

FBF response to the EBA Discussion Paper on defining liquid assets in the LCR under the draft CRR (EBA/DP/2013/01).

The French Banking Federation appreciates the EBA's efforts in trying to define liquid assets in the LCR under the draft CRR. We think it is a complex exercise that should be carefully dealt with considering the potential implication on the lending capacity of banks and financial stability.

The Discussion Paper (DP) on defining liquid assets intends to develop a quantitative methodology to derive asset class described with simple characteristics: **we support EBA objective to target definition of Liquid Assets based on asset class and easy to get (publicly available) asset's characteristics**, provided that the number of asset classes and subcategories are not too numerous and are flexible enough to accommodate evolution in assets or market environment.

As the classification process will need to be updated over time for changes in market environment, it is important that the classification process is made transparent enough to enable banks to duplicate it so that they can anticipate changes in regulator-defined asset classes and avoid 'cliff effects' that would happen at each regulatory update. This would also be helpful in dealing with assets that are not covered by EBA methodology (ie: non EU assets). The possibility to duplicate the classification process will require that it is based on publicly available data (rather than on data available only to regulators, such as MiFID data).

1- General comments:

Lack of data on Repo transactions

The methodology is based only on buy and sale historical data, which denies the role of repurchase agreement (repo) market in the liquidity of assets. The traded volumes on repo markets (bilateral repo, tri-party repo and CCP repos) are huge and are often bigger than the volumes on buy and sale market. Considering the repo market is absolutely necessary for any Liquid Asset classification process.

The need for clear definitions

We understand that the EBA intends to publish definitions such as "Corporate bonds with ratings above A and issue size above M€ are assets of high liquidity and credit quality".

We favour such an output, based on clear asset classes and other objective criteria. The need for clear definitions, indeed, would not only be operationally enforceable, but it would also give clarity to the system. This clarity is a desirable outcome, as the choices made by the banks today concerning their liquid assets are systemically made in a conservative manner, since there is a risk that the asset is not recognized as a liquid asset in the end by the supervisor, at the detriment of the diversification objective. Moreover, clear definitions allow for a harmonized LCR framework within the Union.

However, when setting the limits, one should take care to avoid cliff effects. For example, the rating criterion should be set at a relatively low rating level. Indeed, for example, if the rating limit is set at A, banks will not buy any A-rated securities due to the risk that their rating may be downgraded to BBB.

The requirement to extend the classification process to equities will lead to adopt an equity-specific classification process, which is necessary as the market and available data are equity-specific. We suggest that EBA classification process does not need to be a one-size-fits-all. As an illustration, assets that are eligible to General Collateral Basket for repo in major CCPs should be considered liquid without further requirement as trillions euros of repos are executed on these assets.

As market-liquidity and asset classes evolve over time, EBA should clarify what will be the update process over time to adapt the definition of Liquid Assets to an evolving environment.

Focus on EU currencies

The approach would only cover EUR-denominated assets, implying that it would exclude other major world currencies – notably Swiss Franc (**CHF**), Japanese Yen (**JPY**), and, above all, the US Dollar (**USD**). The latter, in particular, is a significant omission in light of the fact that the US dollar is considered to be the world's main exchange currency. Moreover, to the extent, that European sovereign bonds are denominated in USD, the understanding is that they would be excluded from the EBA analysis. It is also unclear how assets denominated in the non-EU currencies will ultimately be treated in the LCR calculation. This aspect of the EBA's methodology warrants reconsideration. We acknowledge EBA's objective to develop a comprehensive basis for its analytical framework against the backdrop of tight timelines for submission. However, we would like to highlight that limiting the scope of this exercise in the manner described above will result in a significant gap in the analysis and prevent development of a broad-based framework addressing the entire market structure.

Market liquidity versus Central Bank eligibility

We observe the EBA discussion paper only focuses on market liquidity. However, Central bank eligibility is an important issue that must not be forgotten when defining liquid assets, given the role that the Central Bank may have in a systemic stress. Indeed, we draw the attention of EBA on the fact that the stress scenario is both idiosyncratic and systemic. Its systemic component justifies taking into account the intervention of the Central Bank in a limited manner and with appropriate haircuts. Recognizing credit facilities granted by the Central Bank would also allow defining a liquid asset class that is not pro-cyclical as market liquidity can be.

Defining haircuts

The suggestion that haircuts on Liquid Assets should be derived from their price volatilities basically denies that those assets will benefit from a flight-to-quality, which should lead to a gross-up factor rather than a haircut. It would also deny the diversification effect between the different assets in the liquidity buffer.

If the minimum 15% haircut applied to level 2 assets is maintained in the final version of the text, our opinion is that level 1 assets should not suffer from any additional haircut. Indeed, the scenario is in that case a flight to quality on level 1 assets. This is the most consistent approach.

Another methodology could be based on haircuts observed on the repo market (or based on the haircuts applied by the ECB to the assets eligible for use as collateral in Eurosystem market operations).

Impact of the Financial Transaction Tax

We also like to highlight the likely impact of the financial transaction tax (FTT), expected to be introduced on 1 January 2014, on the liquidity of financial instruments. FTT will be 0.01% on derivatives and 0.1% on other financial instruments (including shares and bonds). It is important to note that FTT is not applicable at issuance but only on subsequent trading of securities. Proponents of FTT suggest that it is likely to deter excessive trading and promote market stability and long-term investing. Obviously, there is a compelling counterargument that the FTT will result in higher price volatility, increased transaction costs and cost of capital. This will also seriously impact the repo market and overall secondary market liquidity. An interesting comparison for the FTT was the implementation of similar scheme in Sweden during 1989 that led to massive falls in bond sales, futures and options trading eventually causing the scheme to be withdrawn. In light of these concerns, some relaxation in the text is forthcoming whereby, for instance, Repo trades will be treated as a single transaction instead of two, halving the tax levy.

In the process of developing a proposal for classifying assets for their market-liquidity, we recommend that EBA takes the opportunity to:

- compare the result of its classification process to the one the European Central Bank (ECB) applies for assets eligible to monetary policy. This will notably help in determining whether the approach that ECB has developed through its Liquidity Categories could be used to identify Liquid Assets, or at least could constitute an important input in the Liquid Asset categorization process;
- **determine whether or not there are enough Liquid Assets in Europe** for institutions subject to CRR to meet its LCR requirement, *including the other regulatory-driven-demand for similar assets such as the possible EMIR and Dodd-Frank requirements on collateral to post for derivatives*;
- **make sure that the methodology does not lead to excluding a too high portion of assets that are listed as potential liquid assets in the CRR** (this applies notably to equities and Residential Mortgage Backed Securities (RMBS));
- **check the resiliency of the methodology to upcoming changes in tax (FTT) and its consequences on EU-asset market liquidity**;
- **analyze the extent to which the methodology would be pro-cyclical** (ie: assets that would cease to be eligible to Liquid Assets at the inception of a crisis).

Based on the draft CRR, our members are currently attempting to answer the CRR requirement in defining Liquid Assets (ie: same challenge as the one EBA is currently facing). **Our members would be happy to share their analyses and their experience with EBA.**

2- Answers to specific questions

Q1. Given the difficulties with obtaining transactional data outlined here, do you think a data sample cover 2008-2012 is sufficient for this analysis? Would you see merit in extending the sample in those countries where more data is available?

Data availability is the biggest challenge faced by EBA to assess in an objective manner the liquidity of assets.

For the moment, we think that given this lack of data, two approaches are possible:

- **Consulting experts dealing operationally with the repo market.** Documentation on liquidity can be elaborated with their help, based on objective evidence such as a sample of bid-ask spreads for concerned assets. Moreover, the haircuts applied to the different kind of securities on the repo market (that could be supplied by these experts) may be a good sign of the different levels of liquidity of the assets.
- On a longer horizon, another approach could be to **give the European Central Bank, which already defines liquidity classes in its collateral list, the power to define liquid assets for the LCR based on its quality criteria**; this solution is all the more seducing as it would de facto allow a convergence with the monetary policy; it would also be very precise because potentially based on an ISIN database. Considering the issuances denominated in non-EU currencies, we would suggest keeping the same approach consisting in relying on the local central banks (FED, BoJ etc) for the definition of the liquid assets, based on their own quality criteria.

Extending data to longer historical data would help analyzing the pro-cyclicality of the suggested method (ie: it would help back-test the methodology itself), which a very important issue to analyze.

Q2. Do you have additional data sources to suggest? Specifically, can you suggest a source of repo data and gold that would fit our needs?

We have, so far, not found any solid source of data concerning the repo market.

Here are some ideas to extend the information database:

- Custodians may have more information, but we could not check it so far.
- Clearing Houses (LCH Clearnet, Clearstream).
- ICMA European Repo Council bi-annual survey of the repo market might provide useful data.
- Use publicly available data sources such as Bloomberg (notably its BVAL-Bloomberg Valuation Service), Reuters, Datastream, MTS, ION...
- As to gold we would refer to the London Bullion Market Association, which is still the primary market reference for gold trading worldwide.

Q3. Do you agree with the list of liquidity metrics under consideration to be used in the EBA assessment, as mentioned in this section and Annex 5? Can you suggest further metrics the EBA should make use of, where information would be available?

The metrics proposed by the EBA are not able, by themselves, to give an accurate assessment of the actual assets liquidity on the market.

The additional metrics that should be used are:

- The eligibility to Central banks (notably the ECB-Liquidity-categories),
- General Collateral Basket inclusion on repos traded on Major CCPs,
- Asset-specific on repos traded on Major CCPs,
- Other-The-Counter repo market,
- Fixed income trackers components (such as iBoxx, iTraxx...),
- Marketability (i.e. the securities must be readily and immediately be exchangeable for cash can, without significant reductions in value).

As for the suggested liquidity metrics:

- "maximum bid/ask spread" shouldn't be considered as there is no reliable data (bid/ask are simply not traded, and bid/ask are usually set to manage the order book of the market maker for limited order sizes while significant orders and transactions are executed Over-The-Counter without referring to quoted bid/ask spreads).
- "remaining time to maturity" is not relevant when considering the other retained metrics (if the objective is to limit price volatility... the price volatility metric is already considered).
- "minimum trade volume of the assets", 'average volume traded and average trade size (trade volume / number of trades)', 'minimum turnover ratio (trade volume / outstanding volume)' will prove difficult to gather data on.

On the other hand, practical implementation and daily handling and application in the liquidity management of banks for some criteria are very difficult to achieve. It would be costly for banks to reiterate such analyses, with an outcome of probably low quality.

Q4. Do you agree with the list of explanatory characteristics whose linkage to liquidity it is proposed to be tested in the EBA assessment? Can you suggest further characteristics the EBA should assess?

We have some concern with regard to the general explanatory characteristics that refer to market structure that have been identified by the EBA ("presence of a large number of market makers", "wide range of potential buyers" and "transparency"). The practicality for market participants and ability to objectively measure such characteristics is not obvious.

We advocate against the criterion "Remaining time to maturity" as currently envisaged by the EBA (short-term securities being excluded from the buffer). Indeed, if this criterion might maybe be valid for some asset classes on the buy / sale market, it seems to us this is not the case on the repo market.

Here are suggestions for further characteristics that the EBA should assess:

Further Characteristics	Description	Proposed calculation
Share of aggregate repo market during stress	Measures retention of the robustness of securities financing markets during stress	Repo volume as a percentage of total repo market during stress conditions
Change in secured financing haircuts during stress period	Captures any increase in secured financing haircuts during a designated stress period	Percentage change in secured financing haircuts
Repo market acceptance during stressed conditions	Fluctuations in the number of counterparties that accept as collateral during 30 day stressed period	Percentage change in counterparties accepting asset as collateral from major repo agent banks during stressed period
Credit Default Swaps (CDS) spreads		Market data providers

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

The main issue with the suggested methodology is that it will be difficult to implement due to the lack of data (even more so since MiFID data are not available to banks to duplicate EBA's methodology).

However, the suggested methodology has several shortcomings that need to be fixed:

As is, the suggested methodology has several shortcomings that need to be addressed:

- As is, **the methodology is based only on buy and sale historical data**, which denies the role of repurchase agreement (repo) market in the liquidity of assets through *both* its funding capacity (repo side) *and* sale-enhancing capacity (reverse repo side that enables to sale asset obtained through reverse repo). The traded volumes on repo markets (bilateral repo, tri-party repo and CCP repos) are huge and are often bigger than the volumes on buy and sale market. **Considering the repo market is absolutely necessary for any Liquid Asset classification process:** as such, it is an explicit criterion in the BCBS latest guideline.
- As only European assets will be considered by EBA:
 - **the classification process of non-European assets should be clarified.** If the classification is left to the institution, why not European assets too?
 - EBA classification will apply to institutions only to the extent they, or the Group they are part of, are subject to CRR-LCR requirement. This will level the playing field within Europe, which we fully support. However, **European institutions and European Groups will be at competitive *disadvantage* compared to institutions or Groups that would *not* be subject to CRR-LCR and that operate on the very same assets.**
 - Under the SSM regime, how will ECB assumes its role as *on-the-hand-regulator* (and reviewer of the Liquid Asset portfolio of at least European SIFI institutions) and its role as Central Bank (defining its liquid asset base through the Single List)
- The requirement to extend the classification process to equities will lead to adopt an equity-specific classification process, which is necessary and pragmatic as the market and available data are equity-specific. We suggest that EBA classification process does not need to be a one-size-fits-all. As an illustration, assets that are eligible to General Collateral Basket for repo in major CCPs should be considered liquid without further requirement as trillion euros of repos are executed on these assets.
- As market-liquidity and asset classes evolve over time, **EBA should clarify what will be the update process over time to adapt the definition of Liquid Assets to an evolving environment.**
- Any *single and official* process that would identify liquid assets will magnify the market-liquidity of assets deemed liquid, and be detrimental to market liquidity deemed not liquid enough. The pro-cyclicality of the definition of Liquid Assets should be carefully analyzed, so as to minimize the regulatory-driven increase in systemic risk.
- **The suggestion that haircuts of Liquid Assets should be derived from their price volatilities basically denies that those assets will benefit from a flight-to-quality, which should lead to a gross-up factor rather than a haircut. It would also deny the diversification effect between the different assets in the liquidity buffer.**

Besides, as mentioned in Article 481, European authorities should consider the '*international regulatory development*' in modifying the LCR parameters (such as the definition of Liquid assets and the applicable haircuts). We are unaware of any other jurisdictions that are in the process of adopting higher outflow rates for retail deposits. We urge European authorities to avoid gold plating LCR.

- As EBA intends to base its methodology on a database that is *not* accessible to banks, it is essential that EBA discloses its process in sufficient details to facilitate an open discussion that help identifying potential biases in the database or in the analyses. As an illustration of potential biases, the 'database cleaning process' is important to explain as it can have major consequences on the obtained classification (to what extent is the database cleaned? what are the characteristics of the transactions that are cleaned? what is the basis for triggering a cleaning process?...) . Already existing mandatory reporting are requested to a lot of institutions and mainly individual banks. It could be considered to request consolidated reportings to clearing houses or clearing agents which are not so numerous in Europe. This would make easier the building of a deal repository for analysis. In terms of methodology on Repos some interesting leads can be found in the Swiss National Bank Working Paper 2011-14 "Bargaining Power in the Repo Market"¹ which highlights how a repos market can be analysed with specifying segments and relative position from actors.

¹ http://www.snb.ch/n/mmr/reference/working_paper_2011_14/source