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Response to EBA Consultation on currencies with constrained availability of liquid assets (EBA/CP/2013/38)

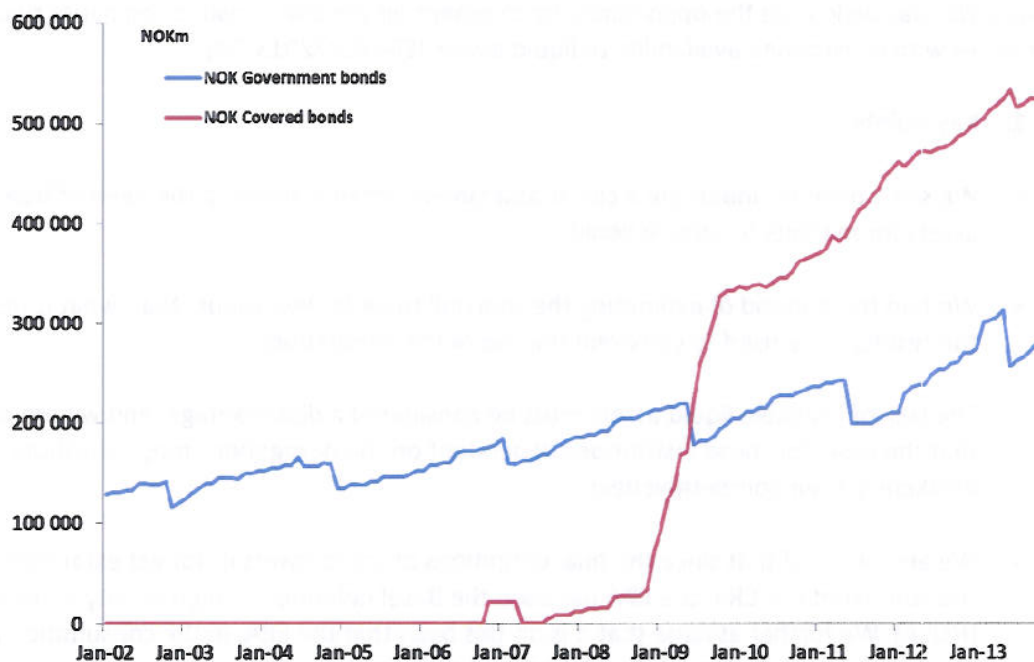
Finance Norway welcomes the opportunity to comment on the EBA consultation paper related to currencies with constrained availability of liquid assets (EBA/CP72013/38).

1. **Key points**

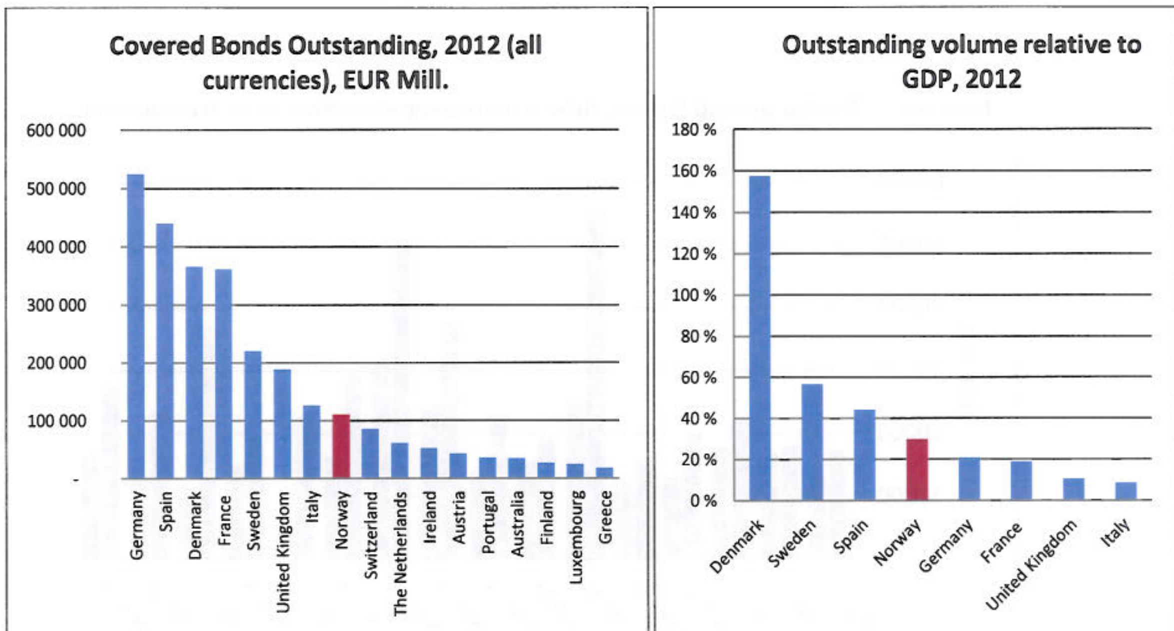
- We see a need to undertake a closer assessment when estimating the need of free-floating assets for markets to remain liquid.
- We find the method of estimating the shortfall to be far less robust than what is needed for the results to be used to constrain the use of the derogations.
- The lack of available liquid assets must be considered a disadvantage, and we are concerned that the costs for those institutions dependent on the derogations may contribute to weakening their competitiveness.
- We are aware of that since the final definitions of liquid assets is not yet established within the context of the CRR, the EBA has used the Basel definition of high quality liquid assets (HQLA). We further assume that it is on this basis that the EBA, in the consultation paper, has deemed the Norwegian covered bond market to not be sufficiently liquid. However, this conclusion seems to be based solely on what is regarded, by the EBA, as low trading volumes. We find the conclusion not to be in line with the actual situation. Given the importance of this issue we will hereinafter present some key features of the Norwegian covered bond market to provide a more nuanced picture.

2. The Norwegian covered bond market

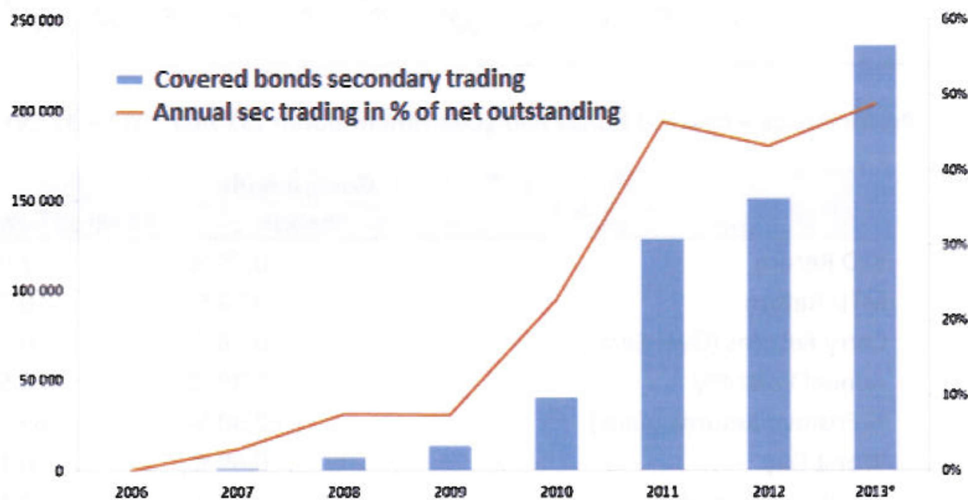
Since the Norwegian covered bond act was passed in June 2007 the domestic covered bond market has outgrown the Norwegian government bond market in terms of outstanding volumes, and is by market participants regarded to be as liquid as the government bond market. During the financial crisis in 2008 – 2009 the government introduced a swap facility, in which covered bonds were exchanged with Norwegian government treasury bills. This essentially meant efficient covered bond funding and no primary market execution risk, and was therefore seen as very favorable by the Norwegian banks. Towards the end of 2009 the swap facility effectively closed and regular market issuance ensued. The swap facility had however boosted the number of issuing institutions in the market and there are now 23 issuers of covered bonds in Norway.



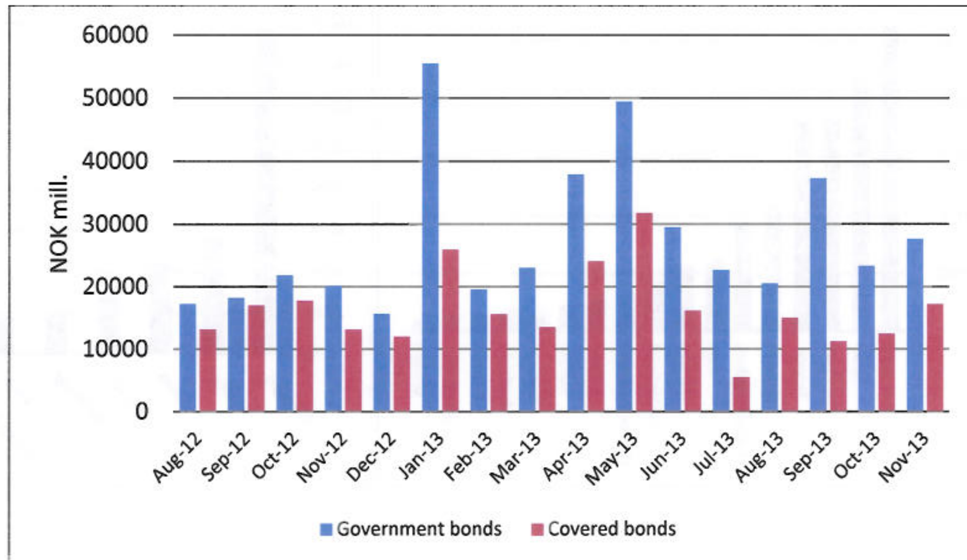
The outstanding volume issued by Norwegian institutions passed EUR 100 billion in 2012, and is relative to GDP the fourth largest covered bond market in Europe.



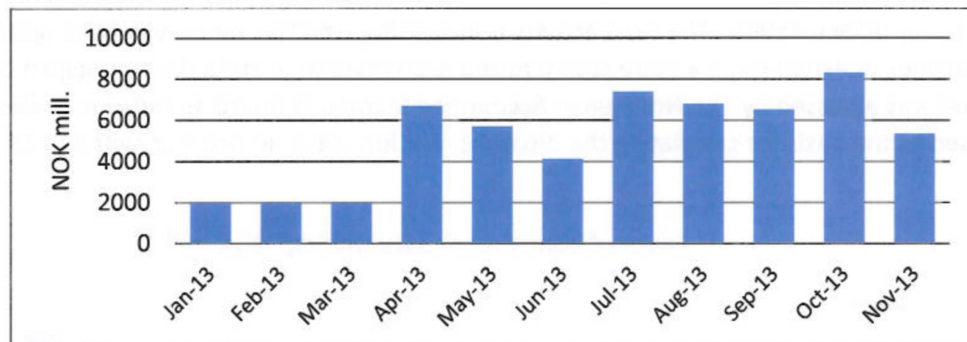
As the market has grown, the activity in the secondary market has been steadily increasing. Data show a turnover rate approximately at the same level as government bonds excluding repos, and with lower price volatility. The repo activity is increasing, and the industry is investigating the possibilities of establishing a more standardized repo market. In 2012 the Norwegian covered bond market was assessed by The Norwegian Accounting Standards Board as sufficiently deep and liquid to be used as the basis for calculating the discount rate for use in accordance with IAS 19.



Oslo Stock Exchange and Nordic ABM – Turnover exclusive repo transactions



Oslo Stock Exchange - Covered Bond Repo transactions

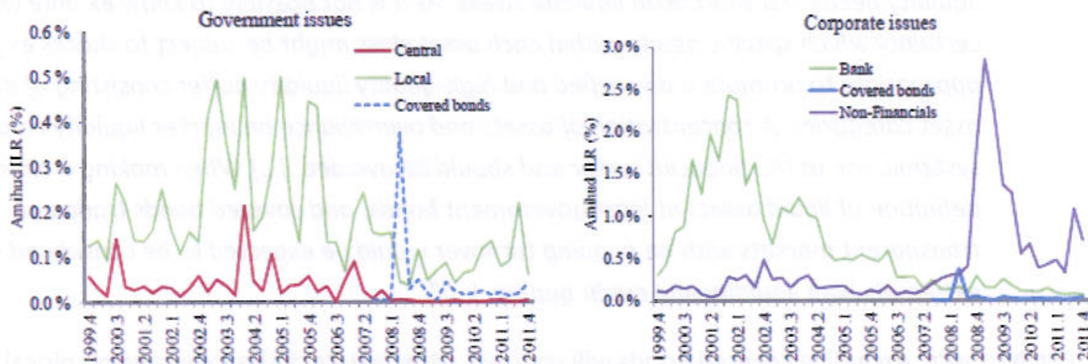


Performance – covered bonds and government bonds (31 Aug 2012 – 31 Oct 2013)

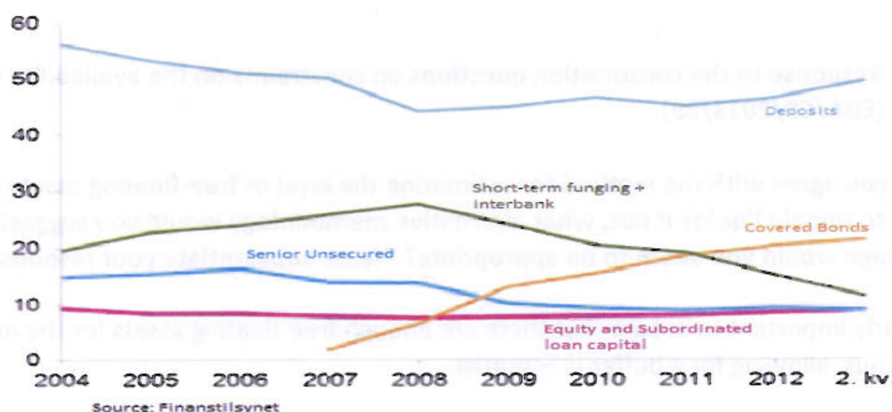
	Government bonds	Covered Bonds
YTD Return	-0.75 %	2.00 %
MTD Return	0.29 %	0.29 %
Carry Returns (Over Swap)	-0.78 %	0.34 %
Annual Volatility	2.38 %	0.52 %
% Positive Returns (daily)	62.30 %	69.95 %
Worst Day	-0.69 %	-0.10 %
Maximum Drawdown	-1.63 %	-0.15 %

Source: Nordea Norwegian Bond index

Rakkestad, Skjeltorp and Ødegaard (2012) found that the Amihud illiquidity (ILR) ratio for Norwegian covered bonds were similar as for government bonds. The ILR measure captures the price impact for each volume unit of trades, where a low ILR indicates a low price impact in response to liquidity demand. As shown below the ILR for covered bonds is similar that of government bonds and significantly lower than for corporate issues. The peak in the ILR during 2008 coincides with the start-up of the Norwegian covered bond market. Impacts at that time will not be comparable to similar incidents today, as the market volume was 1/5 of today's volume.



Due to low public sector borrowing needs, covered bonds offer an important source of long term, high quality assets to the Norwegian capital market. The Norwegian covered bond market is also vital for the banking sector as a funding tool, and has made it possible for banks to significantly increase their share of long term funding.



Well functioning capital markets are generally important for financial stability and covered bonds have already proved to be the most reliable source of wholesale funding through adverse market conditions. Norwegian covered bonds were also important in solving the liquidity crisis in 2008/2009, by being the basis for the "swap arrangement" set up by the government. The phase out of this arrangement during the first half of 2014, and the subsequent refinancing will supply the market with assets which until now have been locked-up due to the swap arrangement.

Defining covered bonds as illiquid and thereby not eligible for the LCR will pose severe problems for Norwegian banks in complying with the LCR-requirements due to a very limited government bond market which limits the pool of eligible liquid assets denominated in NOK. It will also have a detrimental impact on the covered bond market and the national capital market in general. We would also like to point out that such exclusion will not be in line with the following statements included in Recital 100 of the Capital Requirements Regulation (CRR):

> *"Institutions should hold a diversified buffer of liquid assets that they can use to cover liquidity needs in a short term liquidity stress. As it is not possible to know ex ante with certainty which specific assets within each asset class might be subject to shocks ex post, it is appropriate to promote a diversified and high-quality liquidity buffer consisting of different asset categories. A concentration of assets and overreliance on market liquidity creates systemic risk to the financial sector and should be avoided. [...] When making a uniform definition of liquid assets at least government bonds, and covered bonds traded on transparent markets with an ongoing turnover would be expected to be considered assets of extremely high liquidity and credit quality. [...]"*

Furthermore, excluding covered bonds will contradict the results of the extensive empirical study undertaken by the EBA, presented at a public hearing on the 23rd of October 2013, which ranked covered bonds very similar to government bonds.

We find that available data gives sufficient evidence to include covered bonds in the category Extremely High Liquid Assets (Level 1) under the definition of the LCR, ref. CRR article 416 1 (b).

3. Response to the consultation questions on constraints on the availability of liquid assets (EBA/CP/2013/39)

Q1: Do you agree with the method for estimating the level of free-floating assets required for a market to remain liquid? If not, what alternative methodology would you suggest and what percentage would you deem to be appropriate? Please substantiate your response.

It is clearly important to ensure that there are enough free-floating assets for the markets to remain liquid. Thus, allowing for a buffer is essential.

However, we believe that the general approach of assuming a buffer of 25 % of total demand might be an unfortunate simplification. As the EBA recognizes, there might be a need for a larger buffer in smaller markets. On this basis it seems appropriate to consider a more dynamic buffer requirement, which at least takes market size into consideration. An alternative, more precise approach is to conduct an assessment regarding the buffer level of all the different markets when the final definitions are ready.

Q2: Are the assumptions regarding locked-up assets reasonable and, if not, what alternative assumptions should be made? Please substantiate your response.

We agree with the general assumption that assets held by pension funds, insurance companies and central banks are regarded as 100 % locked up. Although, it seems unclear whether the EBA considers all assets owned by foreign investors to be locked-up. There are also other sources of locked-up assets such as collateral held with the central bank for intraday liquidity, collateral posted under CSA's, CCP's, supplementary assets in cover bond pools, etc.

In the consultation paper EBA states that "Specifically for Norway, it has been observed that roughly one fifth of the government debt is held by foreign investors that are dominated by central banks and other buy-and-hold investors, amounting to roughly NOK 105 billion of government debt locked up". This is not in accordance with official data. As of June 2012 the amount of government debt held by foreign investors was close to 50 %. If all debt held by foreign investors is assumed to be locked-up the amount of Norwegian government debt locked up should be NOK 227 billion – not NOK 105 billion.

Q3: Is 110% a reasonable assumption for an institution's target liquidity coverage requirement? If not, please outline what you deem to be a reasonable assumption regarding an institution's target liquidity coverage requirement. Please substantiate your response.

An average 110 % target may be a reasonable starting point in general. The individual institution's adaption to the LCR may however vary significantly between institutions due to size and scope of operations. Large banks operating as settlement banks will for example need to take into account larger fluctuations in liquidity and might need to set the target higher. Smaller banks with more predictable liquidity fluctuations might set the target lower. The target may also vary over different macro cycles and between currencies. Since the macro liquidity in NOK varies much more than for most other currencies, Norwegian banks in general have a higher volatility in their liquidity positions than banks operating in other currencies. This implies that Norwegian banks will need to hold a higher buffer towards the liquidity coverage ratio than banks with less volatile liquidity positions. Thus, an average target of 110% may be too low for NOK, and should be re-examined over time.

Q4: Do you agree with the general approach and its results?

If the calculated shortage shall act as the constraint on the use of derogations it is clearly important that this is estimated correctly. The need for transparency on input data, method and assumptions are crucial. We do not find these areas sufficiently presented in the draft ITS.

The estimated shortfall and thereby the suggested constraint on the use of derogations will be heavily dependent on the assumptions made by the EBA. The shortage of 63% for Norway could easily be calculated both higher and lower, with slightly different assumptions. Our conclusion is that the methodology gives results which are far less robust than what is needed for such an important part of public regulation. The sensitivity analysis clearly supports this view by showing that the shortfall varies from 47 % to 83 %. This suggests that the use of derogations cannot be solely

dependent on the estimated shortfall. It is also clear that the use of derogations will have to vary between banks. Smaller banks will not use a derogation to invest in liquid assets in foreign currencies which might imply that the available pool of liquid assets for larger banks will be less than the average number calculated.

The outstanding amount of government debt in Norway has also been temporarily high in the period 2009 – 2014 due to the swap arrangement established by the Norwegian Government. Available government debt will thus be reduced when the arrangement expires increasing the shortage.

Including Norwegian equities as available liquid assets in Norway overestimates the available liquid assets for banks in Norway. Norwegian banks have no tradition of holding equities on their balance sheet.

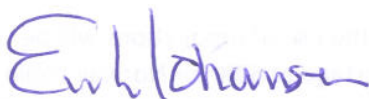
Q5: Do you agree with the above analysis of the cost and benefit impact of the proposals?

We do not agree with pt. 9 in the Draft cost-benefit analysis/impact assessment, where the EBA states that:

"The EBA has currently identified only two EU currencies for which the availability of liquid assets is less than their justified demand. The number of institutions operating in these currencies is also small and the amount of total assets that they hold represents only a small share of the total assets held by the banking sector in the EEA. The risk of creating an uneven playing field for the application of the liquidity coverage requirement is therefore small".

From our point of view, the lack of available liquid assets must be considered as a disadvantage for those having to fulfill 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 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.



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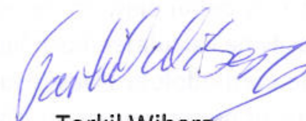

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