VOLKSWAGEN FINANCIAL SERVICES

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# Position on the

# European Banking Authority discussion paper on "Defining Liquid Assets in the Liquidity Coverage Ratio"

On 21st February 2013 the European Banking Authority (EBA) published a discussion paper with the objective of finding a definition of liquid assets that can be used for calculating the Liquidity Coverage Ratio (LCR).

In the Executive Summary of the discussion paper, the EBA explains that Article 481(2) of the draft Capital Requirements Regulation (CRR) defines the assessment mandate of the EBA in relatively broad terms: for example, the EBA is also required to analyse other categories of assets that go beyond the criteria specified in Article 404 of the draft CRR. In particular, the EBA is tasked with including *residential mortgage-backed securities* (RMBS) in the analysis. Securitisations of automobile loans by captive automobile banks (automotive asset-backed securities = Auto ABS), however, have not been explicitly mentioned up to now.

Against this background, we would like to describe to you in the following **A.** our position on the inclusion of Auto ABS as liquid assets in the LCR. Under **B.** we will answer the questions Q1-Q5 posed by the EBA.

## A. Auto ABS as liquid assets

Auto ABS are subject to high quality standards and have an impeccable performance track record. In 2012, Auto ABS made up 11 percent of the entire issue volume of the European securitisation market. Auto ABS was the most frequently marketed asset class with a volume of 24.7 billion euros, ahead of RMBS with a volume of 17.9 billion euros.

Auto ABS from Premium issuers enjoy a very high reputation among investors and are assessed as extremely low-risk investments. A major reason for this, in particular, is that the value development of used vehicles and the default rates of automobile financing have largely remained constant over many years as well as throughout the finance crisis. Auto ABS have therefore proved to be crisis-resistant in the past and, thanks to their high granularity, they have not caused investors to suffer any losses.

In addition, no distinctions are made by the European Central Bank (ECB) as regards the asset classes in assessing the deposit eligibility of ABS securities, but it is only the quality of the securities that is evaluated. Asset Backed Securities with a very good rating have been accepted as central bank eligible assets for a long time and allow institutions to gain quick access to liquidty by participating in the European Central Bank's open market operations.

It is meanwhile generally recognised that some sectors of the securitisation market, such as subprime mortgage financing in the USA in particular, have developed very badly. In Europe, on the other hand, a completely different picture has emerged. An


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analysis from Standard & Poor's, for example, reveals that between mid-2007 and mid-2011 European transactions have shown a default rate of only 1.2% while the losses of US transactions totalled 9.7%.

The default rate of Volkswagen Financial Services (VWFSAG) transactions during the same period amounted to 0.0%. Auto ABS were therefore counted, even during the crisis, among the most marketable and safest classes of asset.

### *Significance for the automobile banks: refinancing through Auto ABS*

Already today, the financial service companies of the German automobile manufacturers cover a significant portion of their refinancing needs through the securitisation of their customer receivables. If banks, which are among the largest investors on the European securitisation market with 39 percent, cannot take Auto ABS into account in their liquidity buffer, it will become unattractive for them to invest in such securities. It is therefore to be feared that the ABS market will shrink significantly.

The significance of any restriction of the ABS market becomes clear when looking at the refinancing structure of Volkswagen Financial Services AG as an example. VWFSAG is financed to approx. 13% through ABS (corresponding to EUR 14.6 billion as at 31.12.2012). If Auto ABS are excluded in future under CRR I from being taken into account to meet the LCR, it can be assumed that around 30% of the investors on the ABS market will disappear. This would mean that, calculated in euros, VWFSAG would lose around EUR 4.4 billion of its refinancing funds.

### *Significance for the real economy*

Corresponding effects can also be expected for other branches of the real economy in addition to the automobile industry that finance themselves through ABS (e.g. trade receivables financing). If this refinancing instrument were to be restricted as planned, this would in our view entail a significant weakening of the business effectiveness of companies since ABS cannot be easily replaced by other sources of refinancing.

A refinancing gap for the automobile banks means they are no longer able to make sufficient financing resources available to customers. This ultimately leads to a decline in sales figures and therefore a decline in business production.

### *Liquidity of alternative means of refinancing*

Residential mortgage-backed securities (RMBS) as well as government securities and corporate bonds are to be eligible for inclusion as highly liquid assets. In the present economic climate, however, these financial assets are subject to much higher fluctuations in value than Auto ABS are. The latter are still based on the motor vehicle itself, whereby used vehicle prices have proved to be extremely stable over recent years.

The supposed complexity of ABS transactions in relation to corporate or government bonds is being counteracted by European banks, in particular, through experience gained during the finance market crisis in that simpler structures are being created and uniform standards are being placed on the market governing platforms and the securitisation programmes deployed. These developments are currently still providing for better transparency and greater acceptance, also among investors. So, if RMBS, government securities and corporate bonds are classified as highly liquid assets, this should certainly be the case for Auto ABS.

*Conclusion*

We therefore consider it essential to include Auto ABS – especially in view of their quality, impeccable performance history and importance as a refinancing instrument – within the scope of highly liquid assets that may be held as part of the LCR buffer. If RMBS, which pose a higher risk for investors, are classified as highly liquid assets, this should certainly be the case for the much safer Auto ABS.

If this does not occur, this would have a serious negative impact on the refinancing, and therefore also the sales, of the German automobile industry.

## B. Replies to the questions Q1 to Q5

*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?*

Looking at a data sample of a 5 year period is certainly sufficient bearing in mind the short tenor of the auto ABS asset class. Weighted average life of auto ABS transactions is ususally between 1.5 and 2 years. This can be proven from both our longstanding ABS programmes Driver and VCL on national and international basis.

Whenever available, the longer the better data history is preferrable in order to capture as many as possible economic cycles.

*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?*

Going forward, the best possible source will be the European Data Warehouse. However, it will take some time to build up the relevant data history. In the interim, one could use either data coming from the originator directly or the market valuation data of ECB which is provided by Banque de France.

*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?*

*Q4. Do you agree with the list of explanatory characteristics whose linkage to liquidity is proposed to be tested in the EBA assessment? Can you suggest further characteristics the EBA should assess?*

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

We would like to answer questions Q3 to Q5 together.

In principle, from a methodological and theoretical point of view we agree with the proposals as set out in the discussion paper. However, we are concerned that the proposed approach could trigger self-amplified effects. The recognition of an asset as highly liquid or liquid will in future be itself a variable that explains liquidity. The reason is that the demand for certain securities to be recognised as highly liquid or liquid will strongly increase due to its official recognition as highly liquid or liquid, because such securities can be used to meet the liquidity requirements according to Part 6 of the CRR.

On the other hand, there is the risk that certain types of securities recognised as European Central Bank eligible, today accepted as liquidity assets according to existing national liquidity regulations but no longer to be recognised as liquid assets according to the outcome of the “liquidity scoring” by the EBA, will be less attractive for investors in the future, which would reduce the liquidity and marketability of such securities with negative implications.

To counter such negative impacts, we suggest complementing the proposal in such a way that securities accepted by the European Central Bank to be eligible to draw liquidity from the European Central Bank for a long period should be recognised as liquid assets as well. This applies in particular to asset-backed securities backed by motor vehicle loans and leases. This asset category has a strong track record, has never failed in Europe even in crisis times, has been accepted by the European Central Bank in case of high credit quality rating to be eligible for a long time, and has thus enabled institutions holding such ABS to draw liquidity at all times by a tender procedure. Consequently, we would welcome the consideration of asset-backed securities with a top external rating that are European Central Bank eligible as liquid assets.

Braunschweig, 21st March 2013