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EBA-CP-2013-19@eba.europa.eu

**Comments on consultation paper on  
Additional liquidity outflows corresponding to collateral  
needs resulting from the impact of an adverse market  
scenario on the institution's derivate transactions, financing  
transactions and other contracts for liquidity reporting**

**Introduction**

Swedish Bankers' Association welcomes the invitation to comment on the consultation on additional liquidity monitoring metrics.

It is important to synchronize these reporting requirements with others. For instance we see some parts of this reporting being very close to some parts of the reporting of Assets Encumbrance. It is also important to synchronize the reporting with the LCR rules to reduce the reporting costs and resources.

We find it hard to give answers to some questions because we can't see any clear definition of what is describing the reason for outflows. We believe that without any clear definition of the scenario within the outflows should appear it will be hard to give a clear description of the effects of the outflow.

It is of great importance to understand the economical consequences of this regulation before it is possible to have a strong opinion about its content. But because of the missing facts about the adverse scenario it is not possible to conclude the assessment of this regulation.

We would also stress that implementing the reporting will need sufficient time for the



banks. It could take considerable time to adapt the reporting system and to educate staff.

Swedish Bankers' Association support the comments on the consultation done by the European Banking Federation, EBF. However, the specific views of the Swedish Bankers' Association are stated in this comment letter.

### **Specific comments**

#### **Standard method**

*The outcome overshoots historical worst outflow by a large amount.*

The stress test is constructed so that the institutions always must choose the most adverse scenario, using the absolutely most conservative outcome as the stress test result. This practice is inconsistent with other EBA reporting, which does not ask for the worst case scenario.

Notably, with regards to the chosen method for interest rate scenarios, by requiring the institutions to always choose the worst interest rate scenario for any currency, regardless of what scenario is chosen for other currencies, important correlation effects between various interest rate curves are lost, and the combination of interest rate curve shifts may end up being unrealistic.

According to preliminary calculations made, the Standard method leads to significantly higher additional cash outflows compared to the historical look back approach, even when the historical period covers the time of the Lehman bankruptcy, which was arguably one of the most distressed periods in modern financial history. The main reasons for this are the conservative scenario assumptions e.g. high percentage of shocks and the assumptions on diversifications and correlations applied in the model. Especially when it comes to the interest risk factor the Standard method gives excessive outflows since no correlations between interest rates in different currencies are considered in the method.

It would be highly appreciated if the RTS would give a background to the proposed scenario parameters and assumption applied in the Standard Method.

Furthermore, the implementation of the Standard method will take time and require investments in IT system especially considering the number of scenarios needed for the calculation. Thus, there must be an adequate amount of time to make it possible for institutions to properly implement the Standard method before the regulation come into force.





### **Simplified method**

*The outcome is simply too unrealistic.*

The Simplified method is even more conservative and generates higher outflows compared to Standard approach due to the applied outflow factors. However, the Simplified method is less costly to implement.

Since the Simplified method gives an even more conservative outcome compared to Standard method we strongly believe that the historical back stop approach should be used as a benchmark to define a maximum of additional liquidity outflows applied in LCR calculation.

Furthermore, there is an important methodological concern with the simplified approach due to the fact that it does not take into account any netting effects. By selecting only the larger of the notionals, the effects of netting between two positions having opposite sensitivities to the same risk factor are not taken into account.

### **Comments to questions**

The comments by the Swedish Bankers' Association follow the questions asked in the consultation on asset encumbrance. Questions have been answered where we have comments of importance to us.

**Q1.** *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?*

Purchased options that are currently out-of-the money or near at-the-money cannot lead to significant outflows because their net present value is floored at zero. The underlying can be any risk factor class, such as interest rates, equities, currencies, etc.

**Q2.** *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.*

Yes.

**Q3.** *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.*



Cases where a security is lent against collateral that is also a security represent such a possibility. The value of the lent security may also fluctuate.

**Q4.** *Are paragraphs 2c and 2d sufficient for reducing incentives for cherry picking behaviour? Are there other specifications that could help this purpose?*

Yes.

**Q5.** *Are there any aspects of the standard method that you would describe differently? If so, how would you describe these? Are there methodological concerns? If so, what are these and how should they be addressed? Are the scenarios described in annex I appropriately calibrated? If not, how would you suggest improving calibration?*

The standard method appears to be sufficiently described.

Perhaps it would make more sense to specify CDS scenarios in terms of basis point changes, in the same way as CDS indices, rather than rating migrations. Ratings and CDS spreads do not always correspond, so that it is not straightforward to determine the effect on the spread of a downgrade. One may of course use an average of spreads mapped to ratings of companies in the same country or sector. However, we suspect the spread shifts will be highly inconsistent between institutions. Moreover, a rating itself does not have a constant credit spread. Is the intention that the spread should widen or tighten so that it reaches the current spread of a counterparty rated three notches higher or lower or that of a stressed period?

**Q6.** *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?*

Any derivative with at least one cash flow in a foreign currency is sensitive to both interest rate and exchange rate shocks because the cash flow is both discounted with its respective interest rate and converted to the reporting currency. This includes cross currency swaps, interest rate swaps in foreign currency and currency forwards. Moreover, structured products have components that may be sensitive to different risk factors. To alleviate the inaccuracy of modeling this using the Standard method, we suggest the historical look back approach, which would capture correlation effects.





Overall we are of the opinion that this is difficult to answer because we have problems understanding the outflow factor. Nevertheless we see problems with currency swaps because of its relation with many different risk dimensions.

**Q7.** *How do you view the restriction in paragraph 3 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?*

As most collateral is cash, this restriction has no material effect.

**Q8.** *What are the expected implementation costs of the standard method and what is the time you would need for implementation? If possible, please compare it to the implementation costs of the other methods.*

The Standard method will take considerable time to implement and a large amount of resources must be devoted to calibrate the results. Furthermore, new IT investments need to be undertaken. It will take longer to implement than the simplified method.

The cost estimate for the standard and advanced method is roughly the same. See answer to Q17.

**Q10.** *How would you view an insertion of a special foreign exchange rate shock for currency pairs between the Euro and a currency participating in the ERM II? If positively, what shock factor would be appropriate, taking into account compulsory intervention rates?*

Any measures to improve the accuracy of the model are welcome. The following comment assumes that leaving ERM II or changing the compulsory intervention rates is not part of the scenario. In this case, the scenario magnitude could potentially be as large as the scenarios outlined for other currencies.

In practice, the ERM II currencies deviate very little, usually less than 1%, from the central rates. It may be prudent, however, to consider a scenario exceeding 1%, as a crisis may put significant buying or selling pressure on one of the currencies, pushing the rate away from the central rate with a force large enough for central banks not to be able or willing to maintain the narrow 1% band, which is not compulsory anyway.

DKK is distinct from LVL and LTL in that has a very narrow band between the upper and lower compulsory intervention rates. For this currency it makes sense that the scenario cannot exceed the current exchange rates distance to the farthest of the



upper and lower boundary. In any event, for the DKK/EUR pair, the scenario should not exceed 4.3%, which is the full size of the band.

LTL, however, has a band is so wide that the width already eclipses the size of the proposed scenarios. There is a possibility that the exchange rate is close to either the upper or lower compulsory intervention rate, which would limit possible moves, so that the scenario magnitude could be limited to the distance to the relevant boundary. LVL will be replaced by EUR before this regulation takes effect.

We also suggest reducing the scenario magnitudes for other low-volatility currency pairs. The largest monthly change in the SEK/NOK exchange rate since 1971 is 13%, which is not even close to the proposed 20%.

In general, however, the contribution from this improvement to the model's accuracy would be very small compared to what is needed to bring the scenario outcome to a realistic level.

***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?*

While we understand that the simplified method is supposed to penalize adopters and give an incentive to use the standard method, currently the outflows are about 10 times as big as under the standard method. It is not that the outflow factors are too high, but the problem is rather the lack of recognition of netting. Netting agreements are legally enforceable and worked as expected even under the Lehman bankruptcy.

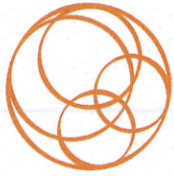
Otherwise the simplified method appears to be sufficiently described.

***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.*

Our opinion is that the costs to implement this will vary a lot between banks and be dependent on the size and complexity of the banks operation.

***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?*





It would be appropriate, but the impact on the aggregate result is very minor. This is a very small concern compared to the other inaccuracies of the model.

**Q15.** *Are there any aspects of the advanced method based on EPE that you would describe differently? If, so please provide details? Are there methodological concerns? If so, please provide details of these concerns and how in your view they could be addressed? Are there any additional adjustments or conditions that you see as appropriate especially in view of an absence of an approval process? If so, please provide details? Is the 99% confidence level appropriate? If not, please justify why?*

We are concerned that the initial margin used with central clearing counterparties (CCP) might impose unwanted complexity and heavy calculations for the advanced method. We are seeking advice on how to perform the calculation using approximating methods to avoid having to model the VaR calculation performed by the CCP.

The text refers to 2C 'if collateral is received on any of the transactions or contracts within the set it can be fully and immediately used to...' We question the word immediately and suggest replacing with the term 'available' to reflect the timeliness in the collateral process. In addition we seek clarity that the intent of the text is simply to secure that the collateral received is available for re-hypothecation. The 99% confidence interval is also used for capital modeling purposes and is therefore considered relevant.

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

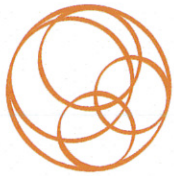
Further detailing of the treatment of details in the collateral agreements will be needed compared to the current state of implementation.

**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.*

The cost is the same as for the standard method. One large Swedish bank has estimated the implementation cost for derivatives to EUR 350.000 and the implementation time to 6 months. The cost for SFT's is not estimated.

**Q18.** *What impact in terms of liquidity coverage requirement do you foresee of the application of the internal model based method on your institution?*

For one of the larger Swedish banks the effect of increased liquidity buffer will be around EUR 6 Millions. This is just a rough estimate mainly based on historical



developments in net paid collateral. Clarity over the exact impact will not be available until the actual model has been implemented.

**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?*

The VaR method could be used for an approximate result with some reasonable assumptions, but the advanced method based on EPE is preferred.

**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?*

There can be many different difficulties. For instance we foresee difficulties with the use of historical data from the last 30 days. Because of the cyclicity over the year the last 30 days will maybe not be that good proxy for the coming 30 days.

The historical look-back approach is the best among the suggested models, because it is non-parametric and does not involve making simplifications about correlations and magnitude of scenarios. To account for cyclicity in liquidity flows we suggest using a history including a stressed period, such as the time surrounding the Lehman bankruptcy of 2008. While the historical look back approach is inaccurate in the sense that the portfolio at the time was different from the portfolio now, the overall portfolio composition is similar. One way to compensate for portfolio size growth is to scale the outflow by the size of the portfolio now divided by the portfolio then.

**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?*

The historical method does not incorporate the crisis cycles which could be a disadvantage.

**Q24:** *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?*

Because of the restrictions on the use of the simplified method and due to the fact that this method does not take into account any netting effect, some institutions will be obliged to opt for the standard method even though their derivative portfolios do not generate a significant liquidity risk (this is the case for the institutions which





derivative positions are in back-to-back for instance). For these institutions, the implementation costs will be substantial but will not necessarily lead to a better liquidity risk management.

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