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EACB draft position paper on EBA discussion paper on the process to define highly liquid assets in the LCR

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A. GENERAL REMARKS

EACB appreciates EBA's efforts in developing a methodology to define liquid assets. It seems that a significant "academic" work has been done by EBA when developing the discussion paper. This is difficult to challenge in detail for the time being. Nonetheless, we would like to express some concerns and suggestions relating to the proposed methodology.

Scope of Application

The discussion paper explicitly mentions transferable (and listed) assets with high and very high liquidity and credit quality. This is in accordance with article 481 (2) CRR-draft. However, in addition to that, the current CRR-draft allows for further assets to be qualified as high liquid assets in the LCR (i.e. in article 404 (1) (1) lit dc.). Nevertheless, the classification criteria suggested by the EBA do not refer to these additional assets.

Impact of future regulation

The impact of the recent regulatory developments, such as Basel III and the EU's financial transaction tax (FTT) proposal should be carefully considered. These will have a significant impact on market liquidity. In particular, the FTT proposal is expected to have a substantial negative impact on the debt securities and repo markets leading to considerable shrinking of such markets. This will reflect in the availability of short term liquidity. Combined with a restrictive definition of liquid assets, it could prove damaging to banking business.

Wider definition of liquidity

In general, the test of liquidity of an asset should not be limited to its transferability but must also take into account the ability of the bank to "repo" it. The repo market allows banks to raise funds on money markets by pledging assets - it is a key source of short-term liquidity.

The inclusion of level 2B assets as suggested by BCBS (amongst which RMBS) in the stock of HQLA will prove beneficial to the bank's mortgage lending possibilities and thus have a positive impact on the real economy and housing market. Furthermore, it leads to a more diversified liquidity buffer. Nonetheless, 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, it will have a limited impact because the European economy is mostly financed by banks and not by capital markets. Therefore, the HQLA should be extend the to all standby facilities granted by central banks and central bank eligible assets.

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 fulfil a set of required criteria.

Avoiding market distortions

In case of too narrowly defined criteria, the demand for HQLA will exceed the supply. This would disproportionally drive up the prices of the HQLA and therefore favour the HQLA market segments. Other market segments, which are not fulfilling the HQLA criteria, will be at a disadvantage and the banks' demand for the specific asset. This can have an impact on the real economy and banks' SME business which is of high importance as the SMEs are the backbone of the European economy. This can happen 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 as compared to benchmark issues of big corporates, which are already represented on the market with a big, liquid total volume;
- ECB-eligible corporate loans as compared to HQLA corporate bonds.

The effect of the rules will lead to a self fulfilling prophecy. What is included in the liquidity buffer will become liquid, as more and more market participants will try to hold such assets to satisfy the LCR requirements.

EBA should take the above mentioned issues into consideration. Moreover, it should measure the total amount of liquid assets after applying all the rules to see if it is not too restrictive.

Size of domestic market and locally active banks

The Basel III Agreement is focusing on the stability of the global system when defining the liquid assets. It does not deal with the institutions which are active primarily in the domestic markets. The most important factors, in this case, are related to the domestic environment. We do not believe that small institutions should hold as liquid assets highly rated US bonds or stocks listed in other stock exchanges in the EU than the national one. Instead they should rather hold domestic bonds or shares, components of the main index of the domestic stock exchange, even if those securities have no external rating or are rated below A.

The possibility of diversification of liquid assets is desirable also in the case of BBB rated countries or non-investment grade countries. Therefore, at least securities denominated in local currencies should be accepted as 'locally high quality liquid assets'. These should be allowed to be used for covering the net cash-outflow in domestic currencies, provided that the rating of the securities is near to the sovereign rating and the higher volatility is reflected in higher haircuts. Therefore, it is worth reporting separately these assets during the observation period. We think that this approach would be in line with the principle defined by EBA that if "a certain asset class is liquid in a specific EU jurisdiction does not imply that the same asset class would be liquid in all EU jurisdictions."

Moreover, any kind of metrics which is defined in absolute values does not take into account the size of the domestic market. This would be detrimental for all small EU countries, especially for those outside the Eurozone. This issue should be reflected in the proposed methodology. The inclusion of some relative metrics and qualitative judgements could improve the situation.

Size of banks and liquidity portfolio size and composition

The size of the bank and the and the liquidity portfolio size should be taken into account. Depending on the size, a different behaviour will be displayed by banks. In case a bank wishes to liquidate part of the buffer, there is a difference in the units of the assets to be liquidated, as well in the volume of the buffer 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 in the market. If a big bank has to liquidate a buffer of several billion, this can't be done without raising attention and experiencing price reactions.

Moreover, it has to be taken into account that the literature cited is based on the evidence from large markets and not small ones. One of our concerns is that practically the proposed metrics applied in small and non-investment grade countries do not widen the HQLA to also include assets which would be liquid assets otherwise. Small local banks in non-investment grade countries will require a different composition of liquid assets as compared to a similar bank in an investment grade country, due to the limitations imposed by the sovereign rating over the other domestic ratings. Mortgage bonds in domestic markets will not be treated as HQLA even if thy are liquid in the domestic market, for example.

Limitations of historical market data and use of more forward looking method

Historical market data (volume and bid-ask spreads) don't deliver a clear statement about the liquidity of bonds in certain market phases. In phases with buyer surplus and low trading activity, volumes are low despite good demand, because there are too few sellers in the market. At the same time the bid-ask-spreads are wide. Currently, we are experiencing such a market phase. However, considering the volume and bid-ask spreads in this case does not entail a fair assessment of the ability to raise liquidity. As there is a demand, banks would be able to raise liquidity - they could easily sell bonds.

In addition, the market conditions will change with the introduction of the Financial Transaction Tax. The transactions volumes are expected to decline, because of the burden of taxes and duties.

Moreover, historical data will not be able to reflect the rising liquidity of certain assets, which is caused by liquidity requirements. If an asset class is a homogenous, European wide HQLA, there will be a natural demand for this asset class.

We also see a limitation with regard to the date sources of historical data. The database 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.

As a result of the above mentioned problems, we see significant limitations to the ability of historical data to reflect the future liquidity characteristics of certain assets. Thus, in general we believe that a methodology for defining liquid assets should put more emphasis on more macro-economic, qualitative aspects instead of quantitative aspects. As previously mentioned, recent regulatory developments, such as Basel III and FTT have should be considered as well. These will have a significant impact on market liquidity. Therefore, a more forward looking methodology, making use of qualitative aspects is desirable.

To our understanding, each individual institution needs to make its own judgment, based on the outcome of EBA's methodology, whether or not a specific ISIN is LCR compliant This seems inefficient and could lead to inconsistencies. A list with LCR compliant assets (ISIN) at a central European level should be published instead. We favour a central definition of HQLA classes, taking into account macroeconomic risks, whether through an European institution (European Central Bank, European Bank Supervisor) or a national authority (Central Bank) taking into account national characteristics. This authority should keep an ISIN based central register of HQLA (for transparency reasons and to avoid arbitrage). The bandwidth of the HQLA should be based on the collateral list of the ECB, in order not to create a price war and not to disadvantage some sectors, and to guarantee enough supply with HQLA.

In the following section you can find the answers to the specific questions.

B. ANSWERS TO SPECIFIC 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?

At a first glance, the data sample cover 2008-2012 seems conservative and not a fair depiction of liquidity characteristics, since it covers a stress period. However, market liquidity is difficult to forecast on base of historical analysis. This is especially true in the light of current regulatory developments, such as Basel III and the EU's financial transaction tax (FTT) proposal. In particular, the FTT proposal will have a significant negative impact on the debt securities and repo markets.

Other important limitations apply to the use of historical data, specifically it does not deliver a clear statement about the liquidity of bonds in certain market phases and will not be able to reflect the rising liquidity of certain assets, which is caused by liquidity requirements. (see general comments "Limitations of historical market data and use of more forward looking method"). We believe that a methodology for defining liquid assets should put more emphasis on more macro-economic, qualitative aspects instead of quantitative aspects.

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?

We consider it is necessary to make the analysis based on a broad range of data sources. The EBA discussion papers mentions the MiFiD transaction reports. It is important that the analysis of the repo transactions is based on a number of different sources as well.

For the analysis of repos (tri-party repos), data from agents (LCH, Clearstream, BoNY, etc.) could also be used. These agents have an extensive pool of data on repo transactions. We suggest as additional data sources Astec (Sungard) and Equilend. These might provide useful repo data as well. Further, the ICMA European Repo Council bi-annual survey of the repo market might prove useful.

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?

A condition for the recognition of a security in the highly liquid assets is the marketability (i.e. the securities must be readily and immediately be exchanged for cash can, without significant reductions in value). Some of the EBA liquidity and activity measures listed in the discussion papers ("minimum trade volume of the assets", "proven record of price stability") are important measures that market participants should take into account. On the other hand, practical implementation and daily handling and application in the liquidity management of banks of other criteria is very difficult to do. The criterion "Remaining time to maturity" (as an asset characteristic) is highly dependent on the current market conditions. In some market phases there are more short-term securities of certain issuers and in other situations rather the long-running emissions are more common. Moreover, the influence of this criterion on the liquidity is also dependent on the asset class. Thus, this issue has to be carefully examined in order to make valid inferences.

The bid / ask spread and turnover ratio are particularly vulnerable to cliff effects and therefore appear less suitable.

Additionally, we have serious concerns that the proposed metrics do not take into account the size of the specific countries and the domestic markets.

Q4. 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?

Some of the EACB members have assessed their securities and have found that the following criteria objectively describe the market liquidity of those assets:

- Central bank eligibility
- Capability for GC Pooling and extended GC Pooling or repo-ability (tri-party repurchase agreements, bilateral agreements)

- Listing on a recognized stock exchange
- Ease and confidence of pricing (excluding complex structured products)
- High credit quality

The first two criteria are considered “general explanatory characteristics that refer to market structure”. The criteria indicated are not intended to be fulfilled all at the same time, but rather if 3 out of 5 criteria are met, the asset could be considered as HQLA.

We have some concerns with regard to the general explanatory characteristics that refer to market structure that have been identified by the EBA ("presence of a large number of market makers", "wide range of potential buyers" and "transparency"). The practicality for market participants and ability to objectively measure such characteristics is not evident. Rather, the collateral eligibility and repo ability should be considered in this case as well as GC pooling ability.

The issue size (EBA general explanatory characteristics specific to asset) is not a suitable criterion for the market liquidity of a security. Even securities with a volume of less than 250 million euros, for example, can easily be converted into cash at any time as part of a repo of eligible issuers. As an example, issues by German Länder often have a small issue size but may be converted at any time at the ECB/ Eurex in liquidity and have a low credit risk.

Moreover, we suggest the list to be complemented with institution specific aspects such as share that the institution owns in relation to the total outstanding amount in the market, share that the institution owns in relation to the total liquidity buffer of the institution (concentration).

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

The methodology should be more forward looking, taken into account qualitative aspects, such as future regulatory developments. In fact, the qualitative aspects should get more weight than the quantitative aspects, since recent history has proven that market circumstances can change rapidly. Moreover, new regulatory developments have a significant impact on the market, so history becomes less relevant.

The methodology should include, at least to some extent, relative metrics and qualitative judgements which take into account the size of the country and the development level of the economy.

In light of the diverse business models of banks, a simpler procedure for measuring market liquidity of securities for liquidity buffers of the LCR appears to be desirable. Criteria to be observed at the level of individual securities are very hard to define objectively. Thresholds should be avoided due to lack of practicality. In general, a large list of criteria should also be avoided. The focus should be on a few, most relevant criteria, generally recognized in the market as an indicator of high market liquidity of an asset. Also, it seems reasonable to validate the identified criteria in the future and adjust the approach, if necessary.

More asset classes could be useful. Allowing for the grading of liquidity through different haircuts could be included.