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EBA - Discussion Paper on Defining Liquid Assets in the LCR under the draft CRR

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the EBA - Discussion Paper on Defining Liquid Assets in the LCR under the draft CRR and would like to submit the following position:

I. General Remarks

EBA's approach is based on a quantitative assessment of the liquidity of individual assets based on transactional data and this evidence is going to be used to construct specific definitions of the characteristics of assets that qualify as potentially high quality liquid assets. The methodology for combining different liquidity metrics together and return a relative ranking is not disclosed in the document.

Even if all liquidity metrics listed by EBA seem to be relevant, the approach presented in the discussion paper is subject to the following major flaws :

- Regime shift: statistical evidence based on 2008-2012 period would not bring meaningful results for predicting future behavior of potentially liquid assets since there will be a major regime change with the introduction in the EU of the Financial Transactions Tax (FTT) that will cause a serious distortion in the functioning of private financial markets. Moreover the new Basel 3 regulation itself will create a drastic change, since any asset that will be classified by Regulators as highly liquid will benefit of increased liquidity and any asset not eligible will experience a less liquid market place.
- Data availability: transactional data are only available for a delimited set of assets and transactions (e.g. not for repo transactions, not for many assets that are liquid but not "actively traded" since they are priced in relative value terms,...)

Based on this considerations, we would deem more appropriate to avoid a purely quantitative driven approach based on historical time series and develop an approach based only on static characteristics (e.g. issuer type, rating, volume of issues,...) ensuring that the results are fully aligned with central bank eligibility criteria and allow for sufficient diversification of the portfolio of liquid assets.

1. The general **proposed metrics** which will be used for proofing the market liquidity of assets (trading volume, outstanding amounts, bid-offer spreads, transparent pricing, min. turn-over ratio, price-stability,...) **seems to be appropriate for equities and corporate bonds**. For **Government bonds**, especially in emerging markets like CEE where market liquidity is low but local banks are required to hold liquidity buffer in local currencies, local, central bank eligible government bonds should be accepted as HLA as well.
2. Generally, we think it is of crucial importance to strongly **link the centralbank-eligibility to the liquidity value**, i.e. the definition of highly-liquid assets.
3. Besides of the proposed metrics and asset classes, what is important to mention is that we would like to see **Minimum Reserve balances as part of the HLA not only in excess of the required minimum**, but to the extent that the local regulator would allow it - even temporarily going below the required limit - in times of stress at its own discretion. **Liquidity reserves** of decentralised co-operations of credit institutions, which they are obliged to hold at central institution level by statutory local law, should also be HLA-compliant, as otherwise on a solo basis, these banks would have to invest into **additional HLA-compliant assets** on top of the existing mandatory deposits, which is an extra unnecessary burden beyond the existing conditions without any need.
4. It should also be made clear that qualifying **liquid assets in the trading book are part of HLA**. After all, they could be accessed in a liquidity crisis the same way than any other HLA in the banking book.
5. Availability of data for the analysis is a key issue. **Observed prices and spreads** will be used instead of quoted prices and spreads. For the proposal for debt securities to use **transaction reporting databases held by national authorities**.

It's clear from the paper that there was already an extended research conducted in the topic by reviewing relevant published studies. While studies for equity markets exist for a wide range of markets, a **large part of the literature on corporate and government bonds**, and other asset classes are concentrated on the US data. This will be the first **comprehensive analysis on the liquidity of different asset classes on the European market**.

6. Due to the fact that at the moment, **no results of the proposed methods and metrics are available** and it is also **difficult to judge the economic effect** on the liquidity value of examined asset classes, it is difficult to comment on the proposed actions/considerations in more detail. In order to be able to judge EBAs assessment it is necessary to wait for the announced „detailed quantitative assessment of the liquidity of individual assets”, which is why we would appreciate to get these data provided soon.

7. What from our point of view will be important is, that **banks should have the possibility to proof** (via internal data/analysis) **that the liquidity value of certain assets is different** to the general assumption calculated based on aggregated level (Regulatory reporting / national bank data).
8. An important **open question to EBA** is if analysis will cover securities of all countries where Austrian banks are operating (CESEE). If that's not the case it would be a real challenge gathering the necessary data as well as the guidance how to perform the analysis in a comparable way. Here we would expect a more detailed information by EBA to all affected banks what EBA's strategy will be.
9. The **analysis** done so far is based on past observations. In this context we want to highlight that any current ongoing regulatory discussions that might have a substantial impact are not yet recognized or its potential impact calculated. The introduction of a Financial Transaction Tax (FTT) under Enhanced Cooperation as set out by the European Commission on 14. February 2013 would be such an important regulation where its impact needs to be considered, especially liquidity issues like required buffers or remaining liquid assets within a certain market after introducing such a tax.
10. Historical market data
 - a) Historical market data (volume of sales and Bid-Ask-spreads) don't deliver a clear statement about the liquidity of bonds in certain market phases. This is because
 - in phases with buyer surplus and low issuing activity, revenues are low despite good demand, because there are no buyers in the market. At the same time the bid-ask-spreads are wide, because traders won't lose any bonds in dried-up markets, which they can't cover again. In such a market phase, we are at the moment, the demand would be here, but no revenues are taken place
 - transactions in the whole markets decline, because of the burden of taxes and duties (transaction tax)
 - b) Data basis of MiFID doesn't contain enough data from OTC buys between banks and institutional clients and only represents a small part of the whole market.
 - c) Historical data don't take into account the rising liquidity, which is caused by liquidity requirements.
 - If an asset class is a homogenous, European wide HQLA, there will be a natural demand in this asset class, because every bank investor in Europe will gain the same advantage from the asset
11. Market distortions
 - a) We can assume, with too narrowly defined criteria, the demand for HQLA will exceed the supply. This would drive up the prices of this HQLA disproportionately and excessively and therefore favour HQLA market segments, while other market segments are disadvantaged, which aren't fulfilling the HQLA criteria. This would transfer to the real economy, when for example bonds of certain countries or certain issue volume won't be considered liquid:

- corporate bonds from the SME segment with low issue volume, which are sold increasingly to buy-and-hold investors vs. benchmark issues of big corporates, which are already represented on the market with a big, liquid total volume
- HQLA corporate bonds vs. ECB-eligible corporate loans

12. Proportionality

- a) The size of the bank and the size of the buffer are not taken into account. However, there is a distinction to be made in which units the assets, as well in which volume the buffer has to be liquidated. If a bank has a liquidity buffer of for example 200 million Euros in 10 to 40 different bonds, this liquidity buffer can be liquidated without creating attention and without price movements on the market. If a big bank has to liquidate a buffer of several billion, this can't be done with creating attention and price reactions.

13. Self fulfilling prophecy

- a) The main EU problem still remains the restrictive definition of the liquidity buffer. The extension proposed by the Basel Committee (corporate securities rated BBB- to A+ and RMBS rated above AA) - while remaining important in the case of some countries - will have a limited impact because the European economy is mostly financed by banks and not by capital markets. Therefore, the European regulators should extend the HQLA to all standby facilities granted by central banks and central bank eligible assets.
- b) Additionally, we suggest to carefully review the requirements for liquid assets and to include other central bank eligible but non-tradable assets in the monitoring and evaluation exercise for the observation period. Historical data on many asset classes might not be readily available yet, but can prove to be important at a later stage. It must be ensured that after the observation period asset classes can become eligible for inclusion in the highly liquid assets category, if they fulfill a set of required criteria. The characteristic of being a liquid asset will influence the price level of the asset class and the banks' demand for the specific asset. This can also have an impact on the banks' SME business which is of high importance as the SMEs are the backbone of the European economy.

II. Questions

Q1. 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?

A1. see General Remarks; moreover we would like to stress that market liquidity is difficult to forecast on the basis of historical analysis. Especially the FTT will reduce trading activity which is somehow contradictory to this historical backward looking methodology.

Q2. Do you have additional data sources to suggest? Specifically, can you suggest a source of repo data and gold that would fit our needs?

A2. No. It is not clear how a consistent quantitative approach for assets that are actively traded in repo/reverse repo transactions, but not in secondary markets could be developed. Data basis of MiFID doesn't contain enough data from OTC buys between banks and institutional clients

and only represents a small part of the whole market. A number of different sources shall be used.

Q3. 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?

A3. The liquidity metrics listed are all relevant.

Q4. Do

you agree with the list of explanatory characteristics whose link to liquidity it is proposed to be tested in the EBA assessment? Can you suggest further characteristics the EBA should assess?

A4. Many of the explanatory characteristics (e.g. large number of market makers, traded via additional platforms and markets, wide range of potential buyers) cannot be handled in quantitative terms, since they are more qualitative (e.g. 5 not very active market makers could be much less effective in providing liquidity than two big ones; number of buyers is largely depending on pricing and risk taking capacity in a specific moment).

Q5. Do you agree with the methodology proposed? Do you have alternative approaches that might be used?

A5. The approach proposed could bring to biased results since it is not taking into account that many assets are priced and traded in relative value terms: even if the actual volume traded are low, certain assets could be very liquid because highly correlated with other liquid assets. It is also to be mentioned that the proposed approach could never be replicated or back-tested by the banks (because of data availability and resources) so the institutions would not be in the position to challenge or improve it.

Finally, we kindly ask EBA to ensure that Undertakings for Collective Investment in Transferable Securities (UCITS) regulated by Directive 2009/65/EC fulfil the criteria of Art. 405 par 5 CRR.

Kindly give our remarks due consideration.

Yours sincerely,

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