Associazione Bancaria Italiana

ABI Response to EBA Discussion Paper On Defining Liquid Assets in the LCR under the draft CRR

March 2013

POSITION PAPER

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General considerations

Proposals to EBA

1) ABI acknowledges the importance and the difficulty of the EBA exercise.
ABI has analysed the detailed suggestions of the proposed methodology, and has noted that the methodology for combining different liquidity metrics together and return a relative ranking is not disclosed in the document and has come to the following considered proposal: EBA and the national supervisory authorities could substantially benefit from using what is already in place and well tested in terms of the liquidity categories for marketable assets for the Eurosystem credit operations. In the following paragraphs we will better detail the reasons behind our proposal number 1.

2) Furthermore ABI proposes to adopt a twofold approach with the ECB methodology being the "standardised approach" and the possibility allowed to more sophisticated banks to use their own analysis subject to local regulatory approval.
This approach could overcome some methodological weakness embedded in a standardized approach. Just to give an example at page 16 of the Discussion Paper the Credit Rating is considered the only general explanatory characteristics specific to an asset that takes into account credit risk.
Credit ratings are an acceptable solution but they are not the best driver that can be used to explain the link "credit-liquidity" because of the cliff effects generated by down/up ratings procedures and transaction inspired by regulatory arbitrage. An alternative solution within an internal model could be the use of credit spreads that can be considered an objective an uninterrupted market assessment of the credit-liquidity relationship.

Arguments in favor of proposal 1)

In order to promote a smooth financial market functioning, under normal and stressed conditions, it is important to reduce as much as possible the uncertainty about the EBA work definition of buffer for liquidity, both in terms of its length and of the final outcome.

We would like to draw the attention on the benefits granted by the simple and pragmatic approach proposed by ABI. Following the "Guideline of the European Central Bank on monetary policy instruments and procedures of the Eurosystem" leads to:

- **minimize any unintended negative consequence on the smooth market functioning**, since any EBA unjustified divergence from ECB is going to have a remarkable impact inter alia on:
  - the repo market, and in particular the asset categories eligible for certain baskets and the related haircuts;
  - any collateral management, margined business and central counterparties (CCP) activities, both in terms of eligibility criteria and risk control framework;
  - the trading activity for any financial instruments included in the (Liquidity Coverage Ratio (LCR) definition, especially in terms of trading limits by risk management offices.

- **efficiently and effectively leverage on the several years of experience and testing by the Eurosystem, and especially the ECB risk management**. As proven by the EBA consultation paper, the liquidity measurement is a sensitive and difficult subject, which in our view should neither be subject to banking supervisory discretion nor diversified by location, at least in the EU. The EBA approach risks going in this direction.
- **leverage on the competence accumulated over years on an issue where securities supervisors and central banks may have an important experience to share**. Central banks are knowledgeable mainly because of the expertise gathered in the implementation of monetary policy (collateral management, risk management), which requires, to be effective, a smooth market functioning, financial integration and financial stability.
- **further promote cooperation between the EBA and the ECB in view of the forthcoming supervisory responsibilities for the ECB**.
- cope with the criticisms that the approach presented in the discussion paper will certainly create. Its major flaws in or view are:
    - **Regime shift**: statistical evidence based on 2008-2012 period would not bring meaningful results for predicting future behavior of potentially liquid assets since there will be a major regime change with the introduction in the EU of the Financial Transactions Tax (FTT) that will cause a serious distortion in the functioning of private financial markets. Moreover the new Basel 3 regulation itself will create a drastic change, since any asset that will be classified by Regulators as highly liquid will benefit of increased liquidity and any asset not eligible will experience a less liquid market place
    - **Data availability**: transactional data may only be available for a limited set of asset classes and financial instruments (e.g. not for repo transaction, not for many assets that are liquid but not "actively traded" since they are priced in relative value terms,…). Especially from a liquidity perspective quantitative repo data is necessary for a correct assessment of the underlying liquidity characteristics
    - **Qualitative or quantitative analysis?** Many of the explanatory characteristics (e.g. large number of market makers, traded via additional platforms and markets, wide range of potential buyers) cannot be handled in quantitative terms, since they are more qualitative (e.g. five not very active market makers could be much less effective in providing liquidity than two big ones; number of buyers is largely depending on pricing and risk taking capacity in a specific moment)[1]. (see also question 4 of the discussion paper)
    - **Biased and not replicable results**: the proposed approach might bring to biased results since it is not taking into account that many assets are priced and traded in relative value terms: even if the actual volumes traded are low, certain assets could be very liquid because highly correlated with other liquid assets. It is also to be mentioned that the proposed approach could never be replicated or back-tested by the banks (because of data availability and resources) so the institutions would not be in the position to challenge it or improve it[2].

[1] See also question 4 of the discussion paper
[2] See also question 5 of the discussion paper

Additional considerations for possible objections regarding proposal 1)

On the scope: One may argue that the scope of the Eurosystem list of eligible assets is not consistent with the EBA exercise. In contrast, **the list of ECB eligible assets – which does not include gold, equities and commodities -** is sufficiently broad in terms of issuer location (EEA plus G10), issuer type (all), asset type (all relevant), currency denomination (most relevant currencies) and creditworthiness. This implies that the Eurosystem scope is compatible with the EBA scope since there should be sufficient information for EBA to make use of the Eurosystem classification for most of the relevant assets to be included in the LCR. **EBA could focus its efforts on those asset categories not included in the broad list of ECB eligible assets or on minor countries and less relevant currencies or major not EU currencies**.

ABI will be glad to collaborate to this.

On the objective: it could be argued that the objective, and more specifically the time horizon, of the ECB risk management differs from those of the banking supervisory authorities. In the event this applies, this should not be leading to a different methodology to assess the market liquidity of asset categories rather to different inputs for parameters, such as the time horizon, which the ECB uses when computing the haircuts for the different liquidity categories. In order to be market-neutral, the methodology applied by EBA should be dependent on the types of instruments and their markets, not on the banking supervisors' objectives. It would have unforeseen market consequences to be assessed, if EBA methodology was diverging from the Eurosystem methodology, without justification.

On the data: one may argue that the ECB is not in the same position than European supervisors in particular ESMA, in terms of data availability for the executed transactions. This seems a valid counterargument. It is positive that EBA is willing to use, as primary source of data for debt securities, the transaction reporting databases held by national authorities, which were created due to mandatory reporting requirements under the Markets in Financial Instruments Directive (MiFID). It would be even better if a single centralised database was set-up and used by ESMA and EBA. As preferred option, ABI would encourage a fruitful cooperation between the European supervisory authorities and the ECB in terms of data exchange, also for the purpose of defining liquidity measurement methodologies.

On CRR categories (Level 1 and Level 2): these could be easily derived considering Table 6. For example Level 1 asset are those belonging to the first second and third ECB liquidity categories while for the remaining asset (Level 2).