

## The Barometer of Public Opinion on Refugees



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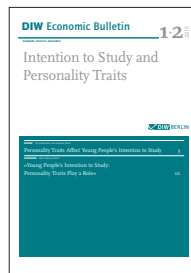
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## NEXT ISSUE OF DIW ECONOMIC BULLETIN

# R&D investments of foreign-owned companies in Germany

# German public opinion on admitting refugees

By Jürgen Gerhards, Silke Hans, and Jürgen Schupp

Since the beginning of 2016, the Socio-Economic Panel (SOEP) study has been conducting a monthly survey of German attitudes, expectations, and fears concerning migration. The third wave of the survey,—the Barometer of Public Opinion on Refugees in Germany (Stimmungsbarometer zu Geflüchteten in Deutschland)—, conducted in March 2016, shows that more than half of all respondents still associate the influx of refugees with more risks than opportunities. Nonetheless, a clear majority (81 percent of respondents) are in favor of admitting refugees and those fleeing political persecution, in accordance with international law. At the same time, however, the majority are of the conviction that refugees should be sent back to their home country once their reason for leaving it no longer pertains. Only 28 percent of all respondents are in favor of allowing refugees who have already been living in Germany for some time to remain in the country even after the situation in their country of origin has improved.

Since September 2014, surveys conducted by the elections research group (*Forschungsgruppe Wahlen*) have consistently ranked issues concerning migration, foreigners, and refugees as the most important problem in Germany.<sup>1</sup> In each of the SOEP's January, February, and March 2016 surveys conducted for the Barometer of Public Opinion on Refugees in Germany, approximately three-quarters of respondents felt that the recent influx of refugees brought more risks than opportunities for Germany, at least in the short term.<sup>2</sup>

Does the German population's perception of this influx as a problem imply that the majority are not in favor of allowing any more refugees and persecuted individuals into the country? Which groups of refugees do Germans think should be granted asylum and which groups would they rather keep out? Should individuals who have been granted asylum be allowed to stay in Germany even when the reason they fled their home country no longer pertains? The third wave of the Barometer of Public Opinion on Refugees in Germany, which is a representative survey of around 2,000 individuals conducted in Germany in March 2016,<sup>3</sup> provides information that will help us to answer these questions.

## Clear majority of German public in favor of temporarily admitting refugees and persecuted peoples in accordance with international law

The conditions under which refugees and politically persecuted individuals are admitted into the European Union and Germany is codified in various laws. At the

<sup>1</sup> [http://www.forschungsgruppe.de/Umfragen/Politbarometer/Langzeitentwicklung\\_-\\_Themen\\_im\\_Ueberblick/Politik\\_II/#Probl1](http://www.forschungsgruppe.de/Umfragen/Politbarometer/Langzeitentwicklung_-_Themen_im_Ueberblick/Politik_II/#Probl1), accessed April 24, 2016.

<sup>2</sup> For an analysis of the January 2016 findings, see Philipp Eisnecker and Jürgen Schupp, "Flüchtlingzuwanderung: Mehrheit der Deutschen befürchtet negative Auswirkungen auf Wirtschaft und Gesellschaft," *DIW Wochenbericht*, no. 8 (2016), and for an update of the February 2016 findings, see Philipp Eisnecker and Jürgen Schupp, "Stimmungsbarometer zu Geflüchteten in Deutschland," *SOEPpapers on Multidisciplinary Panel Data Research*, no. 833 (Berlin: 2016).

<sup>3</sup> For more in-depth information about the survey, see Eisnecker and Schupp, "Flüchtlingzuwanderung."

Table 1

### Public opinion on the admission of different groups of refugees

In percent

Reason for seeking asylum	Disapproval	Ambivalence	Approval	Mean <sup>1</sup>
Subsidiary Protection (EU-Law)	10	8	81	8.9
Political Persecution because of ... (Geneva Convention)	20	16	63	7.4
Human rights activities	14	12	74	8.3
Labor union activities	31	20	49	6.5
Religion (Christian)	14	14	72	8.2
Religion (Muslims)	31	18	51	6.7
Ethnic Minority	21	15	64	7.6
Homosexuality	27	16	57	7.1
Overall assessment of all reasons for seeking asylum	19	13	69	7.4

<sup>1</sup> Values 1 to 11.

Source: CAPI-Bus, Module "Barometer of Public Opinion on Refugees in Germany", February 25, 2016 – March 21, 2016. Calculations made by authors.

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A clear majority of respondents approves of those fleeing from war or civil war being granted the right to reside in Germany.

national level, Article 16a of the Basic Law of the Federal Republic of Germany sets out the right of asylum for persons persecuted on political grounds. In international law, the UN Convention and Protocol Relating to the Status of Refugees (1951 Refugee Convention) is the most pertinent: according to Article 1a of the Convention, a refugee is an individual who, "owing to a well-founded fear of being persecuted for reasons of race, religion, nationality, membership of a particular social group or political opinion, is outside the country of his nationality, and is unable or, owing to such fear, is unwilling to avail himself of the protection of that country." Whether or not there is evidence that an asylum-seeker has been persecuted, is established in an asylum procedure.<sup>4</sup>

The 1951 Refugee Convention, ratified by 146 countries, does not, however, apply to individuals who are fleeing war or civil war in their country of origin. The protection of this category of refugees is codified by what is known as the Qualification Directive<sup>5</sup> in EU law and is regulated in the national laws of the EU member states. Refugees

<sup>4</sup> For a recent explanation of the German terms *Flucht*, *Asyl*, and *Migration*, see Robert Bosch Stiftung, *Chancen erkennen – Perspektiven schaffen – Integration ermöglichen. Bericht der Robert Bosch Expertenkommission zur Neuausrichtung der Flüchtlingspolitik* (Stuttgart: 2016), 27–35.

<sup>5</sup> Council Directive 2004/83/EC of April 29, 2004 as well as Directive 2011/95/EU of December 13, 2011.

who fall outside the scope of the 1951 Refugee Convention are eligible for "subsidiary protection" if they face a real risk of suffering "serious harm,"<sup>6</sup> such as the death penalty, torture, or a threat to their lives caused by situations of international or internal armed conflict in their country of origin.<sup>7</sup>

Even if, in a democracy, a given law can be said to have a high level of legitimacy because it is either ratified by a government which was elected by the people or by the country's parliament, the public may not necessarily feel it to be legitimate. People may deem the legally defined conditions under which asylum status may be granted to be more or less legitimate. Accordingly, they will tend to either be in favor of or against admitting refugees or those fleeing political persecution.

The picture depicted by the Barometer is unambiguous (see Table 1): citizens largely perceive the law to be legitimate. The clear majority of respondents are of the conviction that people who seek refuge in Germany due to armed conflict in their country of origin should receive *subsidiary protection*. Popular support, at 81 percent and with a mean value of 8.9 on a scale from one to eleven (see box), is very high and, in fact, compared with all other reasons given for seeking asylum, represents the highest level of approval<sup>8</sup>.

### German public not in strong support of all reasons for seeking asylum

A majority of the public feel that persons who are protected under the 1951 Refugee Convention should be admitted into Germany. While popular support is relatively high at 63 percent with a median value of 7.4 and spans all reasons for persecution, it is considerably lower than in the case of refugees fleeing war and civil war. Around one in five respondents (compared with one in ten in the case of war refugees) is against Germany admitting persecuted people according to the 1951 Refugee Convention. Further, respondents apparently do not deem all reasons for seeking asylum set out in the Convention as equally legitimate. With respect to political persecution in the broadest sense, for instance, per-

<sup>6</sup> Directive 2011/95/EU, Article 15.

<sup>7</sup> In Germany, Section 4, para. 1 of the Asylum Act (AsylG) legislates for such obstacles to reoulement specific to the country of destination.

<sup>8</sup> This is important, since armed conflict in the country of origin will increasingly be the primary reason for Syrian refugees, currently the largest group of refugees in Germany, to be granted asylum in the future. For a transitional period, Syrians were awarded automatic refugee status under international law (1951 Refugee Convention). This is a higher protection status which accords more rights but has more stringent criteria. With the reintroduction of case-by-case assessments for Syrian refugees—the asylum procedure was simplified for them from November 2014 to December 2015—subsidiary protection status will once again become increasingly important.

Box

### The data source of the Barometer of Public Opinion on Refugees in Germany

The Barometer of Public Opinion on Refugees in Germany is a survey conducted in conjunction with DIW Berlin's longitudinal survey, Socio-Economic Panel (SOEP) study, and with the survey institute *TNS Infratest Sozialforschung* in Munich. The data source of each survey is a multi-layered, representative random sample with around 2,000 face-to-face interviews per wave, including questions on multiple issues. The survey's target group is Germans living in households, aged 14 and older. The field time of the survey results presented here was from February 25 to March 21, 2016.

In the refugee survey conducted in March 2016, respondents were asked, among other things, which groups of people, in their opinion, should be allowed to stay in Germany for several years as refugees and/or as those fleeing political persecution, and which should not. The questions were formulated in line with the two existing laws. First, respondents were asked about those eligible for subsidiary protection. Second, they were asked about various groups covered by the Geneva Convention, who are considered to be victims of political persecution. Here, a distinction was drawn between different reasons for persecution:

those at risk of persecution on the grounds of their commitment to *human rights* or *labor unions*, and those persecuted because of their religion as *Muslims* or *Christians*, as members of an *ethnic minority*, or as *homosexuals*. Respondents were asked in each case to indicate on a scale of 1 to 11 whether the relevant groups should be deported (1) or be allowed to remain in Germany (11).

The data in the tables show, for each reason for seeking asylum, the arithmetic mean of the level of support for the right of residency (minimum: 1, maximum: 11) as well as the share of respondents whose attitude toward the right of residency is negative (values of 1 to 5 on the scale), neutral (6), or positive (7 to 11). For each of the legal dimensions (subsidiary protection due to war, recognition on account of persecution in accordance with the Geneva Convention), and for all reasons for fleeing, the mean value of agreement with the various items was also calculated. Here, values between 5.5 and 6.5 are considered to be "neutral" while lower and higher values represent rejection of and agreement with the right of residence, respectively.

secution as a result of involvement in human rights activities is seen by 74 percent of respondents as a legitimate reason to be given asylum in Germany, compared with persecution for labor union activity, which meets the approval of just 49 percent of respondents.<sup>9</sup>

Similar differences are evident when we examine the persecution of individuals belonging to certain minority groups. While almost three-quarters of respondents are in favor of granting the right of residence to persecuted Christians, that figure is far lower in the case of persecuted ethnic minorities, homosexuals, and particularly persecuted Muslims.

The discrepancies with regard to religion are particularly striking. In this context, clearly the fact that around half of all respondents feel that refugees pose a threat to German cultural life and core values plays a role. This

threat is primarily projected onto Muslim refugees. Respondents who believe that refugees predominantly undermine rather than enrich Germany's cultural life and core values, tend to oppose the admission of persecuted Muslims, as is illustrated with the bivariate correlations of  $r=0.45$  and  $r=0.47$ , respectively. The correlation with opposition to persecuted Christians being admitted into Germany in contrast is substantially lower ( $r = 0.31$  and  $r = 0.32$ , respectively).

### Majority of German public in favor of temporary residence for those granted refugee status

Overall, the Barometer findings show that German perceptions of the legitimacy of admitting politically persecuted individuals into Germany corresponds, by and large, with existing law. This also applies to the permitted length of stay in Germany. Asylum law limits the right of residence as a matter of principle and makes it contingent on the continued existence of the reason for admission. Persons granted asylum under Article 16a of the Basic Law of Germany and those awarded refugee status under the 1951 Refugee Convention are subject to the same residency regulations and both initially receive a temporary three-year residence permit. Provided

<sup>9</sup> It is possible that survey respondents in Germany may find it difficult to imagine that people in other countries could be persecuted for labor union activity. In any case, this topic receives much less media attention than the persecution of human rights activists. Perhaps, labor union activity has more negative connotations than human rights activism. Labor union activity often involves the representation of an individual's own particular interests whereas human rights activists tend to be driven by more universalist motives.

Table 2

**Public opinion on the duration of residence rights granted to refugees**  
In percent

	Opinion on the admission of refugees <sup>1</sup>			Total
	Approval	Ambivalence	Disapproval	
<b>When people granted refugee status have been living in Germany for some years, and the situation in their country of origin has improved, those refugees should...</b>				
...be repatriated (values 1 to 5)	82	65	45	55
neutral (6)	10	18	19	17
... be allowed to remain in Germany (values 7 to 11)	9	17	35	28

<sup>1</sup> According to the overall assessment of all reasons for seeking asylum in the final row of table 1.

Source: CAPI-Bus, Module "Barometer of Public Opinion on Refugees in Germany", February 25, 2016 – March 21, 2016. Calculations made by authors.

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Majority of Germans is in favor of repatriating those granted refugee status when the situation in the country of origin has improved.

there is no justification for revocation of the entitlement to asylum or refugee status, a permanent residence permit is then granted. Persons granted subsidiary protection, however, are generally initially awarded a one-year residence permit which can then be extended repeatedly by a further two years.<sup>10</sup> For each extension, the authorities must assess whether the conditions for awarding protection status continue to exist, for example, whether the armed conflict in the country of origin is ongoing. Only after seven years can an individual granted subsidiary protection receive a permanent residence permit under very strict conditions.<sup>11</sup> Thus, refugee status and subsidiary protection are not the same as the right to permanent residency in Germany.

According to the present survey, this aspect of the law also meets with the approval of the German population. The Barometer of Public Opinion on Refugees asks whether respondents feel that refugees who were admitted into Germany and who have been living in the country for some years should be repatriated as soon as the situation

<sup>10</sup> For more detail on the different laws, see the German Federal Office for Migration and Refugees (Bundesamt für Migration und Flüchtlinge), *Der Ablauf des deutschen Asylverfahrens* (last updated July 2015) (Nuremberg: 2015), accessed April 25, 2016, [http://www.bamf.de/SharedDocs/Anlagen/DE/Downloads/Infothek/Asyl/schema-ablaufasylverfahren.pdf?\\_\\_blob=publicationFile](http://www.bamf.de/SharedDocs/Anlagen/DE/Downloads/Infothek/Asyl/schema-ablaufasylverfahren.pdf?__blob=publicationFile)

<sup>11</sup> See <http://www.bamf.de/DE/Migration/AsylFluechtlinge/Asylverfahren/Rechtsfolgen/rechtsfolgen-node.html>, accessed April 25, 2016.

in their country of origin has sufficiently improved. At 55 percent, the majority of respondents believe that, in such cases, refugees should indeed be repatriated (see Table 2). Just 28 percent are in favor of granting individuals the right to remain. One in six are undecided on this question. Of those respondents who are neither for nor against admitting refugees into Germany, around half advocate repatriation in the event that the situation in the country of origin improves. Among those in favor of admitting refugees into Germany, around one-third believe they should receive a permanent right to reside in Germany (see Table 2).

Overall, the analysis shows a clear overlap between the German public's belief in the legitimacy of admitting refugees into the country and existing law. This applies both to their willingness to accommodate people in need and to provide them with protection, as well as to their interpretation of the right to protection as a temporary right of residence.

**Strong normative anchoring of refugee protection**

How firmly are attitudes toward granting refugee status to those in need of protection anchored in the public consciousness? There are two arguments suggesting that the attitudes described above are stable and strongly internalized norms. First, the willingness to admit asylum seekers is still high despite the fact that many respondents fear disadvantages and risks for Germany as a consequence of the influx of refugees. Second, there are only relatively moderate socio-structural and politically motivated differences in respondents' belief in the legitimacy of admitting refugees into the country—high levels of support for accepting asylum seekers can be observed in almost all sections of the population.

With regard to the first argument, research into the low-cost hypothesis has shown that people stray from their normative attitudes if there are drawbacks to adhering to the norm.<sup>12</sup> It follows from this that the more firmly anchored the norm is, the more willing people will be to accept the disadvantages associated with it. The majority of adults in Germany tend to see the effects of the influx of refugees as negative and are of the opinion that this immigration brings more risks than opportunities in its wake.<sup>13</sup>

<sup>12</sup> For an example of this hypothesis in a study of environmental behavior, see Andreas Diekmann and Peter Preisendörfer, "Persönliches Umweltverhalten – Diskrepanzen zwischen Anspruch und Wirklichkeit," *Kölner Zeitschrift für Soziologie und Sozialpsychologie* 41 (2) (1992): 226–251.

<sup>13</sup> See Eisnecker and Schupp, "Flüchtlingenzuwanderung."

Table 3

**Assessment of the consequences of refugee migration**

In percent

	Consequences are ...			Approval of the admission of refugees from war or civil war among those who expect <i>negative</i> consequences from refugee migration
	rather negative	ambi-valent	rather positive	
<b>Social consequences of refugee migration</b>				
Is good or bad for the economy	39	23	39	71
Cultural life is undermined or enriched by refugees	44	21	35	70
Germany becomes a worse or better place to live because of the refugees	47	30	23	72
The core values of our society are undermined or enriched by refugees	51	30	18	70
The influx of refugees bears more risks or opportunities in the <i>short term</i>	74	11	15	78
The influx of refugees bears more risks or opportunities in the <i>long term</i>	48	15	37	70
<b>Personal consequences of refugee migration</b>				
	<b>high (60-100)</b>	<b>medium (50)</b>	<b>low (0-40)</b>	
Likelihood of <i>negative</i> personal consequences	19	9	72	62

Source: CAPI-Bus, Module "Barometer of Public Opinion on Refugees in Germany", February 25, 2016 – March 21, 2016. Calculations made by authors.

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Despite the rather negative expectations regarding the social consequences of the influx of refugees, only one in five Germans expect negative effects for themselves or their families.

In the March 2016 survey of the Barometer of Public Opinion on Refugees in Germany, respondents were asked again for their views on various issues such as how they thought immigration would impact on the economy or cultural life in Germany (see Table 3). It is only in relation to the consequences for the German economy that positive and negative assessments are more or less equally balanced. In all other dimensions, the expectation that the influx of refugees will have primarily negative effects prevails. This applies in particular to the short-term effects. Almost three-quarters of respondents believe that the influx of refugees brings more risks than opportunities in the short term. 15 percent of respondents see more opportunities than risks, although the Barometer's latest survey shows that negativity levels are slightly lower in all dimensions, compared to the results from January and February 2016, and the positive assessments are higher. It is remarkable, however, that, given their negative expectations for society as a whole, almost three-quarters of adults consider the probability of negative *personal* consequences to be low.

People's overall negative view has only a limited impact on their acceptance of granting people asylum in Germany. Table 3 shows the share of those who see primarily negative effects of refugee immigration but still support accepting those fleeing war and civil war. Even in this rather pessimistic group, over 70 percent of respon-

dents are in favor of granting refugees the right to remain in Germany. In particular, the fear of short-term problems appears to have virtually no effect on people's willingness to take in refugees. It is only among those who fear an increased chance of negative effects for themselves or their family that proportionally fewer respondents advocate a right of residence for (civil) war refugees. At 62 percent, however, here, too, supporters are still in the majority. In any case, at 19 percent, this group includes only a minority of respondents.

With regard to the second argument,—the high level of consistency in the findings across different groups of persons—election and attitude research has shown that belonging to particular social groups is associated with a higher probability of supporting xenophobic attitudes and of voting for right-wing parties.<sup>14</sup> We can assume that this also applies to attitudes toward acceptance of refugees. However, Table 4, which shows support for refugees across different groups, indicates that this is only the case to a very limited extent. Although there are certainly differences according to the respondents' level of education, place of origin (region), religious affiliation,

<sup>14</sup> See, for example, Kai Arzheimer, "Die Wahl extremistischer Parteien" in *Handbuch Wahlforschung*, eds., Jürgen W. Falter und Harald Schoen, 2nd ed. (Wiesbaden: 2014), 523-561.



Table 4

**Approval of the admission of refugees from war or civil war in different social groups**

In percent

Social background and political orientation					
Education	low (9-year-degree)	medium (10-year-degree)	high (12-year-degree)		
	79	77	87		
Region of residence	East Germany	West Germany			
	74	83			
Place of residence	rural	small town	urban		
	74	86	86		
Political orientation	left	moderately left	medium	moderately right	right
	88	85	80	79	73
Religious denomination	none	Catholic	Protestant	Muslim	
	76	83	81	89	
Contact with refugees					
Professionally	never	occasionally	weekly	(almost) daily	
	79	86	84	79	
Day-to-day live	never	occasionally	weekly	(almost) daily	
	77	83	82	82	
Larger refugee shelter near place of residence	no	place of residence	neighborhood		
	78	79	88		

Source: CAPI-Bus, Module "Barometer of Public Opinion on Refugees in Germany", February 25, 2016 – March 21, 2016. Calculations made by authors.

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### Socio-demographic groups hardly differ in their approval of the admission of refugees from war or civil war.

and political leaning, these are comparatively less pronounced. Even in the groups that are least in favor of granting residence—those living in rural regions, eastern Germans, individuals with a lower level of education, and supporters of right-wing politics—an overwhelming 70 percent of respondents are nevertheless in favor of refugees being granted temporary residence in Germany. This also applies to respondents describing themselves as belonging to the right-wing of the political spectrum.

It also has very little effect whether respondents have contact with refugees, be it professionally, in their day-to-day lives, or from living near a mid- to large-sized refugee shelter. It might seem reasonable to assume that the type of contact would affect attitudes to right of residence, either positively or negatively. Here, too, the differences are minor, however, and there is a high level of support across all groups.

## Conclusion

Willingness to admit refugees is clearly based less on self-interest and considerations of the benefits than on a normative imperative to provide protection for those in

need. The German people support the current legal regulations although they believe that admitting refugees is not without its risks and disadvantages for their country.

However, the data also show that in the view of many Germans, the normative obligation to assist no longer pertains if the reason for fleeing and the persecution cease to exist. Only 28 percent of all respondents were in favor of allowing refugees who have already been in Germany for several years to remain if the situation in their home country improves. Here, too, German opinion is in agreement with applicable laws. The exceptional acts of fleeing war and persecution are regulated in *international law*. Permanent immigration is decided on the basis of *national immigration law* and the right of residence. The criteria regulating admission here are quite different and these do not so much follow universal norms as national interests first and foremost. Due to demographic change in Germany, it might be entirely in the national interest not to send refugees who, in the space of a few years, have become well integrated in the labor market and society back to their home countries as is typically done today but instead to offer them long-term prospects in Germany.



## THE BAROMETER OF PUBLIC OPINION ON REFUGEES IN GERMANY

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## SIX QUESTIONS TO JÜRGEN SCHUPP

# »Majority of German public back UN Refugee Convention«

1. Professor Schupp, in Germany, public debate on the refugee issue has sometimes been quite heated. Is the population really as concerned as it often appears? If we are talking about granting refugees the right to remain in Germany in accordance with the 1951 Refugee Convention, it's clear that the vast majority of the population are in favor of granting temporary asylum. This particularly applies to refugees who were forced to flee their countries of origin due to civil war or armed conflict.
2. What do respondents to the SOEP's Barometer of Public Opinion on Refugees in Germany feel about the risks of admitting refugees into the country? In answer to the question as to whether respondents primarily perceive the risks or whether they also see the opportunities of immigration, it is clear that a firm majority of the population associate immigration with risks rather than opportunities. Particularly when it comes to short-term risks, three-quarters of respondents consider these outweigh any potential opportunities. Even if we only focus on respondents' assessment of the economic consequences of immigration, it wasn't until our March survey that respondents thought risks and opportunities were more or less on an equal footing. With regard to the economy, just over one-third of respondents felt immigration brought more opportunities and the same proportion associated it with more risks. Specifically when it comes to the short-term consequences, however, the population's concerns and negative attitudes prevail.
3. What exactly are the population's concerns? One worry is that immigration may affect and potentially jeopardize society's values. However, we also asked people if they were afraid of being personally disadvantaged as a result of refugees being admitted into the country and a total of 20 percent of respondents were concerned that this might happen.
4. To what extent is support for admitting refugees into Germany contingent on their reason for seeking asylum? Here too, we distinguished between different scenarios in our survey questions. The reason that meets with most support is also the one that is currently the basis for granting subsidiary protection in Germany, in other words, displacement because of war or civil war (the question of whether there is a direct threat to life and limb). If an individual is disadvantaged and forced to flee as a result of campaigning for human rights in their country of origin, this reason is assigned similarly high importance. However, according to our indicators, an individual who has been disadvantaged due to labor union activism, for instance, meets with a lower level of popular approval.
5. Should refugees be allowed to stay in Germany, or should they be deported, even if they have been living here for a number of years? This is the second key finding of our study. Alongside a considerable majority who believe that refugees should be admitted into Germany, we also see a majority (55 percent) who are in favor of these individuals returning home once the situation in their countries of origin has improved. Only around 28 percent of respondents advocated a permanent right to remain in Germany, regardless of the circumstances in their home countries and any changes to that situation.
6. To what extent do survey responses differ by category of respondents? Here, the same pattern can be observed as in other studies. Those with higher levels of education are more likely to be in favor of refugees being granted the right of residency and support repatriation to a lesser degree. Negative attitudes tend to prevail among eastern Germans, and if we look at political leaning, our findings are also in line with the stereotype that support for admitting refugees into the country is less pronounced among those to the right of the political spectrum. Yet even among the members of this group, there is a majority in favor of granting at least temporary asylum to those forced to leave their countries of origin for humanitarian reasons.

Interview by Erich Wittenberg

# Design and pitfalls of Basel's new liquidity rules

By Philipp König, and David Pothier

Following the financial crisis of 2008/09, the Basel Committee on Banking Supervision introduced a new framework for banking regulation, commonly known as Basel III. For the first time since the inception of global banking regulation in 1988, Basel III contains explicit mandatory rules for liquidity regulation. The cornerstones of the new liquidity regulation are two balance sheet ratios that seek to reduce banks' liquidity transformation. While regulation addressing liquidity risk in the banking sector is clearly desirable, the new rules have several pitfalls. First, the two ratios rely on different definitions of liquidity and funding stability which makes the regulatory framework unnecessarily complicated and opaque. Second, it is unclear whether a ratio-based approach is the most effective and efficient way to rectify liquidity problems in the banking sector. Third, it is unclear how the new liquidity rules interact with existing monetary implementation frameworks of central banks and whether they hamper a smooth steering of policy interest rates.

A defining feature of banks is liquidity and maturity transformation. Banks invest in risky long-term and illiquid assets (e.g. loans to non-financial firms, household mortgages), and finance their operations using short-term and liquid liabilities (e.g. retail deposits). Liquidity and maturity transformation by banks is desirable as it creates economic efficiency gains. At the same time, since the duration of assets and liabilities are not perfectly matched, this subjects banks to *liquidity risk*. Thus, even if a bank is fundamentally solvent, it may not have enough cash at hand to meet funding outflows whenever too many of its short-term creditors reclaim their deposits at once.

A key objective of banking regulation is to make individual banks (micro-prudential) and the banking sector as a whole (macro-prudential) more resilient to sudden changes in economic and financial conditions. The first two rounds of concerted international banking regulation, Basel I and II, which came into effect in 1988 and 2007 respectively, largely centered around capital regulation, focusing primarily on credit risk and the solvency of banks. Liquidity risk and liquidity crises, it was believed, could be best addressed by a combination of banks' individual liquidity management, deposit insurance schemes and access to central bank discount windows.

The 2007–2009 Global Financial Crisis (GFC) clearly showed that this framework was insufficient to prevent systemic liquidity crises. In the decades preceding the GFC, banks progressively replaced retail deposits by other forms of short-term funding, including unsecured wholesale debt or bi-party or tri-party repurchase agreements (repos). Such *cash equivalent* instruments were widely perceived as a safe source of short-term funding by both banks and regulators, and they were consequently caught unprepared when many of these wholesale funding markets suddenly collapsed during the GFC. Policy-makers since the GFC have consequently sought to re-vamp existing regulatory structures to reduce the degree of liquidity mismatch on banks' balance sheets.

An important new development in banking regulation since the GFC is the Basel III Accord, drawn up by the Basel Committee on Banking Supervision in 2010–11. This latest revision of the Basel Accords introduces two new minimum coverage ratios intended to regulate banks' liquidity risk. These changes significantly broaden the scope of global banking regulations, and constitute the first attempt to establish a global framework for liquidity regulation. The present bulletin discusses the pros and cons of these measures. In particular, it points out that while new liquidity regulation is needed in order to deal with the problem of excessive liquidity transformation in the banking sector, it is less clear whether the new Basel rules are the best possible policy instruments to deal with this problem.

### Why did banks build up excessive liquidity risks?

At its core, liquidity regulation seeks to rectify a perceived *market failure*: i.e. left unregulated, the banking sector is prone to engage in excessive liquidity transformation. This market failure is rationalized as resulting from *externalities* that distort banks' financing decisions. In other words, even though insufficient liquidity in the banking system may result in significant costs for the economy, these costs are rarely borne exclusively by banks.

A key challenge of liquidity regulation is that there is no unique definition of liquidity.<sup>1</sup> That being said, one can distinguish between three broadly interrelated dimensions of liquidity.<sup>2</sup> First, *market liquidity* refers to the ease with which financial assets can be traded close to their fundamental price. Second, the closely related concept of *funding liquidity* refers to the ready availability of cash and the ease with which financial intermediaries can obtain funding. A distinctive feature of the GFC was the pronounced deterioration in market liquidity, especially after the bankruptcy of Lehman Brothers in September 2008 (See Figure 1). The sudden drop in market liquidity can partly be explained by the adverse price effects caused by systemic deleveraging in the banking and financial sectors.<sup>3</sup> This worsened funding liquidity conditions, as measured by the haircuts applied to a wide class of marketable assets (See Table 1). In particular, investors became reticent to provide short-term funding to banks due to underlying uncertainty about the quality of assets being posted as collateral, leading liquidity-strained banks to further selling assets outright and put-

<sup>1</sup> Tirole, Jean. "Illiquidity and All Its Friends." *Journal of Economic Literature* (2011): 287–325.

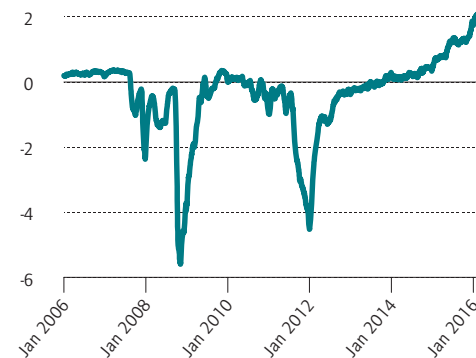
<sup>2</sup> Foucault, T., Pagano, M. and Röell, A. (2013): *Market Liquidity*, Oxford University Press, New York.

<sup>3</sup> Brunnermeier, Markus K. "Deciphering the Liquidity and Credit Crunch 2007–2008." *Journal of Economic Perspectives* 23.1 (2009): 77–100.

Figure 1

### Financial market liquidity

Composite indicator, index



Source: ECB, Statistical Data Warehouse.

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Market liquidity deteriorated markedly in the euro area in the wake of the Lehman crisis.

ting additional downward pressure on prices. A key objective of the new liquidity regulation is to prevent such *fire sales* by limiting the extent of liquidity transformation that can be performed by banks.

The third liquidity dimension is *central bank liquidity*, which refers to banknotes, coins and reserves held with the central bank. Being the monopoly supplier of legal tender and since banks' liabilities must be convertible into legal tender at par, the central bank exerts considerable influence over market and funding liquidity. By buying up assets or by lending to banks, it can affect market prices and provide cash to banks suffering from deposit outflows. But unlimited access to central bank money can also potentially exacerbate the liquidity mismatch of banks' balance sheets.<sup>4</sup> More specifically, the widely held belief that central banks stand ready to inject cash into the banking sector may reduce banks' incentives to self-insure against future liquidity shocks. Hence, another key objective of liquidity regulation is to avoid this potential moral hazard problem by reducing banks' reliance on central bank liquidity in times of crisis.

### Liquidity regulation after the crisis

The cornerstones of liquidity regulation under the Basel III Accord are two new regulatory ratios. First, the *liquidity coverage ratio* (LCR) requires banks to hold

<sup>4</sup> Goodhart, Charles AE. "The regulatory response to the financial crisis." *Journal of Financial Stability* 4.4 (2008): 351–358.

Table 1

**Changes in haircuts on term securities**

In percentage points

	Prime	Non-Prime	Unrated
<b>G7 Government Bonds</b>			
Short-Term	0.5	1	1.5
Medium-Term	1	2	2.5
<b>US Agencies</b>			
Short-Term	0	0	0
Medium-Term	1	3	4
<b>Prime MBS</b>			
AAA-Rated	6	14	20–90
AA- and A-Rated	92	88	75
<b>Asset-Backed Securities</b>			
Structured Products (AAA)	15	30	80
<b>Investment Grade Bonds</b>			
AAA- and AA-Rated	90	85	80
AAA- and AA-Rated	0	0	0
A- and BBB-Rated	7	10	10
A- and BBB-Rated	6	8	10
<b>High-Yield Bonds</b>			
Equity	7	8	20
Equity	0	0	0
G7 Countries	5	8	5
Emerging Economies	5	5	5

Increase of typical haircut on term securities used for financing transactions (difference June 2007–June 2009).

Source: Committee on the Global Financial System.

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Haircuts on marketable securities used for funding purposes increased dramatically at the height of the GFC.

a buffer of sufficient high-quality liquid assets (HQLA) to cover their total net cash outflows over a 30 day stress scenario. Second, the *net stable funding ratio* (NSFR) requires banks' amount of stable funding to exceed a required minimum amount. Ideally, the LCR and NSFR seek to lower liquidity risk by forcing banks to reduce their maturity mismatch, thereby making it easier for them to meet their liabilities when they come due.

The LCR was officially introduced in October, 2015, but will be phased-in gradually over a four year period. Banks are currently required to hold high quality liquid assets (HQLA) that amount to only 70% of their 30 calendar day liquidity needs (under a stress scenario). This minimum requirement will increase by 10% each year, until the phase-in of the LCR is completed in January, 2019. The LCR effectively serves as a mandatory self-insurance against unexpected liquidity shocks. Under the LCR, both assets and liabilities are categorized in terms of their liquidity. Liabilities are ranked in terms of the ease with which they can be rolled over in financial markets. Similarly, assets are ranked in terms of the haircut that must be incurred in case they must be liquidated in a stress scenario (See Box 1). Since the size of the liquidity buffer

depends on banks' liability structure – in particular, the volume of funds that can be withdrawn over 30 days – the LCR is intended to incentivize banks to rely less on debt securities with very short maturities.

The NSFR, in contrast to the LCR, aims to reduce banks' funding risk over a longer time horizon (up to one year). Its implementation is scheduled to start in January, 2018. Stable funding in this context refers to liabilities such as retail deposits, long-term wholesale funding and equity. Available stable funding (ASF) – the numerator of the NSFR – is based on the characteristics of banks' funding sources, including the maturity of their liabilities and the ease with which creditors can withdraw funds. As for the LCR, liabilities are ranked according to their perceived stability. A similar procedure is applied to calculate bank's required stable funding (RSF), in this case using its assets instead of its liabilities. The NSFR then requires that total available stable funding exceeds total required stable funding over a one year time horizon (See Box 1).

The rationale behind such ratios can be traced back to different approaches that have been proposed in the banking literature to manage liquidity risk.<sup>5</sup> The so-called “golden rule of banking” seeks to eliminate liquidity risk by proposing a perfect congruence of maturities of assets and liabilities. This, however, would imply that it is impossible for banks to perform their key function of maturity transformation.<sup>6</sup> Addressing this shortcoming, deposit base theory points to the difference between formal and *de facto* maturities, and the importance of a sticky deposit base that is implicitly continuously prolonged. When *de facto* maturities are taken into account, there remains sufficient leeway to perform maturity transformation even when liquidity risk is low.<sup>7</sup> The run-off factors in the weighting scheme of the LCR are reminiscent of this theory as they put a lower weight on liabilities that are considered more “sticky”, such as customer deposits. Finally, shiftability theory acknowledges the close relationship between variations in asset prices and liquidity risk. Reflecting this, the weighting schemes of the LCR and NSFR take into account that some types of assets are more difficult to trade than others and therefore render the holding bank more illiquid.

A key challenge in the design of the LCR was determining what constitutes HQLA. The required feature of these assets is that they can be converted into cash at little or no loss of value (See Table 2). These assets must therefore

<sup>5</sup> For a general overview, see Hartmann-Wendels, T., Pfingsten, A. and Weber, M. (2010): *Bankbetriebslehre*, 5th Edition, Springer.

<sup>6</sup> Hübner, O. (1854): *Die Banken*.

<sup>7</sup> Wagner, A. (1857): *Beiträge zur Lehre von den Banken*.

Box 1

### The Basel III liquidity ratios

#### The liquidity coverage ratio

The LCR is defined as the ratio of HQLA over the total net cash outflows in the course of 30 calendar days.<sup>1</sup> The new regulatory rules stipulate that, when fully implemented by the end of 2018, the LCR should exceed 100%,

$$LCR \equiv \frac{\text{stock of unencumbered HQLA}}{\text{cash outflows over 30 day stress scenario}} \times 100 \\ \geq 100 \%$$

To calculate a bank's HQLA, its assets are broadly categorized into one of two liquidity groups: Level 1 assets are not subject to a haircut, and include highly liquid assets such as central bank reserves and government debt. Level 2 assets, on the other hand, are subject to a variable haircut (ranging from 15% to 50%) applied to the market value of the assets, and include, for example, covered bonds and corporate debt. Banks must satisfy their LCR with a sufficiently high contribution of Level 1 assets, i.e. Level 2 assets are only allowed to cover up to 40% of HQLA (or up to 2/3 of Level 1). Thus, the numerator of the LCR is given by

$$HQLA \equiv \text{Level 1} \\ + \min \left\{ \sum_i (1 - \text{haircut}_i) \times \text{Level 2 asset}_i, \frac{2}{3} \times \text{Level 1} \right\}$$

The net cash outflows during a stress scenario in the denominator of the LCR are calculated based on a partial loss of retail deposits, a relatively larger loss of wholesale funding, contractual outflows from derivative contracts and off-balance sheet exposures. For each of these liability items, so-called run-off rates are defined (based on experience and stress simulations). National banking supervisors have some discretion in fixing these run-off

rates. Projected cash outflows are then calculated by multiplying liability positions by run-off rates. To derive the projected net cash outflows that enter the LCR's denominator, estimated cash inflows over the next 30 days are subtracted from cash outflows. However, inflows are allowed to cover only at most 75% of outflows. Thus, the denominator of the LCR is given by

$$\text{Net cash outflows} \equiv \text{Outflows} - \min \{ 0.75 \times \text{Outflows}, \text{Inflows} \}$$

#### The net stable funding ratio

The NSFR is defined as the ratio of the available amount of stable funding (ASF) over the required amount of stable funding (RSF).<sup>2</sup> The new regulatory rules stipulate that the NSFR should exceed 100%,

$$NSFR \equiv \frac{ASF}{RSF} \times 100 \geq 100$$

In the calculation of the NSFR different liabilities will be ranked according to their perceived stability. For example, regulatory capital is given a 100% factor weight, while demand deposits are given a 95% factor weight. A bank's total ASF is then determined as the sum of its capital and other liabilities, weighted by these factors. A similar procedure is applied to calculate a bank's RSF, in this case using its assets instead of its liabilities. RSF factors are assigned to various classes of assets, depending on the ease with which they can be liquidated or used as collateral to secure borrowing. The RSF therefore measures the portion of banks' assets that are perceived as being illiquid and that should be backed by stable funding sources. For example, central bank reserves are given a RSF factor weight of 0%, while corporate debt securities with a credit ranking at least equal to AA- are given a 15% factor weight.

<sup>1</sup> See Basel Committee on Banking Supervision (2013): Basel III – The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, par. 14: <http://www.bis.org/publ/bcbs238.pdf>

<sup>2</sup> See Basel Committee on Banking Supervision (2014): Basel III – The Net Stable Funding Ratio and Liquidity Risk Monitoring Tools, par. 5: <http://www.bis.org/bcbs/publ/d295.pdf>

be: (1) low risk, (2) easy to value, (3) have a low correlation with other risky assets, and (4) be listed on a recognized exchange.<sup>8</sup> Importantly, these assets must also be *unencumbered*. Thus, high quality liquid assets used as collateral to secure lending from the central bank do not

count towards the LCR. This has potentially important consequences for the implementation of monetary policy.

Since the GFC, banks have significantly adjusted their balance sheets in order to increase the stability of their funding sources. A 2011 survey by the Basel Committee provides a rough estimation of the magnitude of the adjustment that banks will have to make in order to satisfy the LCR. The survey of 209 banks suggested a HQLA

<sup>8</sup> Basel Committee on Banking Supervision. "The Liquidity Coverage Ratio and liquidity risk monitoring tools." *Bank for International Settlements* (2013):



shortfall of 1.8 trillion euros under a 100% LCR, which corresponds to approximately 3% of their total assets.<sup>9</sup> Similarly, by applying the NSFR weighting procedure to data from 27 Global Systemically Important Banks (G-SIBs), calculations by the International Monetary Fund (IMF) show that 55% of these had net stable funding ratios below the future mandatory level of 100% in 2008.<sup>10</sup> By the second quarter of 2013, this fraction had decreased to 18%. Most of this change can be attributed to an increase in available stable funding (ASF), suggesting that adjustments have primarily taken place on the liability-side of banks' balance sheets.

### Pitfalls of the new liquidity regulation

Evaluating the utility of Basel III's liquidity rules requires answering two key questions. The first is whether the banking and financial sector engage in excessive liquidity transformation? As discussed above, there are good reasons to believe that, left unregulated, banks tend to expose themselves to too much liquidity risk. The second, more difficult, question to answer is whether the proposed regulatory measures are the most appropriate policy tools to reduce the occurrence of systemic liquidity crises? Indeed, a well-known concern surrounding quantity-restriction is the difficulty involved in determining the appropriate regulatory minima. Set too low, the liquidity requirements may fail to provide the desired level of insurance. Set too high, the banking sector may reduce lending intended to finance productive investments.

An important question that can be raised concerning Basel III's new liquidity requirements is: why do we need both? On one hand, the LCR requires banks' liquid assets to exceed its unstable funding. On the other hand, the NSFR requires banks' stable funding to exceed its illiquid assets. At the most basic level, one of these two requirements must be redundant, since the balance sheet identity requires assets to equal liabilities. If the two differ in practice, it is because different weighting schemes are used (See Box 3). No clear rationale has been provided in the documents accompanying the new rules as to why this should be the case, aside perhaps from the fact that the two ratios are meant to be applied to different time horizons (30 days versus one year). At best, these discrepancies run the risk of increasing uncertainty with regards to the implementation of the new liquidity requirements. At worst, they open the door to regulatory arbitrage.

<sup>9</sup> Committee on the Global Financial System. "Asset encumbrance, financial reform and the demand for collateral assets." *Bank of International Settlements* (2013).

<sup>10</sup> Gobat, Jeanne, Mamoru Yanase, and Joseph Maloney. "The Net Stable Funding Ratio: Impact and Issues for Consideration." *International Monetary Fund* (2014).

Table 2

### Weighting scheme for calculation of LCR

In percent

High Quality Liquid Assets (HQLA)	Factor
<b>Level 1 Assets</b>	
Coins and bank notes	100
Securities from sovereigns, CBs and PSEs with 0% risk weight	100
Central bank reserves	100
Domesitic sovereign or central bank debt with non-0% risk weight	100
<b>Level 2A Assets</b>	
Securities from sovereigns, CBs and PSEs with 20% risk weight	85
Corporate debt securities rated AA- or higher	85
Covered bonds rated AA- or higher	85
<b>Level 2B Assets</b>	
Qualifying RMBS	75
Corporate debt securities rated between A+ and BBB-	50
Qualifying common equity shares	50
<b>Cash Outflows</b>	<b>Factor</b>
<b>Retail deposits</b>	
Demand deposits and terms deposits (less than 30 days maturity)	3-10
Term deposits with residual maturity greater than 30 days	0
<b>Unsecured wholesale funding</b>	
Demand and term deposits (less than 30 days maturity) provided by SMEs	5-10
Operational deposits	5-25
Cooperative banks in an institutional network	25
NFC, sovereigns, CBs and PSEs	20-40
<b>Secured funding</b>	
Central bank counterparty or backed by Level 1 Assets	0
Backed by Level 2A Assets	15
Backed by non-Level 1 or non-Level-2A Assets with domestic sovereigns	25
Backed by RMBS eligible for inclusion in Level 2B Assets	25
Backed by other Level 2B Assets	50
<b>Cash Inflows</b>	
Backed by Level 1 Assets	0
Credit or liquidity facilities	0
Operational deposits held at other financial institutions	0
Backed by Level 2A Assets	15
Backed by Level 2B Assets	25-50
Marginal lending backed by all other collateral	50
Net derivative cash inflows	100

Source: Bank for International Settlements.

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A common criticism of minimum liquidity requirements is the "Goodhart Critique," according to which mandatory liquidity holdings are, in fact, not liquid.<sup>11</sup> To make his point, Goodhart tells the story of a traveler that arrives at a train station late at night, and sees a single taxi parked outside. He hails the taxi, but the driver tells him that he cannot take him to his destination because local by-laws require that there must always be a taxi at the sta-

<sup>11</sup> Goodhart (2011); *Ibid.*



## Box 2

**The difference between LCR and NSFR and the impact of the weighting scheme**

The definitions of *LCR* and *NSFR* each rely on a certain definition of asset liquidity and funding stability.<sup>1</sup> Assuming that, in contrast to the Basel III rules, a consistent weighting scheme of assets and liabilities is employed across both ratios, one ratio becomes redundant. Let  $A_i$  denote a bank's assets in category  $i = 1, 2, \dots, I$  (e.g. loans to households, government bonds etc.) and  $L_j$  its liabilities in category  $j = 1, 2, \dots, J$  (e.g. retail deposits, bank bonds, equity etc.). As in the Basel III requirements, funding stability and liquidity are measured through a weighting scheme: numbers  $\alpha_i$  signify the liquidity of an asset of type  $i$  (ranging from 0 when the asset is completely illiquid to 1 when the asset is perfectly liquid), and  $\lambda_j$  that measure the stability of funding type  $j$  (ranging from 0 when the funding is unstable (e.g. overnight interbank deposits) to 1 when the funding is stable (e.g. long-term debt with maturity greater one year)). The *LCR* and the *NSFR* can then be written as

$$LCR \equiv \frac{\sum_i \alpha_i A_i}{\sum_j \lambda_j L_j} \quad \text{and} \quad NSFR \equiv \frac{\sum_j (1 - \lambda_j) L_j}{\sum_i (1 - \alpha_i) A_i}$$

<sup>1</sup> This discussion follows Repullo, R. (2010): The New Regulatory Architecture – A Critical Assessment of Basel III, Presentation held at London School of Economics, [ftp://ftp.cemfi.es/pdf/papers/repullo/Repullo%20FMG%20October%202010.pdf](http://ftp.cemfi.es/pdf/papers/repullo/Repullo%20FMG%20October%202010.pdf)

To see that one ratio is redundant, given the consistent weighting scheme, assume  $LCR \geq 1$ . Then, using the balance sheet identity  $\sum_i A_i \equiv \sum_j L_j$ , it follows that  $NSFR \geq 1$ . Hence, the only reason why one ratio can hold while the other fails to hold is due to a different definition of liquidity and stability in the design of the ratios.<sup>2</sup> This is further elaborated on in Table on page 257 where a stylized balance sheet with key asset and liability categories is shown. Using the *LCR* and *NSFR* weights (Table 2 on page 255 and Table 3 on page 259), the *LCR* is satisfied at a level of roughly 1.15, while the *NSFR* requirement is violated at a value of 0.95. If a consistent weighting scheme were used, the *NSFR* would hold at a value of 1.11.

As an example for the different weightings, bank debt with a maturity between 30 days and one year has a weight of zero in the *LCR* scheme, but a weight of 50% in the *NSFR* scheme. This is entirely due to the different definition of funding stability and the underlying time horizon that is applied.

<sup>2</sup> To be precise, another reason why the two ratios can differ, even if a consistent weighting scheme is applied, is the fact that Level 2 liquid assets can make up at most 40% of the *LCR*'s numerator.

tion. Analogously, high quality liquid assets should not be considered to be liquid when liquidity requirements become binding. Another potential shortcoming of quantity restrictions is that, for fear of being penalized for violating the minimum coverage ratios, banks may opt to hoard liquidity during times of financial stress. Such cash hoarding may lead to lower asset prices (e.g. due to asymmetric information about asset returns), implying that banks' desire to maintain a certain level of funding liquidity may perversely lead to a substantial reduction in market liquidity.<sup>12</sup> To be fair, these criticisms are to some extent taken into account in the design of the *LCR*, as the minimum requirement of *HQLA* may be allowed to fall below net cash outflows during periods of financial stress. The exact modalities of this flexibility are, however, far from clear in the existing documentation published by the Basel Committee.

<sup>12</sup> Malherbe, Frédéric. "Self-Fulfilling Liquidity Dry-Ups." *The Journal of Finance* 69.2 (2014): 947-970.

These criticisms of minimum coverage ratios nonetheless raise the question of whether there exist other, more efficient, instruments that can be used to reduce banks' liquidity risk? An obvious alternative to quantity-based restrictions are price-based mechanisms that seek to penalize banks that heavily rely on short-term unstable funding.<sup>13</sup> A clear advantage of such price-based mechanisms is that they, by construction, incorporate a structured system of sanctions that penalize banks when their liquidity ratios fall. Price-based mechanisms are already implicitly permitted under the Basel III Accord, as Committed Liquidity Facilities (*CLF*) can count towards banks' *HQLA*.<sup>14</sup> A *CLF* allows central banks to provide committed liquidity lines toward banks' stocks of liquid assets in exchange for an up-front fee. This effectively acts as a tax on liquidity since banks have to pay a fixed fee for

<sup>13</sup> Perotti, Enrico, and Javier Suarez. "A Pigovian Approach to Liquidity Regulation." *International Journal of Central Banking* (2011).

<sup>14</sup> Stein, Jeremy C. "Liquidity regulation and central banking." *Speech at the "Finding the Right Balance" 2013 Credit Markets Symposium sponsored by the Federal Reserve Bank of Richmond, Charlotte, North Carolina*. 2013.

Table

**Stylized example of LCR and NSFR calculation**

Assets					Liabilities				
	Asset Value	LCR Liquidity Weights	NSFR RSF Factor	RSF Factor based on LCR Weights		Liability Value	LCR Run-off Rate	NSFR ASF Factor	ASF Factor based on LCR Run-off rates
Central Bank Reserves	10	100%	0%	0%	Retail Deposits	15	5%	95%	95%
Sovereign Bonds	30	100%	5%	0%	FX-Deposits	10	10%	90%	90%
Corporate Bonds	15	85%	15%	15%	Short-term interbank debt	50	100%	0%	0%
RMBS <sup>1</sup>	40	25%	65%	75%	Long-term debt	30			
Stocks	5	50%	50%	50%	of which maturity >1 year	20	0%	100%	100%
Commercial Loans	40	0%	85%	100%	of which maturity <1 year	10	0%	50%	100%
					Central Bank credit	20	25%	0%	75%
					Equity	15	0%	100%	100%
<b>Total</b>	<b>140</b>				<b>Total</b>	<b>140</b>			

LCR		NSFR		NSFR using LCR weighting	
HQLA	65.25	RSF		66.25	RSF*
NCO	56.75	ASF		63.25	ASF*
LCR = HQLA/NCO	1.15	NSFR = ASF/RSF		0.95	NSFR* = ASF*/RSF*
					74.75
					83.25
					1.11

<sup>1</sup> Residential mortgage backed securities.

Source: Authors' calculations.

When the different weighting schemes are applied, only the LCR is met. However, when the weighting schemes are consistent, both ratios are satisfied.

every euro of liquidity obtained through the CLF. Such a mechanism was originally introduced in order to allow banks operating in economies with a shortage of HQLA to participate in the LCR. This includes economies with small sovereign debt markets, such as South Africa and Australia. But it could potentially be used more extensively in the future if the global supply of available HQLA were to decrease significantly.

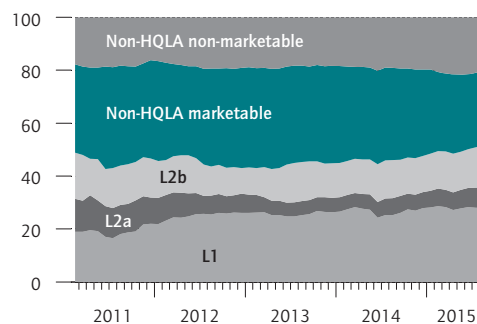
**Consequences of liquidity regulation for monetary policy**

The introduction of Basel III's liquidity requirements is expected to significantly affect banks' liquidity management practices. Even though banks have already gone some way since the GFC to meet the criteria set by the LCR and NSFR, the regulatory ratios will nonetheless restrict their ability to freely manage their balance sheets going forward. *Inter alia*, this may affect banks' demand for funds from the interbank market. Since standard monetary policy is generally operationalized through steering some benchmark interest rate on the interbank

Figure 2

**Eurosystem collateral composition**

In percent of total collateral after haircuts



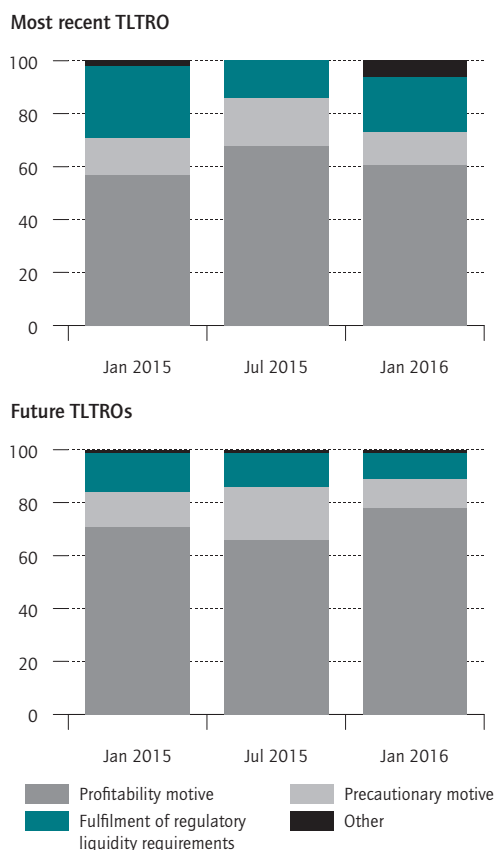
Source: ECB, taken from Bucalossi, A. et al. (2016): *Basel III and recourse to monetary policy operations*. European Central Bank Occasional Paper No. 171. 37.

The introduction of the LCR does not seem to have changed the composition of assets used as collateral in aggregate.

Figure 3

**Reasons for participating in TLTRO**

In percent of banks participating in the ECB's bank lending survey



Source: ECB Bank Lending Survey.

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For 10–30% of the banks, the new liquidity regulation is the main reason for participating in the ECB's TLTRO program.

market, changes in banks' demand for interbank funds may affect monetary policy implementation. In particular, if the LCR becomes a binding constraint for banks, central banks may have a harder time controlling overnight interest rates through open market operations.<sup>15</sup> This is because the LCR should increase demand for central bank money, thereby pushing short-term interest rates down towards the floor of the central bank's corridor.

<sup>15</sup> Keister, Todd, and Morten L. Bech. "On the liquidity coverage ratio and monetary policy implementation." *BIS Quarterly Review December* (2012).

In addition to limiting the ability of the central bank to steer overnight rates, the new liquidity ratios may also affect the composition of assets used to secure funding from the central bank. Since assets must be unencumbered in order to qualify for the LCR, the share of non-HQLA collateral posted at the central bank may increase if the set of eligible collateral is larger than the set of HQLA assets. This is the case for a number of central banks, including the European Central Bank. Thus far, recent data published by the ECB show no aggregate reduction in the quantity of HQLA assets posted by banks as collateral (See Figure 2). This aggregate data, however, masks considerable heterogeneity across banks: according to ECB calculations the share of non-HQLA assets pledged as collateral increased significantly between 2011 and 2015 for banks with more than 70% non-HQLA in their asset pools.<sup>16</sup>

Finally, Basel III's new liquidity regulation may also affect the effectiveness of recent unconventional monetary policy measures. The latest round of the ECB's Bank Lending Survey, carried out in January 2016, suggests that regulatory liquidity requirements played an important role in explaining banks' decision to participate in the ECB's 2015 targeted long-term refinancing operations (TLTRO). While this increase partially reflected a reduction in participation due to "precautionary motives," it was also accompanied by a decrease in participation driven by "profitability motives" (see Table 2). Survey results show that this trend is unlikely to continue in the new wave of TLTROs offered in 2016, even though regulatory motives still explain between 10% and 15% of banks' participation decisions. It remains to be seen, however, whether the future introduction of the NSFR will dampen long-term refinancing operations' ability to direct funds towards new productive investments.

## Conclusion

The events during the GFC, in particular the market turmoil that followed the default of Lehman Brothers in Autumn 2008, laid bare the banking sector's excessive exposure to liquidity risk. Against this background, the initiative of the G-20 in 2008 to improve liquidity risk management in the financial sector,<sup>17</sup> eventually culminating in the new Basel III liquidity rules, accommodates the need for better practices to reduce the risk of future liquidity crises like the GFC. That being said, it is questionable whether the new Basel III liquidity rules live up to these expectations.

<sup>16</sup> Bucalossi, A. et. al. "Basel III and recourse to Eurosystem monetary policy operations." *ECB Occasional Paper* (2016).

<sup>17</sup> See the declaration of the G20 in 2008: <http://www.g20.utoronto.ca/2008/2008declaration1115.html>

First, it is unclear why the two new regulatory ratios (LCR and NSFR) are based on different (implicit) definitions of funding stability and liquidity. A coherent definition would result in a consistent weighting scheme and make one of the two ratios redundant. The current design of these ratios is rather *ad hoc* and the incentives it creates are uncertain. This is problematic as liquidity regulation should be concerned with steering incentives of banks *ex ante* in order to prevent them from relying too heavily on central bank liquidity provision during times of financial stress. A more simplified and transparent approach would foster the effectiveness of the new liquidity regulation in terms of incentive provision and prevent the risk of regulatory arbitrage.

Second, not enough attention has been paid to the potential interaction between the new liquidity rules and existing bank capital regulations. The weighting schemes of the ratios take into account that some assets cannot be liquidated immediately for their full value. However, such fire-sales produce losses that cut into the capital base of a financial institution. Using up its liquidity in case of stress may therefore ultimately threaten a bank's solvency. In addition, funding liquidity, i.e. the ease with which a bank can borrow to meet liquidity shortfalls, clearly depends on the solvency of the borrower. Hence, it would clearly be desirable to deal with liquidity risk, at least partially, via additional capital charges.<sup>18</sup>

Third, the present state of Basel III leaves open what will happen in case a bank repeatedly fails to meet the minimum coverage ratios. Here, an automatic sanction procedure that enforces compliance with the rules would be desirable. For example, by way of mandatory rights offerings, banks that do not meet the liquidity rules for a certain period of time would be forced to issue equity and use the resulting cash proceeds to increase their liquidity buffers. As this would penalize existing shareholders, it would improve incentives for compliance.

<sup>18</sup> On the relationship between liquidity and capital regulation, see König, P. (2015): Liquidity Requirements – A Double-Edged Sword. International Journal of Central Banking. 11(4), 129-168.

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Table 3

**Weighting scheme for calculation of NSFR**  
In percent

ASF Category	ASF Factor
Total regulatory capital	100
Other capital instruments and liabilities with effective residual maturity of one year or more	100
Stable demand deposits and term deposits with residual maturity of less than one year	95
Less stable non-maturity deposits and term deposits with residual maturity of less than one year	90
Operational Deposits	50
Funding with residual maturity of less than one year provided by NFCs, sovereigns and PSEs	50
Other funding with residual maturity of not less than six months and less than one year, including funding provided by CBs	50
All other liabilities and equity, including liabilities without a stated maturity	0
Net payable derivatives	0
RSF Category	RSF Factor
Coins and banknotes	0
Central bank reserves	0
Unencumbered loans to banks with residual maturities of less than six months	0
Other unencumbered Level 1 Assets	5
Unencumbered Level 2A Assets	15
Unencumbered Level 2B Assets	50
HQLA encumbered for a period of six months or more and less than one year	50
Loans to banks with residual maturities six months or more and less than one year	50
Deposits held at toehr financial institutions	50
All other assets with residual maturity of less than on year, including loans to NFC, sovereigns and PSEs	50
Unencumbered residential mortgages with a residual maturity of one year or more and risk weight less than or equal to 35%	65
Other unencumbered loans	65
Other unencumbered performing loans with risk wieghts greater than 35% and residential mortgages of one year or more	85
Unencumbered securities that are not in default	85
Traded commodities, including gold	85
All assetsthat are encumbered for one year or more	100
Net receivable derivatives	100
All other assets, including non-performing loans, non-exchange-traded equities, fixed assets, pension assets, etc.	100

Source: Bank for International Settlements.

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