Brussels, 13 December 2013

***Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.***

# EBF Response to the EBA Consultations on currencies with constrained availability of Liquid Assets

The EBF welcomes the opportunity to comment on the EBA consultation paper related to:

- Currencies with an extremely narrow definition of central bank eligibility (EBA/CP/2013/37);
- Currencies for which the justified demand for liquid assets exceeds the availability of those assets under Article 419(4) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR) (EBA/CP/2013/38);
- Derogations for currencies with constraints on the availability of liquid assets (EBA/CP/2013/39);

We would like to highlight the following concerns:

## General Remarks

### Timeline

The EBA will report only once on currencies for which the justified demand for liquid assets exceeds the availability of those assets, to the European Commission by 31 March 2014, before the delegated act on LCR is published in June 2014. Hence, the EBA will not be able to take into account the effects of its own recommendations to the European Commission on the definition of Liquid Assets, on the applicable caps that apply to inflows, and to different Liquid Asset categories within the LCR. The EBF understands that the EBA plans to update its analysis once the delegated act on the LCR has been published in June 2014. EBF Members urge the EBA to update its analysis as soon as its own recommendations are known and it can embed these into its analysis.

### Identification of currencies with a deficit of Liquid Assets

EBA is right to leave the identification of non EEA currencies to local regulators. In this regard it should be made clear that it should also be up to the local regulators how to address the identified shortage of liquid assets. However, it should be noted that this creates uncertainties for European banks since CRR-LCR will be binding on them before these analyses are completed. Moreover, EBA should clarify the treatment to be retained for the jurisdictions where the Basel III Liquidity Coverage Requirement will not be implemented.

In particular we note that EUR currency is not analysed and there is no intent to complete the analysis on EUR by March 2014. Only DKK and NOK have been analysed. The EBF considers it advisable to conduct the assessment of available liquid assets in all EU currencies, to better understand the relative differences between currencies as well as to preserve the ability to observe trends in liquid asset availability in the future. In particular the classification of covered bonds as illiquid in Norway should not be taken on a stand-alone basis but in alignment with the assessment of covered bonds in a broader perspective in Europe.

EBF a.i.s.b.l
ETI Registration number: 4722660838-23
56, Avenue des Arts B-1000 Brussels
+32 (0)2 508 37 11 Phone
+32 (0)2 511 23 28 Fax
www.ebf-fbe.eu

Methodology and Assumptions for determining Liquid Asset shortfalls in currencies

If the calculated shortage shall act as the constraint on the use of derogations it is clearly important that this is estimated correctly. The need for transparency on input data, method and assumptions are crucial. We do not find these areas sufficiently presented in the draft ITS. This will be particularly important for the EUR currency analysis.

When it comes to EBAs assessment of the NOK and DKK we would like to point out the following:

- The share of a market which is defined as hold-to-maturity does not seem to be based on a thorough analysis for each asset class.
    - It is not clear whether the total amount held by foreign investors automatically is defined as hold-to-maturity. According to the paper 20% of the Norwegian government debt is held by foreign investors that are dominated by central banks and other buy-and-hold investors, amounting to roughly NOK 105bn. According to the Norwegian Ministry of Finance the amount held by foreign investors was close to 50%.
    - According to the paper, nearly 20% of the Danish government debt is held by foreign central banks. However, the total holdings of Danish government debt, by foreign investors are roughly twice as much and from a domestic perspective highly inaccessible. Additionally, some domestic collective investment funds as well as government funds investing in Danish government debt are also to a large extend considered buy-and-hold investors – in total roughly up to 20%.
- The buffer needed for the markets to stay liquid after the LCR is fulfilled can be argued to differ from market to market.

Furthermore, we note that the method to determine the deficit of Liquid Assets is too narrow, as it does not take into account:

- The QIS results published by the EBA itself, which show that 46% of Liquid Assets of European banks are held in the form of deposits at Central Banks;
- The credit limits that banks have to adopt for their investment portfolio that constitute actual operational limits to the Liquid Assets they could actually use (and the market would accept);
- The concentration risk in government debt (even though disentangling the banking industry from the sovereign risk is an intended objective of the regulations);
- The impact of unrealised gains and losses of their Available-for-Securities that are no longer filtered out of prudential capital, which creates a disincentive to invest in securities, even more so long term securities.

All of the above are potential flaws in EBA analyses that should be better reflected upon.

Finally, it is not clear with what frequency the calculation will be repeated, or who can make the request for recalculation. In this case it seems more likely that a series of changes over some longer timeframe will impact on the outcome rather than a single event changing the outcome ‘overnight’. Thus, it seems more appropriate to repeat the calculation regularly. On top of this, banks should also have some time to adjust – especially in times of reducing an estimated shortfall and thus reduced need for using derogations.

Envisaged derogations and limits to them

Banks with activities in jurisdictions with deficits of available Liquid Assets, as defined by regulators, are penalised twice since additional haircuts apply to the derogations as well as caps on the total usage of the derogation.

We support the view that banks should not have economic incentives to use the derogations. However, from our point of view, the lack of available Liquid Assets must be considered as a disadvantage for those having to fulfil the LCR, and not an advantage or a result of less professional liquidity management. We thus find the EBA's suggested additional requirements (assessment and notification) unnecessary and representing an additional regulatory burden to the institutions becoming dependent on the derogations.

Setting a cap on the usage of derogations based on a macro perspective may also have unintended consequences on the market for liquid assets. A macro average shortage of liquidity reflects a range of individual bank (micro) shortages. Banks with a shortage below average (or with no shortage) will have an incentive not to reduce their holdings of liquid assets in order not to hit the cap and thus further draining the market for Liquid Assets, i.e. increasing the costs for banks with a shortage above average.

The additional 8% haircut for debt in currencies different from the currency of the net cash outflows does not take into account the fact that currency risk may be hedged (as addressed by Article 418(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."). Thus, there is a risk of counteracting the rule of applying this 8% cap on any discrepancy between the distribution by currency of Liquid Assets and Net Cash Outflows.

Finally, EBF Members are concerned that the EBA specifies the price conditions of Central Bank facilities to banks as well as the haircuts to be applied by the Central Bank to the collateral. This seems beyond its mandate and would ignore market factors and the macroeconomic mandate of Central Banks.

Proportionality of derogations for smaller banks

We note that it was said in the EBA hearing on 19 November that the observance of the principle of proportionality (PoP) with regard to the application of the derogations was not mandated to the EBA in its task to provide its technical standard by the CRR.

According to the EU supervisory authorities, the PoP may be applicable even when it is not spelled out in specific legal texts. It can, therefore, be applied even if the specific CRR provision concerned has not made an explicit reference to the PoP (3L3 Task Force on Internal Governance, Cross-sectoral stock-take and analysis of internal governance requirements).

The use of foreign currencies to fulfil the LCR requirements will increase the currency risk in the banking sector. This will especially be problematic for smaller banks, not having foreign exposures as a significant or natural part of their businesses. For these banks the second alternative of credit lines from the central bank will be the only derogation available. Typically, banks will be resistant to use the liquidity available through such facilities, due to the following negative market assessment. The lines will then represent more a cost than actual liquidity.

Contact Person: Timothy Buenker, t.buenker@ebf-fbe.eu (+32 (02) 508 37 22)
Related documents:
**1. Currencies with an extremely narrow definition of central bank eligibility (EBA/CP/2013/37):**

http://www.eba.europa.eu/documents/10180/455100/EBA+CP+2013+37+%28Draft+CP+on+ITS+on+currencies+with+extremely+narrow+central+bank+eligibility%29.pdf

**2. Currencies for which the justified demand for liquid assets exceeds the availability of those assets under Article 419(4) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR) (EBA/CP/2013/38):**
http://www.eba.europa.eu/documents/10180/455301/EBA+CP+2013+38+%28Draft+CP+on+ITS+on+list+of+currencies+with+liquid+asset+shortage%29.pdf

**3. Derogations for currencies with constraints on the availability of liquid assets (EBA/CP/2013/39)**
http://www.eba.europa.eu/documents/10180/455312/EBA+CP+2013+39+%28Draft+CP+on+RTS+for+the+use+of+derogations%29.pdf

**Response to Consultation Questions on Currencies with an extremely narrow definition of central bank eligibility (EBA/CP/2013/37):**

**Q1: Do you agree with the general approach and its results?**

Yes, we agree.

**Q.2 Do you agree with the above analysis of the cost and benefit impact of the proposals?**

Yes, we agree.

**Response to Consultation Questions on Currencies for which the justified demand for liquid assets exceeds the availability of those assets under Article 419(4) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR) (EBA/CP/2013/38):**

**Q1: Do you agree with the method for estimating the level of free-floating assets required for a market to remain liquid? If not, what alternative methodology would you suggest and what percentage would you deem to be appropriate? Please substantiate your response.**

In principle we agree, however flexibility in setting the level of required free-floating assets would be more appropriate. The general approach of assuming a buffer of 25% of total demand might be an unfortunate simplification. As the EBA recognises, there might be a need for a larger buffer in smaller markets. On this basis it seems appropriate to consider a more dynamic buffer requirement, which at least takes market size into consideration.

Furthermore, we disagree with the classification of Norwegian covered bonds as illiquid. As recognised by EBA the asset class has gained importance in Norway over the last years and the covered bond market (over NOK 500bn) has overtaken the government bond market in size and shows much lower volatility. Especially the supply side liquidity has improved with issuance taking place almost on a daily basis. We believe the assessment of covered bonds should be aligned with the assessment of the asset class on European level. See General Remarks.

**Q.2 Are the assumptions regarding locked-up assets reasonable and, if not, what alternative assumptions should be made? Please substantiate your response.**

In principle we agree, however the assessment of locked-up assets should be far more sophisticated reflecting differences in investor preferences and historic behaviour between jurisdictions (markets). See General Remarks.

**Q3: Is 110% a reasonable assumption for an institution's target liquidity coverage requirement? If not, please outline what you deem to be a reasonable assumption regarding an institution's target liquidity coverage requirement. Please substantiate your response.**

In principle we agree, however setting an average fixed target for an institution's LCR may not be wise since the target may vary over different macro cycles and/or between different institutions with different business models. Thus, an average target of 110% may be reasonable for a start but should be re-examined over time.

**Q4: Do you agree with the general approach and its results?**

The estimated shortfall and thereby the suggested constraint on the use of derogations will be very dependent on the assumptions made by the EBA. The shortage for Norway and Denmark could easily be calculated both higher and lower, with slightly different assumptions. Our conclusion is that the methodology gives results which are far less robust then what is needed for such an important part of public regulation. The sensitivity analysis clearly supports this view by showing that the shortfall varies from 47% to 83% in the case of Norway. This suggests that the use of derogations cannot be solely dependent on this estimate. See General Remarks.

**Q5: Do you agree with the above analysis of the cost and benefit impact of the proposals?**

We do not agree with point 9 in the Draft cost-benefit analysis/impact assessment, where the EBA states that:

> *"The EBA has currently identified only two EU currencies for which the availability of liquid assets is less than their justified demand. The number of institutions operating in these currencies is also small and the amount of total assets that they hold represents only a small share of the total assets held by the banking sector in the EEA. <u>The risk of creating an uneven playing field for the application of the liquidity coverage requirement is therefore small</u>".*

From our point of view, the lack of available Liquid Assets must be considered as a disadvantage for those having to fulfill the LCR, and not an advantage or a result of less professional liquidity management. The current proposal regarding the use of the derogations will involve higher costs and a competitive disadvantage.

We thus find it misleading of the EBA to state that the risk of creating an uneven playing field is small based on the fact that the number of institutions and total assets in Norway and Denmark is small relative to the number of institutions and total assets held by the banking sector in the EEA.

**Response to Consultation Questions on Derogations for currencies with constraints on the availability of liquid assets (EBA/CP/2013/39)**

**Q1: Do you agree with the proposed notification mechanism, its contents and timelines? If not, why not, and what should be altered?**

We agree with the proposed mechanism of notification as it assures a level playing field. However, the timing of notification may not be possible due to market changes. The updating of the notification should not be annually, but be at a shorter interval.

It should be noted that the calculation of the credit line fee according to the pricing formula envisaged by the EBA is potentially challenging from an operational point of view, especially when the assets kept to secure the credit lines are non-marketable assets. Depending on the hypothesis and the quality of the data retained for the analysis, the results of the fee valuation may differ significantly between the banks; which is not contributing to a level playing field. Therefore, we favour a fee that could be valued based on management data provided by the banks, but that would be identical for all the institutions using the derogation B.

**Q.2 Are the steps to prevent the unnecessary use of a derogation clearly described? Do you see these steps as appropriate? If not, why not, and what should be altered? Are there any additional specifications that could clarify the assessments under paragraphs 1 and 2 of Article 3?**

We do not see the steps as necessary as the use of derogations comes with a cost. Thus, banks by nature have a high incentive to reduce the need for derogations by reducing the need for liquid assets by sound liquidity management and increasing the holdings of liquid assets as much as possible from the market. See General Remarks.

**Q3: Are the workings and conditions of derogation A clearly described? Do you see these steps as appropriate? If not, why not, and what should be altered?**

See our response to Question 2 above.

**Q4: What criteria would you regard as useful for evaluating the historical evidence as mentioned in paragraph (4a) of Article 4?**

For currencies not actively traded in global foreign exchange markets we find 10 years is a very long period, 5 years would be more appropriate.

**Q5: Is the additional 8% haircut on foreign-currency-denominated assets held under derogation A appropriate? If not, why not, and what alternative treatment would you propose?**

The additional 8% haircut for debt in currencies different from the currency of the net cash outflows does not take into account the fact that currency risk may be hedged (as addressed by Article 418(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."). Thus, there is a risk of counteracting the rule of applying this 8% cap on any discrepancy between the distribution by currency of Liquid Assets and Net Cash Outflows.

**Q6: Are the workings and conditions of derogation B clearly described? Do you see these steps as appropriate? If not, why not, and what should be altered?**

We agree that the use of derogation should not be advantageous; however we are concerned that the EBA specifies the price conditions of Central Bank facilities to banks, as well as the haircuts to be applied by the Central Bank to the collateral. This seems beyond its mandate. These credit facilities will be part of the tools available for the Central Bank to lead the monetary policy; hence the pricing conditions should remain its prerogative.

If the EBA retains a pricing formula of these credit lines in its final RTS, we draw its attention on the fact that the resulting fee should not be too high, or the banks will not resort to these facilities, favouring an arbitrage between the fee of these credit lines and the cost of term borrowings from the Central Bank placed on an overnight basis at the Central Bank.

**Q7: Is the proposal to limit the total use of the derogations by an institution to the relevant shortage percentage in the annex of the draft ITS containing a list of currencies with constraints on the availability of liquid assets under Article 419(4) CRR clearly described? If not, why not, and what further matters should be included? Do you see these stipulations as appropriate? If not, why not, and what should be altered?**

We do not find the proposal to limit the total use of derogations appropriate. Rather than setting constraints on a micro level, the usage of derogations should be supervised by appropriate authorities with the possibility of taking additional steps towards the banks using derogations if the total usage of derogations exceeds the total estimated shortage of liquid assets. See General Remarks.

The use of derogations is already strictly framed since firstly the banks have to demonstrate that they have made all the possible efforts to reduce their need for these derogations and moreover there are specific haircut and pricing conditions to offset any economic incentive to use these derogations. As already stated, we find that the methodology gives results which are far less robust then what is needed to cap the usage. Consequently, there is no need to add another constraint such as this quantitative cap. If this cap is retained, the percentage of use of the derogations should also take into account a LCR target at 110% in order to be consistent with the methodology used to define the shortage percentage of liquid assets.

**Q8: Do you agree with the above analysis of the cost and benefit impact of the proposals?**

We do not agree with point 14 in the analysis of the cost and benefit impact of the proposals.

The requirements raised in this RTS will raise material costs for the institutions that will use these derogations, including increased operational costs such as increased reporting requirements and efforts made to reduce the need for the derogations.

**Q9: Please provide any evidence or data that would further inform the analysis of the likely cost and benefit impacts of the proposals.**

NA