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BNP Paribas' response to EBA Consultation Paper on
Draft Regulatory Technical Standards on
Additional Liquidity Outflows due to Collateralized Transactions
Published 23rd May '13, end consultation period: 14th August '13

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BNP Paribas welcomes the opportunity to help the EBA with designing a robust and consistent regulatory framework for liquidity.

The design of the method to measure potential liquidity outflows due to market-risk-driven changes in collateral is an important and difficult issue to address, notably to ensure consistency with other assumptions in the Liquidity Coverage Requirement (LCR).

Please find our general comments below and detailed comments in appendices:

- *Appendix A*: LCR assumptions considered in isolation could lead to inconsistent results – A few examples
- *Appendix B*: Key components to factor in all methods to calculate Liquidity Outflows for collateralized transactions
- *Appendix C*: Detailed Responses to Consultation Paper's Questions

We stand ready for any additional information.

We concur with suggesting several methods, adapted to different level of sophistication or materiality to different banks:

The proposal to have three methods, *Simplified Method*, *Standard Method* and *Internal Method*, is valuable since it will enable to be more adapted to the sophistication level of reporting institutions.

However, it is not clear, a priori, if the methods would lead to similar or very dissimilar results. **Quantitative Impact Studies (QIS) are absolutely necessary.**

How would the election of 1 method amongst the 3 be defined ? Would it need a specific validation by the competent authority ?

The methods should factor in key components to be consistent:

As the LCR assumption set is prone to inconsistencies regarding capital market transactions, with risks of double counting and inconsistencies between different LCR assumptions as illustrated in our *Appendix A*, we recommend modifying the methods so that they factor in key components as detailed in *Appendix B*:

    i.   **Adopt a *Constant Level of Risk approach* in the *Internal Method***, as it is applied in *Simplified Method* and *Standard Method.* This means that the market risk exposure during the next 30 days should be assumed constant with the market risk exposure as of its initial value.

    ii.   To **ensure consistency with LCR systemic crisis scenario and consistency with other LCR assumptions**, the adverse market scenario should be consistent with the other LCR assumptions: Extremely High Credit and Liquid Assets (EHCLA) should be assumed *not to* lose value while non-EHCLA should be assumed to lose 20% of their value (as specified in Article 423(1)).

       Though the *liquidity* values referred to in Article 418(1) of *Liquid Assets* defined in Article 416 combine assumed changes in market values and assumed changes in applicable liquidity

haircuts, they could serve as references to derive LCR-consistent market adverse scenarios for the measurement of potential liquidity outflows on collateralized transactions.

If the retained process to determine market adverse scenario does *not* ensure consistency with the other LCR assumptions, there should be mitigation factors to determine liquidity outflows. Several possibilities could be applied, in isolation or in combination, as listed below:
- o lower the magnitudes of the *Standard Method* shocks and *Internal Method* threshold
- o eliminate market scenarios that are inconsistent with LCR (ex: don't consider scenarios for which equities go up, or credit spreads go down or interest rate go up…)

Attention should be paid to the reduction in European's banks financing capacity:

As each European bank will be subject to LCR, including an additional liquidity outflow for collateralized transactions, each of which will be based on a bank-specific adverse scenario, the additional outflows will decrease the funding capacity of European banks as a whole.

To illustrate, let's consider that European banks were dealing only with other European banks. Then, at global European banking level, considered as a whole (as if it was one bank), there should be no need for a buffer and no need to allocate a portion of their available funding to this buffer. However, as each European bank will have to build up a portion of its liquidity buffer and dedicate a portion of its available funding to additional liquidity outflows for collateralized transactions, it will decrease the amount of financing capacity of each European bank to the detriment of other assets to be funded (notably loans). This effect will be all the more important as, at the individual level, adverse market scenarii differ between banks, which will subsequently create a massive over-sizing of the liquidity needs at a global industry level, as well as per individual bank.

What is true at European level as a whole applies at each group level: there will be a loss of financing capacity.

For all the reasons above, we urge EBA to conduct *Quantitative Impact Studies* (QIS), covering different methods, to determine the extent of those liquidity outflows for each European institution, for *each* European banking group level and for the European banking group level.

Appendix A
LCR Assumptions considered in isolation could lead to inconsistent results: A few examples

Let's consider a few very simple examples:

a) asset swapped position : a fixed rate debt instrument (e.g. a bond) whose fixed rate risk is hedged with a payer fixed/receiver floating swap. Let's assume that the swap is collateralized.

Should the methodology to determine outflow consider the swap in isolation of the debt, the swap would appear to create a directional interest rate risk: a LCR additional outflow for the collateralized swap would be assumed relating to an assumed *decrease* in interest rates (adverse market rate scenario for that collateralized position).

If the debt instrument is an extremely high and credit quality security, with a 0% applicable liquidity value haircut, it means that its LCR-liquidity value is assumed to be *unchanged* in the LCR-stress scenario. Hence, as interest rates are assumed to decrease while the debt security value is assumed to be unchanged: it means that the debt credit spread is assumed to *increase* in exactly the opposite direction to the assumed decrease in interest rate. This is *inconsistent* since this extremely high liquid and credit quality debt instruments would most probably benefit from a flight-to-quality in the LCR stress test scenario with a *decrease* in their credit spread.

Note that, if the LCR-liquidity value haircut was greater than 0%, the assumed increase in debt credit spread would be implicitly assumed to be even bigger (ie: it would be even more inconsistent).

b) In the example above, let's substitute the debt instrument with an equity that would be eligible to the LCR-buffer.

The swap is then an equity swap whose final payment is the difference between the actual change in value of the equity over the life of the swap and the expected change in value of the equity as of inception of the swap.

The adverse market scenario that leads to an outflow due to increase in collateral needs is an *increase* of the equity value, whereas the LCR would allocate an assumed *loss* of value to that very same equity through a higher than 0% applicable liquidity haircut. This is inconsistent.

c) Let's now consider a collateralized swap whose final cash flow for the bank is to receive the change in values of a non-Liquid Asset. This swap loses value for the bank when the value of the asset decreases. Let's assume that the adverse scenario corresponds to a 30% *decrease* in the value of the non-Liquid Asset, which leads to a 30% outflow.

To hedge its market risk exposure, the bank would typically enter into a reverse repo, and sell the security (spot short position). Let's assume that this reverse repo is shorter than 1 month. Then, the LCR assumptions, considered in isolation, applied to the reverse repo would lead to a 100% inflow (reverse repo runoff), offset by a 100% outflow from having to offset the short position (resp. 70% if the buy back is assumed to be for the adverse scenario market value of the equity, and 80% if the buy back is assumed to be for the market value net of the assumed 20% loss as specified in Article 423(1)). This would lead to a 0% outflow (resp. 30% inflow, or 20% inflow).

When combined with the assumed 30% outflows on the collateralized derivative, this perfectly hedged position (P&L-wise and liquidity-wise) should lead to a 0% outflow, which is the case *only if* the short position is assumed to be bought back at the adverse scenario market value of 20% loss.

All of the examples above demonstrate the need for consistency between the different LCR-assumptions to avoid LCR-outflows that could not actually happen simultanously: the direction and magnitude of the shocks to market risk factors should be consistent with the other LCR assumptions.

Appendix B
Key components to factor in *all* methods
to calculate Liquidity Outflows for collateralized transactions

A. *Adopt a* **Constant Level of Risk** *Approach for the* **Internal Method***:*

The outflow that is envisaged for adverse market scenario applied to collateralized transactions relate to a liquidity risk *contingent on the realization of market risk*.

The other LCR assumptions that relate to capital market transactions relate to the *illiquidity risk*: some assets are LCR assumed not to be liquid (non-Liquid Asset).

If the two were to be considered in combination (i.e.: market risk and illiquidity risk), this would lead to inconsistent output, as described below.

Most of the market risk exposure of a bank is managed *dynamically* in dedicated trading books, with constant rebalancing of the portfolio (i.e. adding risk mitigating transactions). If the rebalancing activity was to be denied in the next 30 day to derive a liquidity outflow, this would basically consider that market risk exposures are not managed over that horizon, which would be at odds with the prudential framework for market risk, and would lead to generating liquidity outflows contingent on having a non-managed market risk exposures.

To illustrate, let's consider the example of a collateralized 10 year swap market risk exposure, hedged with a 10 year bond *Future* that matures in the next 30 days. Both the hedged and hedging transactions are collateralized: the discrepancy between potential inflows and outflows from the two collateralized contracts would be minimal (materializing the spread between the swap rate and the *Future* cheapest-to-deliver security, and potential mismatch between the duration of the two transactions).

Over the LCR-horizon (ie 30 days, longer than the 15 days to the *Future* expiry date), the *actual* risk management would be to rebalance the *Future* position into the *Future* of the next expiry date.

Should the rebalancing position be denied (i.e.: ignoring the roll into the next future), a *directional* market risk exposure would appear between the *Future* expiry date and the 30 day LCR horizon: this would hence create a collateral-driven liquidity cash flow since in that remaining period only the collateralized swap would be considered.

Assuming no rebalancing would basically amount to assuming market total illiquidity for managing market risk exposures: this is far too strong an assumption, inconsistent with the market risk prudential framework and well beyond the LCR regulatory framework.

The market-risk-driven liquidity risk over the next 30 days should be considered with assuming rebalancing consistent with actual *dynamic* and *ongoing* market risk actual management.

We suggest that the market-risk-driven liquidity risk is calculated with the assumption of *constant market risk exposure over the next 30 days*,i.e. constant level of risk, *by applying the Internal-Model method at 1 day horizon scaled to 30 day horizon* (typically by multiplying by $\sqrt{20}$).

By the way, the constant market risk exposure is assumed for both *Simplified Method* and *Standard Method*: it should apply to the *Internal Method* too.

B. Ensure Consistency with the other LCR Assumptions:

Article 423(1) specifies an assumption on the loss of values for assets posted as collateral:

> *Collateral other than assets referred to in Article 416(1)(a), (b) and (c), which is posted by the institution for <u>contracts listed in Annex II and credit derivatives</u>, shall be subject to an additional <u>outflow of 20%</u>.*

This derives from BCBS §119

> ***Increased liquidity needs related to the potential for valuation changes on posted collateral securing derivative and other transactions:*** *(<u>20% of the value of non- Level 1 posted collateral</u>). Observation of market practices indicates that most counterparties to derivatives transactions typically are required to secure the mark-to-market valuation of their positions and that this is predominantly done using cash or sovereign, central bank, multilateral development banks, or PSE debt securities with a 0% risk weight under the Basel II standardised approach. When <u>these Level 1 liquid asset securities are posted as collateral, the framework will not require that an additional stock of HQLA be maintained for potential valuation changes</u>. If however, counterparties are securing mark-to-market exposures <u>with other forms of collateral, to cover the potential loss of market value</u> on those securities, 20% of the value of all such posted collateral, net of collateral received on a counterparty basis (provided that the collateral received is not subject to restrictions on reuse or rehypothecation) will be added to the stock of required HQLA by the bank posting such collateral. This 20% will be calculated based on the notional amount required to be posted as collateral after any other haircuts have been applied that may be applicable to the collateral category. Any collateral that is in a segregated margin account can only be used to offset outflows that are associated with payments that are eligible to be offset from that same account.*

Hence, Extremely High Credit and Liquid Assets (EHCLA), as defined in Article 416(1)(b)&(c), are assumed *not* to lose value while non EHCLA are assumed to lose 20% of their value: **To be consistent with LCR, market scenario to derive liquidity outflows on collateralized transactions should be consistent with assumed changes in values as specified in Article 423(1)**
As an illustration, equities should be assumed to lose 20% of their value (and not increase in values as is suggested in all methods). Similarly, credit spreads should be assumed to increase (and not decrease as is suggested).

Alternatively, Article 418(1) could be used as a reference to derive consistent adverse market scenario, since this article defines liquidity values for Liquid Assets as defined in Article 416:

> *The value of a liquid asset to be reported shall be its market value, subject to appropriate haircuts that reflect at least the duration, the credit and liquidity risk and typical repo haircuts in periods of general market stress. The haircuts shall not be less than 15 % for the assets referred to in point (d) of Article 416(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.*

Even though those liquidity values combine assumed changes in market values and assumed changes in applicable liquidity haircuts, they could serve as references to derive LCR-consistent market adverse scenarios for the measurement of potential liquidity outflows on collateralized transactions.

C. Should consistency with other LCR Assumptions not be ensured, mitigation factors should be used:

If the method to determine the adverse market scenario from which liquidity outflows for collateralized transactions are derived was not consistent with other LCR assumptions, **it would be absolutely necessary to mitigate the extent of the inconsistency by introducing mitigation factors such as the ones listed and then detailed below**:

    i. lower the magnitudes of the *Standard Method* shocks and *Internal Method* threshold
    ii. eliminate market scenarios that are inconsistent with LCR

i. Lower the magnitudes of the Standard Method shocks and Internal Method threshold

It is difficult to understand why a 99% threshold is suggested for the *Internal Method*.

In the Expected-Positive-Exposure from which the *Internal Method* is derived, the threshold is implicitly 65% (assuming a Gaussian distribution) as it is an expectation over the adverse scenario (positive counterparty risk exposure). None of the other LCR assumptions is derived from such a percentile approach. Why should a percentile approach be retained for liquidity risk while an expectation is retained for counterparty risk?

We suggest lowering the threshold to a conservative value of 80%, intermediary between the 65% (expectation over adverse market scenario) and 99% (extremely adverse scenario).

The magnitudes of the *Standard Method* shocks should be derived from the retained threshold for the *Internal Method*.

ii. Eliminate market scenarios that are inconsistent with LCR

The market scenarios that are inconsistent with LCR underlying systemic crisis scenario should be filtered out of the set of market scenarios under consideration to derive liquidity outflows.

Hence, all market scenarios for which equities would go up, or credit spreads would go down or interest rate would go up should be eliminated.

This should apply to the three methods: *Simplified Method*, *Standard Method* and *Internal Method*.

Responses to Specific Questions

Q 1. Is there any specific category of contracts subject to this Regulation that could only lead to immaterial additional outflows? If so, could you explain why and clearly specify the type of contract?

The term 'immaterial' is not defined. We suggest it is defined as 'less than 5% of the LCR Buffer of the reporting institution. Once the threshold for materiality is defined, there is no need to exclude or include a priori specific types of contracts: they will be included or excluded by application of the threshold.

Q 2. Does the specification in paragraph 2 give sufficient clarity on which flows are included and excluded for the purposes of this RTS? If not, please provide us with an alternative specification.

No, the specification in paragraph 2 is not clear enough, notably for the treatment of secured funding transactions.

Our understanding is that the intent is to avoid double counting cash flows that would be considered in other part of the LCR framework, such as:
- the requirement to consider derivatives' cash flows, *net of* the LCR-value of offsetting collateral flows as described in Article 422(6) and Article 425(3)
- the cash in-/out-flows on secured transactions (e.g. repo/reverse repo) as described in Article 422(2) and Article 425(2)(d)
- the additional collateral to be posted for collateralized derivatives as described in Article 423(1)

We concur to the intent of avoiding double counting and we suggest it should be explicitly mentioned in this Regulatory Technical Standard (RTS) as an overarching principle when applying it.

For sake of clarity, it would be helpful that the RTS specifies that it covers only the transactions that could lead to collateral changes in the next 30 days.

It would also be helpful to clarify how to exclude partial and final redemptions.

Let's consider two examples:
- a simple collateralized derivative with two certain (hence expected) cash-flows: a first cash-flow equal to 50 to be received in 15 days and a second cash-flow of 50 to be received in 3 months.
  The current present value is 99.99.
  Let's assume that the adverse market scenario leads to a present value of 49.9. The main part of the changes in present value (50 out of 50.09) is explained by the received cash-flow during the 30 day time horizon and should be filtered out from the calculation of liquidity outflows for changes in values of collateralized transactions… if it is already considered in Article 422(6) or Article 425(3).
- **On** an FX Swap maturing in 10 days, should the bank calculate a collateral variability related to market valuation over 10 days on this transaction or should it be excluded from the scope of the calculation?

It is our understanding that the intent of filtering out partial or final cash flows within the next 30 days (which includes filtering out maturing transactions within the next 30 days) is to avoid double counting with other LCR provisions that deal with those cash flows, notably Article 422(6) and 425(3).

However, this makes the calculation process quite complex as the simulations should net out market-scenario-dependent falling due cash flows from the market-scenario-dependent-changes in values of collateralized transactions. By the way, neither the *Simplified Method* nor the *Standard Method* is fully consistent with this filtering out those effects since they consider the changes in *spot* values of collateralized transactions.

An alternative that institutions should be allowed to use, would be to include the next 30 days cash flows in the scope of the liquidity outflows for changes in values of collateralized transactions and to exclude them from the application of Article 422(6) and Article 425(3). In other words, **transactions covered by Article 423(3) should not be covered by Article 422(6) and Article 425(3). This would help limiting the implementation cost.**

Please refer to *Appendix B – Key components to factor in all methods to calculate Liquidity Outflows for collateralized transactions*

Q 3. Would your institution face additional collateral outflows from securities financing transactions for other reason than a decline in value of the collateral? If yes please provide us with a detailed description on the type of contract, the reason for the outflow and the approximate volume.

There are no securities financing transactions that would require additional collateral outflows for other reasons than already considered in the LCR framework: cash in-/out-flows from securities, loss of values of collateralized transactions and downgrade triggers.

Q 4. Are paragraphs 2c and 2d sufficient for reducing incentives for cherry picking behaviour? Are there other specifications that could help this purpose?

As the LCR applies to the institution level, consolidated level and sub-consolidated level (liquidity sub-groups), it should be clarified that paragraph 2c applies at institution level.

For group or sub-group levels, entities in the same group or sub-group could use different methods, depending on their level of sophistication or depending on the materiality of the additional outflow for their institution.

This highlights the issue of articulating institution level and group level additional outflow: please refer to our response to Question #20 for a more detailed analysis.

Basically, paragraph 2d requires that there is no way back from a more '*sophisticated*' method to a less '*sophisticated*' method with order by 'sophistication': Simplified Method < Standard Method < Internal Method.

As there may be circumstances that would justify such changes from an institution, notably when its collateralized transactions decrease in importance (materiality), we suggest that paragraph 2d is reworded in: '*institution shall not revert from…*' to '*institutions shall not revert, without approval by their supervisor, from…*'

Note that the combination of paragraphs 2c and 2d may be interpreted at group (or sub group) level as a 'tainting rule' that requires the whole group (or sub group) to apply the most sophisticated method applied in the group. Our understanding is that it is not the intent of the RTS. Once having

clarified paragraph 2c as suggested above, this combined interpretation risk will no longer exist.

1. *General Comments:*

Please refer to *Appendix B – Key components to factor in all methods to calculate Liquidity Outflows for collateralized transactions*.

The Standardized Shock can lead to internal inconsistencies or double counting:

The valuation process is done within the 'arbitrage free'- framework. This means that, once a risk factor is modified, it may have consequences on the future values of other risk factors.

As illustrations:
- if different shocks are applied to different interest rate curves of different currencies, the 'arbitrage free' valuation framework will lead to changes in future values of foreign exchange between those currencies. Hence, interest rate shocks have ramifications on foreign exchange risk factor.
- If equities are assumed to decrease in values (resp. increase) 'arbitrage free' valuation framework will lead to increase (resp. decrease) in credit spread values
- If FX rates are shocked, triangular arbitrage condition should be respected. For instance, if both EURUSD and EURJPY FX rates are supposed to increase by 10%, USDJPY FX spot cannot increase by 10% under the same scenario

Hence, the 'arbitrage free' valuation framework can lead to possible double counting the effect of some risk factors (foreign exchange risk and credit spread risk in the above described examples).

Standardized shocks on foreign exchange are unclear:

The description of the standard scenario to be applied to foreign exchanges is unclear. As written, this could lead to cumulative shocks to some foreign exchanges.

An illustration of the suggested methodology would be helpful.

Low rate environment:

In the current low rate environment, it should be made clear how to deal with applying downward scenario on interest rates that could lead to negative values.

A possible answer would be to clarify that nominal interest rates should be floored to 0% in the *Internal Method* (since it is specified as such in Annex I for the *Standard Method*). However, as interest rate shocks are not similar for short term and long term rates, as well as the initial values, the flooring process could lead to applying a lower shock to short term rate (as the floor may kick in) and the full shock to long term rate (if the floor does not kick in for long term rates).

Final calibration of the shocks and methodology:

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA could not estimate the cost/benefit analysis (please refer to our response to Question 23).

2. *Detailed Comments:*

The term 'margining set' in Article 2 should be defined.

In Article 2(1)(d) and (1)(g), it is unclear why transactions outside of a 'margining set' should be considered: if they are not covered by a contract to exchange collateral for changes in its values, this

transaction should not be covered by this RTS. Article 2(1)(d) and (1)(g) should be deleted. This most probably go with EBA explanatory text for consultation purposes which is highly unclear: '*Notably, the existence or non-existence of an agreement between two counterparties to mark-to-margin certain positions does not affect the underlying sensitivity of derivative positions to market shocks. For the same reason the EBA has refrained from including the definition of master netting agreements in this RTS*'. If there is no margining set, there is no cash in-/out-flow derived from the change in values of the collateralized transactions.

Article 2(1)(h) deals only with the situation where the method leads to a net cash outflow. It should be made clear that, if it leads to a net cash *inflow*, it should be reported as such: an inflow (ie: a negative outflow).

In Article 2(2)(a) and (c) and in Article 2(3)(i), there is a requirement for 'immediacy' of the collateral outflow or inflow that is not consistent with the LCR 30 day horizon.

In Article 2(2)(a), there is a requirement for 'full' coverage of change in value that is most probably unintended (it would exclude margin call threshold).

In Article 2(3)(ii), the limitation to a portion of liquid asset as providing an inflow has absolutely no sense both economically and in the LCR framework itself: it would introduce a major inconsistency.

Additionally, it should be made clear that a <u>*cash*</u> inflow provides value to the bank (remind that 'cash' in the liquid asset is more restrictive than 'cash' to be received from a counterpart).

Please find below suggested changes:

- *Art.2.(1)~~(d) For transactions and contracts outside of a margining set, institutions shall determine the gross amount of additional outflows by adding together all value decreases resulting from the re-valuation of point (c)~~*.

- *Art.2.(1) ~~(g) For each transaction and contract outside of a margining set, where there is a value increase resulting from the revaluation of point (c), institutions shall determine how much of these amounts are considered to be a usable inflow~~*.

- *Art.2.(2)*(a) *All transactions and contracts are marked-to-market daily and any aggregate change in value leads to ~~immediate~~ collateral outflows or inflows* <u>in the next 30 day</u> *~~that fully cover such change in value~~*.

- *Art.2.(2)*(c) *If collateral is received on any of the transactions or contracts within the set it can be fully ~~and immediately~~ used to cover outflows on any other transaction or contract within this set.*

- *Art.2.(3)(i) the inflow of collateral is unilaterally ~~and immediately~~ available to cover outflows to any other counterparty;*

- *Art.2.(3)(ii):* (ii) *the inflow of collateral is* <u>a cash inflow or a</u> *liquid asset as reported in accordance with Article ~~404~~* <u>416</u>*(1)(a) to ~~(c)~~ (f) of Regulation xx/xxx [CRR, unless excluded according to Article ~~404~~* <u>416</u> *(2) or Article ~~404~~* <u>416</u> *(3) of Regulation xx/xxx [CRR].*

In Annex I:

- the assumed changes in foreign exchange rates are unclear as it seems to imply that there is a cumulative change of some currencies: *The reporting currency appreciates vis-`a-vis all other currencies. The second most important currency appreciates vis-`a-vis all other currencies expect the reporting currency. The third most important currency appreciates vis-`a-vis all other currencies except the reporting currency and the most important currency.*

- it is unclear what are the 'other risk factors' are. Could you illustrate with a few examples?
- The term 'reporting currency' is not defined and may lead to inconsistency since the 'reporting currency' of an institution may not be the currency on which it is most exposed to. We suggest that 'reporting curency' is substituted by 'most significant currency' (ie: the currency that represents the most important portion of the reporting institution's liabilities)

Q 6. What instruments transactions and contracts are you aware of that are sensitive to changes in multiple risk factors? How material are they to your institutions stock of assets of extremely high and high liquidity and credit quality as calculated in accordance with Part Six of CRR? Does the standard method capture these adequately? If not, what alternatives would you consider necessary to ensure they are appropriately incorporated?

Please find below a few examples of transactions that would be sensitive to multiple risk factors:
- all derivative instruments, notably equity-linked derivatives, are sensitive to interest rates
- quanto swap
- hybrid derivatives mixing any two of the following type of risks: stock, FX, interest rate, commodity…
- call on difference between two asset prices (Call (SP500 – Eurostoxx50, K))
- …

Q 7. How do you view the restriction in paragraph 2, point h(ii) that only additional inflows of extremely high liquidity can be recognised outside of margining sets? To what extent do assets of typically lesser liquidity constitute part of collateral flows for your institution? What assets are they? Do these assets typically comprise outflows, inflows or both? How material is it for the LCR of your institution?

The restriction in Article 2(3)(ii) that only additional inflows of extremely high liquidity can be recognized outside of margining sets does not make any sense, neither economically, nor within the LCR framework (ex: Article 422(6), Article 424(1), Article 425(3), .

We urge EBA to delete this restriction as described below:
- *Art.2(3)(ii):* (ii) *the inflow of collateral is* a cash inflow or a *liquid asset as reported in accordance with Article 404 416(1)(a) to (c) (f) of Regulation xx/xxx [CRR, unless excluded according to Article 404 416 (2) or Article 404 416 (3) of Regulation xx/xxx [CRR].*

The huge number of regulations requiring collateral creates shortage of collateral. Hence eligible collateral should not be overly restricted, nor directly nor indirectly by over-penalizing treatment.

Technically speaking, the *Standard Method* seems not too costly to implement at institution level (cf. our response to Question #20 for the consolidated or sub-consolidated levels): this would require the full valuation in a set of scenarios for the covered transactions. The number of scenarios should be close to 16 (= 1 base case scenario + 2 (up/down) x 7 (# of Risk Factors in Annex 1) + 1 *most adverse scenario* taking into account the results of the 15 other scenarios). The *most adverse market scenario* is the most costly step since it calls for repeating the calculation at margining set level with having to retrieve changes in values from different valuation systems as described below:

- *Step 1*:
  - *Step 1.a*: use each valuation system to derive the values of collateralized transactions in 15 standard scenarios
  - *Step 1.b*: consolidate the 15 simulation results from the reevaluation system to derive the most adverse scenario
- *Step 2*:
  - *Step 2.a*: use each valuation system to derive the values of collateralized transactions in the most adverse scenario
  - *Step 2.b*: retrieve the results from Step 2.a from valuation systems by margining set;
  - *Step 2.c*: for each margining set, derive the netting effect from offsetting collateral flows for their liquidity value
  - *Step 2.d*: sum results obtained from Step 2.c.

Besides, there may be technical issues due to the lack of consistency of the standardized shocks (please refer to response to Question #5).

Within the consultation period, the impact of the suggested methods could not be estimated.

In terms of final calibration of the method and of its parameters, we urge EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA will not be able to estimate the cost/benefit analysis (please refer to our response to Question 23).

> Q11. Are there any aspects of the simplified method that you would describe differently? If so, what are these and how would you describe them? Are there methodological concerns? If so, please provide details of these concerns and how in your view they could be addressed? Are the outflows factors described in annex II appropriately calibrated? If not, please describe how they should they be calibrated, justifying your proposal?

Threshold should be based on the whole LCR-Liquidity Buffer and not a portion of it:

The materiality threshold for the Simplified Method should consider the *whole liquidity buffer* and not a portion of it:

- *Art.3 '1. As an alternative to the standard method, institutions may use the simplified method where their overall additional outflow according to the simplified method does not exceed 5 % of liquid assets reported in accordance Article ~~404~~ 416(1)(a) to ~~(c)~~ (f) of Regulation xx/xxx [CRR, unless excluded according to Article ~~404~~ 416 (2) or Article ~~404~~ 416 (3) of Regulation xx/xxx [CRR].and only if the conditions of paragraph 3 of that article are met on any day.'.*

Final calibration of the shocks and methodology:

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA could not estimate the cost/benefit analysis (please refer to our response to Question 23).

> Q12. What are the expected implementation costs of the simplified method and what is the time you would need for implementation? If possible, please compare it to the implementation costs of the other methods.

Technically speaking, the *Simplified Method* seems not too costly to implement at institution level

> Q13. What impact in terms of your institutions liquidity coverage requirement do you foresee for the application of the simplified method? How would this compare to the 5% threshold that is specified in paragraph 1 article 3?

Within the consultation period, the impact of the suggested methods could not be estimated.

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA will not be able to estimate the cost/benefit analysis (please refer to our response to Question 23).

> Q14. Would a special treatment of the narrowest of the currency pegs of the ERM II be appropriate? If so, what shock factor would be appropriate?

1. *General Comments:*

Please refer to *Appendix B – Key components to factor in all methods to calculate Liquidity Outflows for collateralized transactions*.

Which Validation process?

The authorization/validation process for a reporting institution to use the internal model based method is not clear. It should be authorized for the calculation of own funds requirements for counterparty credit risk (Art.5(1)(a)). What does mean Art.5(1)(c): '*these approaches have been validated for the transactions and contracts or risk factors covered <u>by this Regulation</u>*'? Does it mean that there are two validations to be obtained by supervisor? Does it mean that the model should have been validated for the type of instruments/risk factors covered by the RTS?

We suggest that the *Internal Method* process is considered valid if it has been validated for own funds and if the types of underlying contracts are similar.

Delete over-penalizing unjustified restrictions on collateral mitigation value:

The restriction in Article 6(1)(c)(ii) that only additional inflows of extremely high liquidity can be recognized outside of margining sets does not make any sense, neither economically, nor within the LCR framework.

We urge EBA to delete this restriction as described below:

- *Art.6(1)(c)(ii): The inflow of collateral is a liquid asset as reported in accordance with Article ~~404~~ <u>416</u>(1)(a) to ~~(c)~~ (f) of Regulation xx/xxx [CRR, unless excluded according to Article ~~404~~ <u>416</u> (2) or Article ~~404~~ <u>416</u> (3) of Regulation xx/xxx [CRR].*

The huge number of regulations that require collateral creates a 'collateral shortage'. Therefore it is important that eligible collateral is not overly restricted, neither directly nor indirectly.

Final calibration of the shocks and methodology:

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, the EBA will not been able to estimate the cost/benefit analysis (please refer to our response to Question 23).

2. *Specific Comments*

As for Article 2(2), Article 6(2) should be modified as described below:

- Art.6(2) *(a) All transactions and contracts are marked-to-market daily and any aggregate change in value leads to ~~immediate~~ collateral outflows or inflows* <u>in the next 30 day</u> ~~that fully cover such change in value~~*.*

- Art.6(2) *(c) If collateral is received on any of the transactions or contracts within the set it can be ~~fully and immediately~~ used* <u>in the next 30 day</u> *to cover outflows on any other transaction or contract within this set.*

- As mentioned in the answer of Question 2, the treatment of final and partial redemption should be clarified as the *Internal Method* definition is not clear with regards to the exclusion of final and partial cash-flows.

The unexpected changes of values should be calculated at 30 day horizon and net out the expected values at 30 day horizon.

Alternatively, as is suggested in answer to Question 2, institution should be able to include cash flows effect in the liquidity outflows for changes in values of collateralized transactions provided they are excluded from other LCR provisions that deals with those cash flows (as 422(6) and 425(3)).

Q16. Please provide details of what adjustments in the implementation of your EPE model to be considered for the estimation of additional collateral outflows?

Should EPE method be retained (please refer to our response to Questions 19), most of the adjustments relate to:
- switching from counterparty by counterparty EPE approach to a global portfolio approach… which may require enhancements in cross asset correlation
- focusing on the next 30 day horizon for negative change of values;
- taking into account contractual arrangements that can affect additional collateral outflows such as one-sided collateralization, minimum transfers;
- … and the accompanying mitigation effects of the collateral to be received/posted with their LCR-liquidity value (rather than market values)

The process would be as described below:
- For each envisaged 1 day market environment scenario:
  - For each margining set:
    - Calculate the 1 day change in value of the transactions in the margining set;
    - Scale the 1 day change in value of the transactions to a 30 day horizon;
    - Derive the required change in margining set's collateral from the current position and the margining set contractual agreement;
    - Net the amount above by the liquidity value of the incremental collateral to be received/posted. The liquidity value should be consistent with the envisaged market environment, which means that only the CRR-liquidity haircut should apply having filtered out the change in value effect.
  - Sum the above obtained amount over all the considered margining sets.
  - Consider the transactions that are outside of the margining sets above and which are managed to offset market risk exposure of the transactions in the margining set:
    - Derive the cash in-/out-flow from these transactions, assuming that market remains liquid (applying the CRR-haircut effect).
  - Sum this value with the amount obtained in the previous step: this is the net cash in-/out-flow for this specific scenario.
- Consider the distribution of the liquidity outflows (i.e.: filter out the scenarios that lead to liquidity inflow) obtained above, and define the LCR liquidity outflows as:
  - the average over the scenario that leads to liquidity outflows
  - (*if UNexpected approach is retained:* the liquidity outflows corresponding to the selected threshold)

Q17. What are the expected implementation costs of the EPE based advanced method and what is the time you would need for implementation? If possible, please compare it to the implementation costs of the other methods.

Most of the potential costs relate to
- potential extension of the scope compared to the current application scope of the EPE
- considering the LCR-CRR-Liquidity Value of the collateral to be received / posted, which is not known at this stage

This makes the estimation of the implementation costs difficult to determine.

Q18. What impact in terms of liquidity coverage requirement do you foresee of the application of

Within the consultation period, the impact of the suggested methods could not be estimated.

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA could not estimate the cost/benefit analysis (please refer to our response to Question 23).

Q19. How would you view the development of a method based on VaR for the purposes of estimating additional collateral outflows? Could you review this in the context of the abovementioned difficulties?

Please refer to *Appendix B – Key components to factor in all methods to calculate Liquidity Outflows for collateralized transactions.*

We consider that VaR is a valid process to elaborate on to derive additional liquidity outflows for collateralized transactions.

Under our proposal to calculate the additional liquidity outflows under the assumption of constant level of risk, to calculate the liquidity outflow at 1 day horizon and to derive the 30 day liquidity outflows by a scaling operation, the adjustments could be implemented in the Value-at-Risk calculation process as well.

The main adjustment to VaR would then be:
- take into account contractual arrangements that can affect additional collateral outflows such as one-sided collateralization, minimum transfers;
- … and the accompanying mitigation effects of the collateral to be received/posted with their LCR-liquidity value (rather than market values)

We estimate that the VaR based method has less limited implementation costs :
- the VaR process is well established and robust for short term horizon such as the one considered in the LCR (whereas the EPE covers a 1 year horizon);
- It has been validated by supervisors;
- It is consistent with the Constant Level of Risk that we suggest.

Q20. Do you foresee any difficulties in calculating the consolidated estimates? If so, what are these difficulties and why do they arise? How material are they? What would be an appropriate alternative treatment?

The main difficulty lies in having each individual European institutions of the same group (or sub group sub as Liquidity Sub-Group) subjected to LCR requirements, including an institution-level additional outflows for collateralized transactions each one based on an *institution-specific-adverse-market-scenario*. **This will lead to magnifying the requirement for liquidity outflows as the liquidity outflows for the Group will be lower than the liquidity outflows for each individual entity in the Group.** As those entities will be subject to LCR at individual level, they will have to build up and fund a liquidity buffer. Globally, this will then lock funding for an unnecessary liquidity buffer and decrease available funding for loan financing.

That is the reason why it is important that the market scenario from which liquidity outflows are derived are identical: **consistency with other LCR assumptions enable to ensure consistency between institution level liquidity outflows and group level liquidity outflows**.

Should the proposal remain as is, a mitigating strategy could be not to collateralize intra-group

transactions… which may have consequences on other regulatory requirement, notably the large exposure when it is applied even to intragroup transactions.

Final calibration of the shocks and methodology:

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA could not estimate the cost/benefit analysis (please refer to our response to Question 2323).

Q21. How would you like to see the historical look-back approach calibrated? Please provide details together with a justification. Should the method be focused on calendar months or utilize a moving 30 days window? Should the method be based upon full calendar years or be moving with a 24 months window?

The method should be consistent with the application of the BCBS's proposal: maximum observed change over 30 day period over the last 24 months.

Q22. Is the method sufficiently resilient against potential future changes in volatility and against potential future changes in the size or characteristics of a bank's derivative portfolio? If not why and how could any such deficiency be addressed?

The *Historical Method* is the one proposed by BCBS proposal and consequently is the one that non-European institutions may be subject to in the transposition in their jurisdiction.

We agree that the *Historical Method* is a backward looking approach, that will not adopt a forward looking view neither in terms of changes in market risk positions nor in terms of expected changes in market environment (ex: increase in expected volatility will not materialize before volatility actually increases).

As it is based on the actual most adverse observation, there is no lagging effect: an increase in actual liquidity outflow will be considered in the 30 day after they materialize. However, the *Historical Method* creates inertia as the most adverse observation remains the basis for additional outflows for two years.

Additionally, it is important and a challenge to filter out of historical changes in collateral the portion that are is to intermediary cash flows (derivatives payment, early termination…)

Final calibration of the shocks and methodology:

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA could not estimate the cost/benefit analysis (please refer to our response to Question 23.

Q23. Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

We do not agree with the Cost- Benefit Analysis / Impact Assessment since there is _no_ impact assessment of the suggested methodologies on their consequences on European banks for their LCR and in terms of competition vis-à-vis non-European banks that will not be subject to this requirement, and on the consequences on the European banks' financing capacities.

Final calibration of the shocks and methodology:

In terms of final calibration of the method and of its parameters, we urge the EBA to use the LCR

observation period to conduct Quantitative Impact Studies on the proposed methodology. Without those QIS's, EBA could not estimate the cost/benefit analysis (please refer to our response to Question 23).