



## EBA discussion paper on Defining Liquid Assets in the LCR under the draft CRR

### ECBC Response

Brussels, March 2013

The European Covered Bond Council (ECBC)<sup>1</sup> represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was created by the European Mortgage Federation (EMF) in 2004 to represent and promote the interests of covered bond market participants at international level. As of March 2013, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions. ECBC members represent over 95% of the €2.67 trillion outstanding covered bonds.

#### Introduction and General Remarks

The ECBC welcomes the opportunity to express its views on the proposed methodology for the carrying out of the analysis of the European banking Authority (EBA) report. This report aims at providing appropriate uniform definitions of high and of extremely high liquidity and credit quality of transferable assets and appropriate haircuts for the purpose of the LCR requirements as specified under article 481(2) of the draft Capital Requirements Regulation (CRR).

We understand that comments are most helpful if they respond specifically to questions stated. However, before doing so, we would like to make some general comments on the two step methodology proposed by the EBA which will consist of (i) establishing a ranking of asset classes based on their aggregate liquidity properties; and (ii) identifying explanatory characteristics of individual securities that explain observed liquidity differences within asset classes.

Firstly, we welcome the efforts made by the EBA to broaden the scope of its report. Although the analysis of the set of quantitative metrics prescribed within Article 481(2) of the draft CRR will remain the central pillar of its report, the EBA proposes to take a broader approach and assess an expanded list of liquidity metrics and explanatory characteristics. However, the ECBC remains very much concerned about the lack of available sources of data. As described in point 4.2 – Data on Asset Classes, covered bonds are generally traded over the counter (OTC) which, although proving to be a crucial commercial asset during the recent financial turmoil, impedes the production of a comprehensive data set. Hence, we fear that this lack of reliable and comparable data could result in an empirical analysis with distorted results and misleading outcomes. We, therefore, invite the EBA to have a critical view on the results of its liquidity analysis.

---

<sup>1</sup> The European Covered Bond Council is registered in the European Institutions' Transparency Register under European Mortgage Federation ID Number 24967486965-09.



Moreover, we consider that the analysis of explanatory characteristics of individual securities should not lead to a granular definition of high and of extremely high liquid assets. As far as covered bonds are concerned, the ECBC strongly supports an integrated and European approach. We deem that it would be inappropriate to differentiate between covered bonds with similar regulatory and credit protection and which, under European Union (EU) rules and European Central Bank (ECB) criteria, are subject to equal treatment. We also believe that a regulatory differentiation between covered bonds could slow down the convergence of the current covered bond model and jeopardise the level playing field in regards to the funding of European banks. The preferential risk-weight of covered bonds is justified by its high quality features, i.e. strong supervision, strict regulatory and legislative framework, solid safety features (in form of tight eligibility criteria and dual recourse), large and dynamic cover pool, broad and stable investor base and excellent track record. A differentiation based only on the existence of information disclosure would create unjustified cliff effects that may negatively impact the European covered bond market.

Along the same lines, the ECBC does not support the inclusion of a rating threshold for covered bonds. Credit quality can have implications on liquidity and, hence, is one of the quantitative based liquidity metrics required by the CRR. Although a large majority of covered bond programmes in Europe still satisfy the highest rating standards (sometimes even above their respective sovereign), we believe that artificial rating thresholds would introduce a hazardous cliff effect which, in times of turmoil, could have serious pro-cyclical effects. In this context, it is worth noting that one of the objectives of regulators as well as investors is to reduce the reliance on ratings and we consider that such thresholds would be a step in the wrong direction.

More generally, we would like to stress that some of the metrics proposed in Article 481(2)<sup>2</sup> of the draft CRR should be interpreted broadly. For instance, credit ratings, especially when it comes to specific assets such as covered bonds, do not always reflect fully the credit quality of the product. They are considered as only one indicator amongst others and, as a matter of fact, investors tend to steer away from the pure ratings and focus primarily on the additional information provided by the rating agencies that goes beyond the mere ratings assigned. Similarly, a low turn-over could highlight either a stable investor base with a “buy and hold” strategy or a liquidity shortage.

Last but not least, we would like to draw the EBA’s attention to the position paper published by the ECBC in September 2012 (*ECBC Position Paper on the Treatment of Covered Bonds in the Liquidity Coverage Ratios*, [here](#)). This paper presents not only quantitative arguments to support the extremely high liquidity of covered bonds but also qualitative criteria (e.g. credit quality, depth of the investor base, repo eligibility and haircuts, etc.) which we believe should be fully taken into account by the EBA when drafting its final

---

<sup>2</sup> “EBA shall in particular test the adequacy of the following criteria and the appropriate levels for the definition of transferrable assets of high and extremely high liquidity and credit quality:

- a. minimum trade volume of the assets;
- b. minimum outstanding volume of the assets;
- c. transparent pricing and post-trade information;
- d. credit quality steps referred to in Part Three, Title II, Chapter 2 (credit ratings);
- e. proven record of price stability;
- f. average volume traded and average trade size (trade volume / number of trades);
- g. maximum bid/ask spread;
- h. remaining time to maturity;
- i. minimum turnover ratio (trade volume / outstanding volume).”



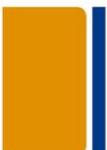
European Covered Bond Council

The Covered Bond Voice of the European Mortgage Federation



report. In this regard, we also invite the EBA to consider the recent establishment of a Covered Bond Label which, in particular, substantially improves transparency in the covered bond market (please see below for further information).

EMF



**European Mortgage Federation aisbl**

Avenue de Cortenbergh, 71 B-1000 Brussels - Belgium | Tel: +32 2 285 40 30 | Fax: +32 2 285 40 31 | TVA BE 411 583 173  
emfinfo@hypo.org | [www.hypo.org](http://www.hypo.org)



## “Covered Bond Label & Transparency Platform go live”

The Covered Bond Label Foundation was officially established in November 2012 and its website ([www.coveredbondlabel.com](http://www.coveredbondlabel.com)) has been fully operational since the 1st of January 2013, with the first Labels issued being effective from the same date.

To recap, the Covered Bond Label responds to a market-wide request for improved standards and transparency in the European covered bond market. The Label establishes a qualitative perimeter for the covered bond market by drawing a clear line of demarcation in the covered bond space and demonstrates the unwavering commitment of the covered bond community to maintaining the quality of the asset class and to strengthening secondary market activity.

The establishment of the Label has required the entire covered bond community to agree upon a common definition of covered bonds and to develop an extensive “Transparency road map” displaying detailed covered bond market data, comparable cover pool information and legislative details on the various legal frameworks designed to protect bondholders. In concrete terms, it has brought together covered bond issuers from 14 different jurisdictions in the development of a National Transparency Template providing cover pool information in a harmonised format on the basis of common guidelines agreed at European level. The chosen format allows for both the recognition of national specificities and the comparability of information required to facilitate investors’ due diligence.

It is worth noting that the commitment to enhance transparency in the covered bond market through the establishment of the Covered Bond Label is not limited to the issuer community. An intense and constructive dialogue was also held with the investor community, major national and European authorities, as well as with the main law firms active in the covered bond arena, which have supported and followed the creation of the Covered Bond Label Foundation and its website.

The Label is embedded in a broad Information Platform that will provide market stakeholders with a unique qualitative and quantitative data centre for the covered bond market with regular information at both cover pool and issuance level ([www.coveredbondlabel.com](http://www.coveredbondlabel.com)). This platform, which will be officially presented at the forthcoming ECBC Plenary Meeting in Rome on the 21<sup>st</sup> of March 2013, highlights the following key elements which are considered essential by investors:

- Covered bond data at issuance level in a comparable format ([link](#));
- Cover pool data displayed (on each individual issuer’s profile from January 2013) on the basis of the respective National Transparency Template ([link](#));
- General information on the issuer ([link](#));
- Contact points at issuer and national level ([link](#)); and
- Description of the legislative framework of every covered bond model and the official legislative text in English (the Covered Bond Label Foundation’s website provides a link to the ECBC’s Comparative Database, which contains a wealth of information on the different legal backgrounds).

As of today, a total of 80 labels have been granted to 66 issuers for a total face value of covered bonds registered which amounts to more than €1.4 trillion (approximately 54% of total outstanding).



**Question 1:** Given the difficulties with obtaining transactional data outlined here, do you think a data sample cover 2008-2012 is sufficient for this analysis? Would you see merit in extending the sample in those countries where more data is available?

The period of 2008-2012 does cover a time of extreme stress in the market place. There is a risk that using that sample will skew the results towards non-bank related paper or non-government related securities such as corporates. Covered bonds as well as many other asset classes have experienced elevated volatility during this period. Moreover, external factors such as the two ECB covered bond purchase programmes have also impacted the covered bond market as the additional demand by the ECB actually lowered the turnover in covered bonds<sup>3</sup>. After the announcement of the first ECB purchase programme, investor demand significantly increased in anticipation of a strong spread tightening of the covered bond product, driven by the additional external demand whilst at the same time the willingness of covered bondholders to sell the bonds was very limited for the same reason. However, despite the relatively low turnover, the liquidity of these covered bonds (defined as the ability to sell the securities) was very good.

We believe that the data available before 2008 would not necessarily be constant across jurisdictions and it is only since November 2007 when MiFID came into being for reporting purposes that the national regulators will have data that is common to all jurisdictions in Europe. In some EU jurisdictions, such as Denmark, there are certainly longer time series available that would be comprehensive enough to be relied upon. If available before 2008, it would be useful to include this as supporting data to demonstrate the liquidity of covered bonds over a longer period.

However, we do not believe covered bond trading information required to properly calculate the liquidity metrics listed in this discussion paper is available in sufficient detail. In addition, the appropriateness of such data may be limited by significant market events which have taken place or may take place in the future. Examples include changes to market making for covered bonds in 2008, the ECB purchase programmes in 2009 and 2011 and the financial transaction tax currently under consideration. Choosing and relying upon explanatory factors will therefore be more practical in the short to medium term as more robust data is compiled.

**Question 2:** Do you have additional data sources to suggest? Specifically, can you suggest a source of repo data and gold that would fit our needs?

We believe Tradeweb, Bloomberg or Euroclear Extractor may have additional data on covered bond trading volume and bid/offer spreads that may be utilized for historical analysis and/or collected going forward. In addition, some exchanges include data. We have included some examples below. As described above, however, it will be difficult to extract and use this data meaningfully.

- Budapest: [here](#) or [here](#);
- Copenhagen: [here](#);
- Frankfurt: [here](#);

<sup>3</sup> The ECB's Securities Markets Programme (SMP) should also have a distorting effect on the empirical analysis within the sovereign sector but also in relation to other asset classes.



- Prague: [here](#); and,
- Stockholm: [here](#).

In addition, we would expect that the national central banks and the ECB have repo data on covered bonds that precede 2008. Lastly, we would like to again steer your attention to our ECBC liquidity paper (*ECBC Position Paper on the Treatment of Covered Bonds in the Liquidity Coverage Ratios*, [here](#)) which was published last year.

**Question 3:** Do you agree with the list of liquidity metrics under consideration to be used in the EBA assessment, as mentioned in this section and Annex 5? Can you suggest further metrics the EBA should make use of, where information would be available?

Covered bonds are purchased by insurance companies, asset managers and banks for their credit quality and yield. By the nature of some of the end users, the securities are held for investment for longer term periods. Insurance companies have, for example, been traditional investors in covered bonds over the years, buying on average between 10% and 15% of all primary EUR benchmark covered bond issuance. While not being active trading accounts, they do represent a structural bid for the product. Recent developments in the sovereign crisis have even strengthened this as insurance companies openly stated that they have stopped buying BTPs and are shifting their Italian country exposure into Italian covered bonds. We have also seen many second tier insurance companies from a number of countries shifting their exposure away from sovereign debt towards covered bonds as they perceive the product to be the higher quality product. While this behaviour is positive for covered bond demand as it increases banks' abilities to liquidate positions even in a stressed environment and proves the high credit quality of covered bonds, it is detrimental to the market liquidity the way EBA is trying to measure it. This long-term investment horizon of a large number of covered bond investors could mean that the free float in the secondary market is diminished to an extent. However the definition of High Quality Liquid Assets (HQLA) is one which institutions can sell or pledge to withstand a liquidity stress. Importantly, the pledge makes it very liquid (HQLA) so the use of CB Repo should be used as a metric. This metric should be available from Central Banks.

We do not agree with the whole process of differentiation within asset classes, and we think that the bonds (sovereign, agency or covered bonds) issued by the smaller countries - Ireland, Austria, Finland, Portugal, Belgium, etc - could be deemed to be less liquid, and drop into a lower category or carry a higher haircut than those issued in Germany, France, Italy, etc. This would simply reflect the difference in market size when empirical figures such as turnover / liquidity or bid/offer spread are compared between larger markets and smaller markets.

**Question 4:** Do you agree with the list of explanatory characteristics whose linkage to liquidity it is proposed to be tested in the EBA assessment? Can you suggest further characteristics the EBA should assess?

Certainly the characteristics specific to an asset class such as number of market makers, trading platforms, large amount of end users should have a direct correlation on liquidity and should be proposed and demonstrated as having a positive impact on covered bond market liquidity.



"Percentage of public placement" may be impractical to monitor. However, requiring a minimum number of joint lead managers, designated market makers (perhaps 3) or current tap issuance to the markets may achieve the same result and would be easier to track.

We do not believe UCITS and CRD compliance are appropriate as this would, for example, exclude Australian and Canadian covered bonds as well as those from other emerging jurisdictions outside of Europe. We believe similar requirements (regulation, max LTVs, etc) can be included without the geographical limitation that UCITS and CRD impose and still maintain liquidity and credit quality.

"Collateral eligibility", as described in Annex 4, could be expanded to include major indices for each relevant asset class (we note that the differing requirements of Bank of England repo eligibility versus the ECB, for example, could lead to disparities across currencies unless a more uniform criterion such as index eligibility can be referenced).

Regarding "remaining time to maturity" - we do not agree with using remaining time to maturity as a metric. In some markets, a more appropriate measure to look at is rather the time since issuance or seasoning of a bond. The longer the actual issuance date lies in the past the less trading there is in a given security as a higher share of the bond will have found its way into buy and hold portfolios. However, in markets with borrower driven demand for buying back or (par) prepaying bonds, the "remaining time to maturity" would appear to be a more suitable characteristic to determine the appropriate haircut.

Setting too high a ratings threshold (i.e. AA) could have unintended consequences. One could imagine a scenario where a sovereign and its issuers' covered bonds were downgraded below the threshold, which would have an immediate negative market and liquidity effect on such assets. Even worse, it introduces cliff effects in the value of LCR liquidity buffers as LCR haircuts of the assets are dramatically increased and market values are potentially reduced due to market reactions.

We are also concerned about issue size if it is to be used as a future explanatory criterion to differentiate between extremely high and highly liquid assets. One problem is that issue size favours both larger institutions and markets. In that case, the regulation does not support a level playing field and in fact, makes it difficult for new entrants. Furthermore, issue size can create cliff effects in LCR liquidity buffers (see above) as issue size varies over an individual asset's life cycle - especially in business models based on match funding of loans and tap sale.

Additional features such regulatory treatment, off the run or on the run, the ability to sell a security rather than just turnover should also be taken into account.

**Question 5:** Do you agree with the methodology proposed? Do you have alternative approaches that might be used?

In the consultation paper, it appears that EBA wants to focus mainly on ex post turnover statistics and bid ask spreads and to run extensive quantitative analysis on these figures. In our view, the proposed approach focuses too heavily on data that is still hard to come by and difficult to interpret.



In light of the lack of comparable and reliable data across asset classes, we believe that the suggested methods to quantify liquidity could result in distorted or even misleading results. Therefore, we consider that a less quantitative and more qualitative approach at this stage would lead to better results, particularly as it seems as if sovereigns are excluded from the analysis.

Qualitative criteria are already part of this exercise but as things stand at the moment, they will not have a very important role in the process. The EBA only plans to back test if these qualitative criteria have any statistical relevance to refine the interpretation of the turnover and bid-ask spread data but they do not seem to have any decisive meaning in their own right. The LCR's purpose is to define assets that banks can liquidate if they need to, which means focussing on the bid only. As such, the EBA should focus on finding qualitative criteria that point to a strong structural bid for a particular product. Merely basing the LCR treatment on ex post trading turnover data would therefore be misleading in our view and does not capture the actual purpose behind the metric.

The relative liquidity of different asset classes could provide a guide to ranking of liquidity. As previously mentioned, liquidity is not a substitute for credit quality and there should be weighted consideration given to the credit quality and also the appeal of covered bonds to investors as a "buy and hold" investment because of its secured quality and its acceptance by the ECB as a pledgeable asset to secure liquidity.

The ECBC has introduced the Covered Bond Label which will ensure that standardised information for all covered bonds is available and will give a greater degree of transparency to covered bonds and indeed this will improve investor appeal and by consequence, liquidity.

While there may be some merit in comparing the liquidity of one asset class with another, we do not agree with the process of differentiation within the covered bond asset class.

