Brussels, 3 October 2019

EBF_038260

EBF response to EBA consultation paper (EBA/CP/2019/05) on Draft Regulatory Technical Standards on Liquidity horizons for the Internal Model Approach (IMA) under points (a) to (d) of Article 325bd(7) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 - CRR2)

Q1. Do you agree with the general methodology? If not, please explain why.

The EBF broadly agrees with the general mapping methodology developed in Article 1 of the draft Regulatory Technical Standard on liquidity horizons.

Nevertheless, some points should be considered by the EBA:

- **Cap on liquidity horizons as defined in Article 325bd(4) of Regulation (EU) 2019/876** (i.e. the definition of the Effective LH in art. 325bd(4)):
  - We regret that at this point it is not part of the EBA mandate and as such out of scope of the consultation. We think that it is important to stress this concern in the context of the consultation.
  - We believe capping the LH for a risk factor at the maturity of the related instrument should be an option, and not a requirement. Indeed, from a theoretical standpoint, this maturity cap reveals some sort of constant position assumption whereby no position shall be renewed beyond its expiry. It seems inconsistent with the general constant risk assumption prevailing in the ES formula itself, where the intensity of risk factors (from 0d to 10d, from 10d to 20d, from 20d to 40d, etc.) is deemed constant throughout the life of the positions in spite of the portfolio ageing. Added to that, it contradicts the allowance to increase the LH of a broad risk factor category at the desk level to avoid breaking of hedges. Finally, this capping requirement will create added operational/computational burdens to implement as well
  - Recommendations: Banks should be allowed to assign all instruments to the regulatory LH; capping at instrument maturity should be an option.

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Q2. Besides systemic risk factors (i.e. risk factors capturing the market/systemic component of the modelled risk), are there other risk factors/parameters that would reflect risks embedded in more than one subcategories or more than one categories?

No answer.

Q3. Do you agree with the treatment reserved for homogenous indices?

While we appreciate EBA's effort, we do not agree with the treatment reserved for homogenous indices in Article 2 of the draft Regulatory Technical Standard on liquidity horizons. Indeed, this treatment seems overly conservative and could generate unintended cliff effects (small changes in a component's ratings can result in significant overall change for the entire index). Requiring that LH for homogeneous indices should be determined using the weighted average LH of the constituents is problematic. Indeed, it imposes further operational and computational burdens. On top of that, it can lead to situations where even one constituent of an investment grade (IG) index being downgraded will result in the weighted average LH to become slightly greater than 20 days, and at that point, the LH of the entire index will have to be switched to the next highest LH, i.e. 40 days, although the index is economically more liquid than its components.

Recommendations: We recommend that, for homogeneous indices:

- When the composition of the index is standardised, the liquidity horizon should be determined consistently with the nature of the entire index. For example, a corporate IG index would be mapped to a liquidity horizon of 40 days and a corporate high yield (HY) index would be mapped to a liquidity horizon of 60 days;
- Otherwise, the weighted average liquidity horizon may be used and assigned to the closest corresponding liquidity horizon (out of 10, 20, 40, 60 and 120 days). For example if the weighted average liquidity horizon is 26 days, the liquidity horizon of the index would be 20 days and if the weighted average liquidity horizon is 33 days, it would be 40 days.

This approach would accurately reflect that indices are economically more liquid than their components.

Q4. Do you have any example of other risk factors that should be subject to the treatment specified for indices?

In our view, other risk factors should be subject to the treatment specified for indices, such as indices or baskets on multi-asset classes.

Q5. Are there any other risk factors for which an ad-hoc treatment should be specified?

The ad-hoc treatment should be specified for other risk factors such as correlation parameters. One area where there has not been sufficient focus is the assignment of correlation parameters into liquidity horizons. Since the correlation is derived from variance and covariance, we propose that correlation (A, B) should be allocated to the longest liquidity horizon prescribed for volatility of A and B. For example, a correlation

between two large cap would be assigned to EQ-20 (instead of EQ-60), or correlation between XAU/USD and EUR/USD would be assigned to CO-60 (instead of CO-120).

Q6. What is your preferred option? Please explain why.

We support a consistent definition across regulations. For that purpose, we would ask EBA to consider a market capitalisation of 1 bln € as a relevant threshold for the determination of large market capitalisation, i.e. the same threshold used for the determination of main indices (i.e. Commission Implementing Regulation (EU) 2016/1646, Recital 1).

We appreciate that the EBA proposal considers constituents of main indices as large market capitalisation. This would align the liquidity horizon of a non-decomposed index with that of its constituents in a look-through approach and, consequently, IMA comparable capital charges.

Besides, we proposed for the mapping of homogenous index instruments (cf. response to Question 3) that the index liquidity horizon be set to the closest supervisory LH of the constituents average liquidity horizon rather than the next higher supervisory LH. However, if the EBA ultimately maintains its approach of homogenous index mapping, Option B would have the additional benefit that a homogenous index mapped liquidity horizon would not be "polluted" by a small fraction of its constituents being map to a higher supervisory LH than the majority of its constituents.

Finally, given the benefit of Option B, which we highlighted above, we do not understand the requirement that an indices components must all be quoted in the Union. The same considerations should lead to the same conclusions and hence all indices listed in the Commission Implementing Regulation (EU) 2016/1646 should be eligible for defining large market capitalisation.

About EBF

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