year	1.58%	2.30%
3 year	1.50%	2.28%
5 years	2.00%	2.11%

Methodology / Source: Compiled by Davy. The credit union deposit rates are sourced by taking the average rate available for credit union deposits from a selection of Irish banks. The retail deposit rates are based on the average of a sample of rates available from a selection of Irish banks.

WARNING: Past performance is not a reliable guide to future performance. These figures are estimates only.

The effect of lower deposit rates on the returns of a credit union portfolio can be assessed if it is assumed that a credit union invests 100% in cash deposits today in line with the maturity profile outlined in Table 3. Based on the average rates available from banks today, the average income return on a credit union portfolio is likely to be approximately 1.31% gross per annum, which is 0.83% lower than the return on a similar portfolio based on retail deposit rates.

[2] AER is the Annual Equivalent Rate. Interest may be subject to DIRT at the prevailing rate (for more information, please visit www.revenue.ie).

TABLE 3: The Potential Effect of the Discrepancy between Credit Union Deposit Rates and Retail Deposit Rates on the Return of a Sample Portfolio

Duration	% Portfolio	Credit Union Deposit Rate (AER)[2]	Retail Deposit Rate (AER)[2]
Within 3 months	35%	0.88%	1.99%
3 months – 1 year	25%	1.42%	2.16%
1-3 years	25%	1.54%	2.29%
3-5 years	15%	1.75%	2.20%
Average Return		1.31%	2.14%

Methodology / Source: Compiled by Davy. The above rates for each term are calculated by using the average of the rates available as represented in Table 2. For example, the credit union deposit rate for 'Within 3 months', is calculated by taking the average of the credit union deposit rate for 'On Demand' and '3 months' from Table 1.

WARNING: Past performance is not a reliable guide to future performance. These figures are estimates only.

When the impact of lower returns is considered on credit union portfolios of varying sizes, the estimated reduction in annual income per annum is significant as seen in Table 4. For example, the annual income on a portfolio of €100 million may be expected to be in the region of €830,000 lower per annum, if the portfolio was entirely invested in cash.

At credit union movement level, there is approximately €7 billion in surplus funds. If these funds were invested entirely in cash, it could result in a reduction in income of approximately €58 million per annum in overall terms.

TABLE 4: The Potential Effect of the Divergence in Returns on a Range of Sample Portfolios as well as on Total Portfolios within the Credit Union Movement in Ireland

	Portfolio Size	Gross Average Return (AER)[2] per Annum		Estimated reduction per annum
		Credit Union 1.31%	Retail 2.14%	
Sample Portfolio A	€20,000,000	€262,000	€428,000	-€166,000
Sample Portfolio B	€50,000,000	€655,000	€1,070,000	-€415,000
Sample Portfolio C	€100,000,000	€1,310,000	€2,140,000	-€830,000
Impact at credit union movement level	€7,000,000,000	€91,700,000	€149,800,000	-€58,100,000

Source: Davy

WARNING: Past performance is not a reliable guide to future performance. These figures are estimates only.

ii. **Credit unions may struggle to pay competitive dividends.** Credit unions are already struggling with bad debts and loan arrears. For those credit unions invested predominantly in cash, the sustained downward pressure on loan demand in addition to rapidly declining income on investment portfolios may result in an inability to pay competitive dividends in the years ahead.

iii. **Credit unions may reach further out the risk spectrum in order to achieve higher portfolio returns.** Based on a sample of credit union portfolios where Davy acts as the investment advisor, we estimate that on average approximately 80-100% of credit union portfolios are allocated to cash deposits. In the event that cash deposits yield the minimal returns outlined in Table 1, we expect that credit unions may look to increase their portfolio exposure to higher yielding asset classes such as bonds and in some cases equities. This is likely to increase the price and interest rate risk of portfolios and may result in significantly more volatility in annual portfolio performance.

[2] AER is the Annual Equivalent Rate. Interest may be subject to DIRT at the prevailing rate (for more information, please visit www.revenue.ie).

iv. **Credit unions may review lending standards and increase risk**. Due to the limited returns available from cash-based investment portfolios, lending standards could become compromised which may negatively impact loan-book quality.

Section 4: Can Credit Unions Apply for a Reclassification?

Basel III provides for certain run-off rates or parameters to be determined at national level. '*While most roll-off rates, draw-down rates and similar factors are harmonised across jurisdictions as outlined in this standard, a few parameters are to be determined by supervisory authorities at national level. Where this is the case, the parameters should be transparent and made publicly available*'[3].

Basel III is being implemented in the EU through the Capital Requirements Directive ('CRD') IV and the Capital Requirements Regulation ('CRR'). These proposals have yet to be finalised and as a result, the treatment of retail / SME deposits is still in draft form. While Member States will have to transpose the directive into national law, the regulation is directly applicable, which means that it creates law that takes immediate effect in all Member States in the same way as a national instrument, without any further action on the part of the national authorities.

Therefore, Ireland will not have national discretion in determining the treatment of credit union funds. For that reason, potential issues identified need to be raised at European level (perhaps with the European Commission or the European Banking Authority, EBA).

The EBA appears to be aware of some of the potential issues of implementing strict uniform criteria across different national jurisdictions in the EU. In their recent discussion paper regarding retail deposits under draft CRR[4], they asked '*Do you believe it would be appropriate to allow derogations from the application of outflow rates on the basis of uniform strict criteria?*' (Question 17).

The responses included the following from the EBA Banking Stakeholder Group: '*Yes, in some cases it would be justified such as when the behaviour of depositors depends on country-specific factors, like 'historical' preferences or the legal framework. However, as this might increase the complexity of the regulatory framework, the scope for derogations should be carefully assessed from a cost/benefit perspective*'[5].

To our knowledge, however, there has been no special case made for credit unions to date, not just in Ireland but in Europe, despite the significant adverse implications it could potentially have for the movement.

Grounds for Credit Unions to Seek Reclassification

Davy believes that there are number of important reasons that may lend support to any application to have credit union funds reclassified:

- Credit union surplus funds are derived from 2.3 million retail investors in Ireland, which in itself suggests that the funds are more stable in nature than the current classification of NBFI.
- Credit unions have historically been treated as sticky, stable deposits by the commercial banks.
- In contrast to corporate deposits, which JP Morgan estimates have fallen by 40% in Ireland since 2008[6] credit unions have increased their deposits with the Irish banks during the period 2008-2010 and beyond.
- Credit unions are not as sophisticated as other entitites which fall into the same category, for example banks and other NBFIs such as insurance companies, money market funds, and pension funds who are likely to be more creative in managing and moving their deposits.
- Basel III provides for certain run-off rates or parameters to be determined at national level.

[3] Source: www.bis.org/publ/bcbs188.pdf
[4] Source: www.eba.europa.eu/cebs/media/Publications/Discussion%20Papers/DP%202013%2002/DP-on-retail-deposits-subject-to-higher-outflows.pdf
[5] Source: www.eba.europa.eu/cebs/media/Publications/Discussion%20Papers/DP%202013%2002/responses/%7BBSG%7D-EBA-Banking-Stakeholder-Group.pdf
[6] Source: J.P. Morgan Flows and Liquidity, March 22, 2013

- It is noteworthy that there is precedent for reclassification. Australia has exercised national discretion with regards to the treatment of self-managed superannuation (pension) funds ('SMSF') and while Basel III text directs that such monies should be included as wholesale funds in the category of non-bank financial corporates, the Australian Prudential Regulatory Authority ('APRA') has proposed that they should be included as retail deposits. However, as they are '*considered to be operated by sophisticated investors, APRA envisages that the appropriate run-off assumption for SMSF deposits will fall within one of the less stable retail deposit run-off categories*'[7].

Section 5: Suggested Next Steps

In the event that credit unions intend to seek a reclassification, Davy suggests that the following steps are considered:

i. Inform and educate the credit union movement of the potential implications of Basel III through representative bodies and investment advisors.

ii. Contact the Central Bank of Ireland (CBI) and the Department of Finance to inform them that you intend to formally approach them with a view to seeking a reclassification of credit union funds.

iii. Build a case to argue that there are solid grounds for credit unions to be moved to a more retail like classification. This case should include:

    - Background to the credit union movement in Ireland.
    - A rationale as to why it is an exceptional case and different to other non-bank financial corporates.
      Collate qualitative data / behavioural analysis to establish the run-off factor of credit union funds experienced by the Irish banks during 2007-10. This information could potentially be sourced from the main pillar banks.

iv. Monitor the implementation of Basel III to check if national discretion is likely to be exercised to reclassify certain groups of investors.

v. Lobby MEPs to make appropriate representations at EU level.

Section 6: Conclusion

It is clear that the implications of credit unions' classification under Basel III are considerable at a time when the movement is already facing significant challenges. It is important, however, that credit unions are fully informed of the impending changes that may affect their long-term stability. It is also essential that cases for reclassification are uniformly represented across all the credit union representative bodies. This should be done in a relatively swift manner so that discretion may be exercised prior to finalisation of proposals and full implementation by banks.

[7] Source: www.apra.gov.au/adi/Documents/ADI_DP_IBLR_November_2011.pdf

Appendix 1

Different Funding Sources and their Treatment under the Basel III Liquidity Requirements

	Funding Source	**Liquidity Coverage Ratio** *Run-off Rate*	**Net Stable Funding Ratio** *Availability Factor for Available Stable Funding (assuming a maturity less than 12 months)*
Retail: *Deposits placed with a bank by a natural person.*	**Stable Retail:** Deposits covered by an effective deposit insurance scheme or by a public guarantee and where: ▶ the depositors have established relationships with the bank that make deposit withdrawal highly unlikely; or ▶ the deposits are in transactional accounts (e.g. accounts where salaries are automatically deposited).	3% and higher	90%
	Less Stable Retail: Supervisory authorities are expected to develop additional buckets of less stable retail deposits. These jurisdiction-specific run-off rates should be clearly outlined and publicly transparent. They could include deposits not covered by an insurance scheme or guarantee, high value deposits, deposits from sophisticated or high net worth individuals, deposits that can be withdrawn quickly (e.g. internet deposits), foreign currency deposits.	10% and higher	80%
	Retail Fixed Term Deposits: The maturity of fixed or time deposits with a residual maturity or withdrawal notice period of greater than 30 days will be recognised if the depositor has no legal right to withdraw deposits within the 30-day time horizon of the LCR.	0%	90%
Unsecured Wholesale Funding: *Liabilities and general obligations raised from non-natural persons (i.e. legal entities, including sole proprietorships and partnerships) and are not collateralised by legal rights to specifically designated assets in the case of bankruptcy, etc.*	**Small Business Customers:** Deposits and other extensions of funds made by non-financial small customers that are managed as retail exposures and are generally considered as having similar liquidity risk characteristics to retail a/cs, provided the aggregated funding raised from one customer is less than €1 million. ▶ Stable ▶ Less Stable	 3% 10%	 90% 80%
	Operational Relationships: Funds from both financial and non-financial customers which qualify are those that are demonstrated to be specifically needed for operational purposes, e.g. clearing, custody or cash management relationship in which the customer is reliant on the bank to perform these services as an independent party.	25%	
	Deposits in Institutional Network of Cooperative Banks: A group of legally autonomous banks with a statutory framework of cooperation with common strategic focus and brand where specific functions are performed by central institutions and/or specialised service providers.	25%	Maximum of 75%
	Non-financial corporates and sovereigns, central banks and public sector entities: All deposits and other extensions of unsecured funding from non-financial corporate customers (that are not categorised as small business customers) and sovereign, CB and PSE customers.	40%	50%
	Other Legal Entities: Funding from other institutions including Non-Bank Financial Institutions (NBFIs), banks, securities firms, insurance companies, fiduciaries, beneficiaries, conduits and SPVs.	100%	0%
Secured Funding: *Liabilities and general obligations that are collateralised by legal rights to specifically designated assets in the case of bankruptcy, etc.*		100%	

Sources: Basel III: International Framework for liquidity risk measurement, standards and monitoring, December 2010
Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013

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