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Response to EBA Consultation on derogations for currencies with constraints on the availability of liquid assets (EBA/CP/2013/39)

Finance Norway welcomes the opportunity to comment on the EBA consultation paper related to derogations for currencies with constraints on the availability of liquid assets (EBA/CP72013/39).

1. Key points

- Banks with activities in jurisdictions with deficits of available liquid assets, as defined by regulators, are penalised twice since additional haircuts apply to the derogations as well as caps on the total usage of the derogation.
- We support the view that banks should not have economic incentives to use the derogations. However, the lack of available liquid assets must be considered as a disadvantage for those having to fulfil the LCR, and not an advantage or a result of less professional liquidity management.
- Setting a cap on the usage of derogations for the individual bank based on a macro perspective may have unintended consequences. A macro average shortage of liquidity reflects a range of individual bank (micro) shortages. Banks with a shortage below average (or with no shortage) will have an incentive not to reduce their holdings of liquid assets in order not to hit the cap and thus further draining the market for liquid assets, i.e. reducing the pool of available liquid assets for banks with a shortage above average.

2. Proportionality of derogations for smaller banks

We note that it was said in the EBA hearing on 19 November that the observance of the principle of proportionality (PoP) with regard to the application of the derogations was not mandated to the EBA in its task to provide its technical standard by the CRR.

According to the EU supervisory authorities, the PoP may be applicable even when it is not spelled out in specific legal texts. It can, therefore, be applied even if the specific CRD provision concerned has not made an explicit reference to the PoP (3L3 Task Force on Internal Governance, Cross-sectoral stock-take and analysis of internal governance requirements).

The use of foreign currencies to fulfil the LCR-requirements will be especially problematic for smaller banks, not having foreign exposures as a significant or natural part of their businesses. For these banks the second alternative of credit lines from the central bank will be the only derogation available. Typically, banks will be resistant to use the liquidity available through such facilities, due to the following negative market assessment. The lines will then represent a regulatory requirement more than an actual liquidity buffer.

3. Response to Consultation Questions on Derogations for currencies with constraints on the availability of liquid assets (EBA/CP/2013/39)

Q1: Do you agree with the proposed notification mechanism, its contents and timelines? If not, why not, and what should be altered?

We agree that it will be appropriate to have a mechanism of notification. There is also a need for an exclusionary provision, as proposed by the EBA, to allow for situations where the 30 day notification period will be inadequate. This might be due to changes in market conditions which might not necessarily be regarded as “exceptional circumstances”. We thus propose that a change is made to the wording to allow for a broader interpretation.

Q.2 Are the steps to prevent the unnecessary use of a derogation clearly described? Do you see these steps as appropriate? If not, why not, and what should be altered? Are there any additional specifications that could clarify the assessments under paragraphs 1 and 2 of Article 3?

The steps to prevent unnecessary use of the derogations are clearly described. However, we do not see the steps as necessary, as the use will come with a cost. Banks will by nature have a high incentive to reduce the need for derogations by sound liquidity management and have a preference for holding liquid tradable assets denominated in relevant currencies.

Requiring banks to test the price effect of purchases of liquid assets in markets where there is a shortage of available assets will result in unnecessary volatility. For large banks such activity might also be in conflict with market abuse regulations due to the size of the required purchases.

Q3: Are the workings and conditions of derogation A clearly described? Do you see these steps as appropriate? If not, why not, and what should be altered?

The workings and conditions of derogation A are clearly described. However, we find certain parts of EBA's suggested additional requirements (assessment and notification) somewhat unnecessary and

rigid, and representing an additional regulatory burden to the institutions becoming dependent on the derogations.

Q4: What criteria would you regard as useful for evaluating the historical evidence as mentioned in paragraph (4a) of Article 4?

As put forward in EBA's consultation paper the fundamentals behind a currency's sensitivity may change over time. To assess the currency risk for currencies not actively traded in global foreign exchange markets we find a period of 5 years to be more appropriate than the proposed 10 years. It might also be appropriate to assess the risk in the relevant currencies based on average movements within the time period.

Q5: Is the additional 8% haircut on foreign-currency-denominated assets held under derogation A appropriate? If not, why not, and what alternative treatment would you propose?

The additional 8% does not take into account the fact that currency risk may be hedged (as addressed by Article 418(1): "If the institution hedges the price risk associated with an asset, it shall take into account the cash flow resulting from the potential close-out of the hedge."). Thus, there is a risk of counteracting the rule of applying this 8% cap on any discrepancy between the distribution by currency of Liquid Assets and Net Cash Outflows.

We find that there should be closer harmonisation with the BCBS standard in this area. I.e., competent authorities should be able to allow for exemptions from the additional 8 % hair cut. As stated in paragraph 61 in the BCBS standard from January 2013, there is a need to accommodate a certain level of currency mismatch that may commonly exist among banks in their ordinary course of business. The Norwegian foreign exchange market is also highly liquid, which allows banks to efficiently hedge their liquid assets denominated in foreign currencies, reducing the need for additional haircuts. Since 1998, monthly turnover in the Norwegian market for foreign exchange swaps has increased by 247 % according to the Triennial Central Bank Survey conducted by BIS¹. Turnover of currency swaps in April 2013 totalled at USD 375 364 mill., constituting to 83 % of total turnover in the foreign exchange market over the same period.

Furthermore the additional 8% haircut on foreign-currency denominated assets does not recognize the risk-reducing correlation effects between liquidity stress in a domestic financial system and its foreign exchange rate. For example, it may be shown that in periods of stress, some currencies may depreciate vs global reserve currencies, USD and EUR, so that banks holding foreign assets denominated in these currencies would benefit when converting these to their home currency.

Q6: Are the workings and conditions of derogation B clearly described? Do you see these steps as appropriate? If not, why not, and what should be altered?

¹ <http://www.bis.org/publ/rpfx13fx.pdf>,
http://www.norges-bank.no/pages/97937/BIS_Report_2013_eng.pdf

If the EBA retains a pricing formula of these credit lines in its final RTS, we draw its attention to the fact that the resulting fee should not be too high, or the banks will not resort to these facilities, favouring an arbitrage between the fee of these credit lines and the cost of term borrowings from the Central Bank placed on an overnight basis at the Central Bank.

In general there is a stigma associated with the use of central bank lending facilities if not part of ordinary money market operations. Banks will enter into such facilities for regulatory purposes only.

Q7: Is the proposal to limit the total use of the derogations by an institution to the relevant shortage percentage in the annex of the draft ITS containing a list of currencies with constraints on the availability of liquid assets under Article 419(4) CRR clearly described? If not, why not, and what further matters should be included? Do you see these stipulations as appropriate? If not, why not, and what should be altered?

As stated in our response to the EBA Consultation on the draft ITS regarding currencies with constrained availability of liquid assets (EBA/CP/2013/38), we find the suggested method of calculating the shortage of liquid assets to be less robust and transparent than what is needed to be basis for such an important part of public regulation.

Generally we do not find it appropriate or necessary to limit the total use of derogations. Rather than setting constraints on macro level, the usage of derogations should be supervised by appropriate authorities with the possibility of taking additional steps towards the banks using derogations if the total usage of derogations exceeds what the estimated shortage should imply.

Furthermore, we cannot see the rationale behind banks having to demonstrate that they have made all the possible efforts to reduce their need for these derogations. There are specific haircuts and pricing conditions to offset any economic incentive to use these derogations. Consequently, there is no need to add another constraint such as this quantitative cap.

Q8: Do you agree with the above analysis of the cost and benefit impact of the proposals?

We do not agree with pt. 14 and 15 in the analysis of the cost and benefit impact of the proposals.

The requirements raised in this RTS will raise material costs for the institutions that will be dependent of the use these derogations, including notification requirements and costs related to efforts made to reduce the need for the derogations.

The lack of available liquid assets must be considered as a disadvantage for those having to fulfil the LCR, and not an advantage or a result of less professional liquidity management. We thus find it misleading of the EBA to claim that the risk of creating an uneven playing field (pt. 15) is small based on the fact that the number of institutions and total assets in Norway and Denmark is small relative to the number of institutions and total assets held by the banking sector in the EEA.

Taking into account the proposed requirements needed to be undertaken by an institution in advance of using the derogations, haircuts on foreign currency fulfillment, increased foreign

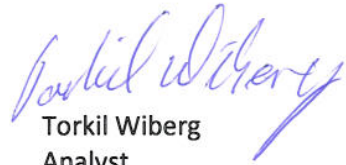
exchange risk, fees paid for credit lines, the need for derogations will pose a severe disadvantage for these institutions.

Q9: Please provide any evidence or data that would further inform the analysis of the likely cost and benefit impacts of the proposals.

Please refer to footnotes under Q5.



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