



The voice of banking
& financial services

European Banking Authority
Tower 42 (Level 18)
25 Old Broad Street
London EC2N 1EX

14 August 2013

Dear Sirs,

BBA response to EBA RTS Additional Liquidity Outflows

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking. The BBA is pleased to respond to this consultation.

Key messages

Implementation timetable

Firms are currently under considerable pressure to implement a wide variety of regulatory changes. Not only are there significant changes to liquidity reporting on both a European and Global level, but there are also a wide variety of other reporting requirements that need to be incorporated into current systems (for example, COREP) which tie closely to liquidity, both in regards to system development and the personnel responsible for implementation.

Bearing this in mind, we would ask the EBA to seriously consider the need to give firms a more realistic time-frame in which to implement these changes, with a view to ensuring firms will be in a position to provide accurate and meaningful data when implementation begins.

Level playing field

We are concerned that the CP significantly departs from Basel standards, and indeed from those in any other jurisdiction. While we understand that the EBA is keen to implement what it believes will help achieve its objectives, this could adversely affect EU- based institutions, or encourage the shifting of risk to non-EU regulated entities. We would thus recommend that the EBA aligns their proposals alongside Basel recommendations where possible, and also consider consulting with other jurisdictions in order to ensure a consistent and coordinated advanced approach.

Conclusion

The BBA fully supports the objective of promoting the short-term resilience of the liquidity risk profile of banks. Annex 1 to this letter contains our formal response to the questions laid out in the consultation, which we trust will help the EBA formulate its final policy. The BBA would be very happy to further assist the EBA in relation to the above.

Yours sincerely

Robert Driver

A handwritten signature in black ink, appearing to read 'R Driver', with a long horizontal flourish underneath.

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Annex 1

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?

We believe all outflows are material.

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.

We acknowledge that items 2(a) and 2(b) are captured separately within the LCR/CRR IV (paragraphs 116 and 119 in Basel 3 and Articles 422.6 and 423.1 in the June 2013 CRR IV text). However, in our view it would be more appropriate to include these items within the scope of this RTS, on the basis that:

- (i) Item 2(a) requires that flows from maturing derivative trades should not be included within the additional collateral outflow calculation. These trades currently form part of the EPE trade population, excluding these trades would mean that any valuation changes on these trades may not be captured. The EBA also needs to provide a definition of maturing. For most trades risk will be small, so it is therefore unlikely that any significant MTM movement re maturing trades. On the assumption that this is to remove the impact of the MTM dropping out of the collateral call from the liquidity requirement, we support excluding these trades.
- (ii) Item 2(b) states that we should not include additional collateral flows resulting from changes in value of collateral already posted. However this will be one of the main sources of additional collateral outflows for secured financing trades and derivatives. Quantifying liquidity requirements due to declines in collateral value under a different scenario may not provide a holistic or consistent approach to capture liquidity outflows (see question 3 below for more details).

In order to capture all collateral outflows in a consistent manner, we propose that a potential option would be for institutions should be allowed to capture the above outflows (item 2(a) and item 2(b)) within their "Additional Collateral Outflows" model. To the extent these outflows are captured within the "Additional Collateral Outflows" model, institutions should be allowed to exclude (or adjust) them from the outflows captured within paragraphs 116 and 119 of the LCR and Articles 422.6 and 423.2 in the June 2013 CRR IV text. The permission for this treatment can be managed as a part of a waiver for the "Additional Collateral Outflows" model.

We stress this would only be an option for firms who want to take this approach, and firms that want to calculate the outflows in accordance with the CRR format outside of their model would still be able to do so.

In addition, further clarification is required for the treatment of contingent collateralised trades, for example, uncollateralised derivative transactions that require collateralisation following a multi notch downgrade as defined in the LCR/CRDIV text. We believe these transactions should be considered as in-scope for this RTS (i.e. considered as collateralised) to capture potential changes in MTM in a stress.

It would be very helpful if the EBA could provide examples that illustrate the interaction of the LCR position according to CRR Art 422.6/423.1, and the "additional liquidity outflows corresponding to collateral needs" defined in this consultation paper. We have provided a couple of examples below to illustrate this point:

(i) equity options

1. short call option on a **non-financial major index company**, out of the money (strike 100, underlying price 80), maturity within 30 days, provided initial margin 5 (cash collateral), calculated potential liquidity outflow from adverse market scenario: 7

2. same as 1, but in the money (strike 100, underlying price 120).

3. same as 1, but option maturity > 30 days

4. same as 2, but option maturity > 30 days

Same as above for an underlying, which is not eligible for the liquidity buffer, i.e. financial equities or a non major index company.

Same as above but provided collateral are securities, which are not eligible for the liquidity buffer.

Same as above but provided collateral are securities according to Art 416 d) (transferable assets that are of high liquidity and credit quality).

(ii) options on interest rate derivatives

1. short interest rate payer swaption out of the money (strike 2.00%, underlying (forward) rate 1.50%), exercise date within 30 days, provided collateral 0.1 (cash collateral), calculated potential liquidity outflow from adverse market scenario: 2

2. same as 1, but in the money (strike 1.50%, underlying (forward) rate 2.00%) and provided collateral 0.5 (cash collateral),

3. same as 1, but exercise date > 30 days

4. same as 2, but exercise date > 30 days

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.

Additional collateral outflows from secured financing trades could occur in the following situations:

- (i) Within triparty repo agreements, there can be additional collateral demands on an institution due to assets becoming ineligible for reasons such as rating downgrade and price change leading to breaches in concentration thresholds. This would also be true for bilateral arrangements and CCP's who give

themselves a free option to do this. We are concerned that this could be a significant source of risk.

- (ii) It is unclear whether any contracts with minimum transfer amounts or thresholds could be considered margining sets. Overwhelming majority of contracts will have one or both features. We would suggest clarifying that that contracts with thresholds and MTAs below a specified level (e.g. EUR10 million or equivalent in another currency) can still be considered a margining set.

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

We are generally happy that the paragraphs meet this objective. However, we would ask the EBA to provide further clarification for trades that cannot be captured by the default methodology used by the firm. For example, certain exotic derivative structures may not be captured by the EPE model, and an alternative approach may be required to capture the additional liquidity outflows.

It should also be noted that the prohibition of a partial use might have a counterproductive effect as an institution cannot use better results from IMM, even if it covers 80 or 90% of the trades. The possibility to implement IMM step by step, for example for main risk factors and major legal entities first (i.e. partial use in coordination with national supervisor), would support the development of IMM better than its prohibition.

Due to the costly nature of model development, it is necessary to provide a waiver procedure for legal entities, products and risk factors, depending on the risk of the respective derivatives portfolio. This waiver procedure will also need to be transparent to ensure appropriate time for the planning and development of the models and systems.

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 EBA needs to provide further clarity around the scope of this question. Is it aiming purely at a class of derivatives, or does it intend to capture all financial instruments that would require additional collateral in times of stress. We would also raise the following issues:

- (i) The paper also seems to discount the possibility that there could be negative interest rates at some point in the future. More details need to be provided as to what action a firm should take in given scenarios in an environment involving negative interest rates.
- (ii) The scope of financial instruments that are covered by the stress should be set out clearly in the RTS. We believe the approach should be explicitly stated as holistic; the same described stress should be applied simultaneously and consistently to all financial instruments to determine any additional outflows that would arise.
- (iii) In the case of bond derivatives / financing transactions, the EBA needs to provide clarity on how value of that security be stressed in re-valuing these transactions.

If the intention is that firm's derive the price change from moving interest rates and other parameters that should be explicitly stated in the RTS. If this is indeed the case, we believe this could involve considerable systems implementation costs (we have assumed the intention was not to cover bond price change under 'Risk Factor Other').

- (iv) The definition of the shocks for risk factor credit risk are potentially confusing as converting a three notch downgrade (and upgrade) into changes in the pricing inputs to CDS models is likely to produce institution specific results unless they share the exact same methodologies. We recommend a straightforward approach consistent with the definition of the shocks for all other risk factors (for example a % up/down shift in the CDS curve).
- (v) The stress itself requires considerable implementation cost and effort as the final scenario has to be derived from the outcome of running each of the risk factors individually and testing the outcome. For a firm trading 30 currencies, this involves $30 \times 2 + 5 \times 2 + 1$ complete scenario runs; re-calculated as frequently as demanded by the local regulators.
- (vi) The 60% stress for "all other equities" seems particularly high. A typical 1:200 stress would indicate that 40% is the correct risk factor, it would be interesting to note which class of equities experienced a magnitude of stress higher.
- (vii) Application of multi-factor stress following single factor stress is unnecessary complication that adds little value to calculation, but would likely require significant systems development across the industry
- (viii) Incorporating outflows as a result of positive shocks is inconsistent with the other aspects of LCR and historical liquidity events. If, for example, equities increased by 20% in OECD markets and 40% in non-OECD, this would tend to increase the value of collateral: (1) currently being financed in secured funding; (2) currently collateralizing equity derivative activities; and (3) held unencumbered, all of which would allow for increased liquidity inflows from increased secured funding or through asset sales.
- (ix) The methodology unnecessarily penalizes banks with portfolios that are protected on downside (from a system liquidity risk perspective, such a portfolio would have "right way risk"). If there is concern that one or more firms may face significant liquidity outflows in a largely positive scenario, we suggest that the subject of a separate consultation that also takes into account some of the countervailing considerations that would appear in other LCR categories.
- (x) The proposal may result in significantly greater estimated outflows than under 24-month look back approach that is unsupported by historical evidence. The small length of time between the proposed finalization of the initial reporting (estimated at 3Q14) and the initial liquidity holding requirement at January 2015 may give EBA and firms very little time between a monitoring requirement and a liquidity holding requirement.
- (xi) The EBA clarified at the public hearing that contracts with no CSAs or certain 1-way CSAs could be excluded from the calculation process. We believe this could be clarified in any final draft to avoid inconsistent application.

We recommend that the EBA permit firms that have little impact on overall financial system (e.g. legal entities that have a balance sheet <EUR 1 billion) to have any outflows set as part of the annual assessment process outlined in Article 420(2). We would also suggest the EBA implements the Basel III agreed 24 month look back as default method, allow for calculation:

- By legal entity looking at total collateral inflows and outflows on daily basis for prior 24 months, identifying highest absolute net outflow.
- By legal entity and by counterparty, netting collateral inflows and outflows with offsetting derivative inflows and outflows (e.g., a EUR100 collateral outflow to Counterparty X that is offset by a EUR100 contractual inflow from Counterparty X related to the maturing payment.

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?

The BBA has no comments.

Q7. How do you view the restriction in paragraph 2, point h(ii) 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?

The EBA needs to provide clarity as to whether 'cash' constitutes a liquid asset within the meaning of that article.

Although assets of lesser liquidity tend to be a small part of firm collateral flows (the majority is extremely highly liquid assets i.e. cash and highly rated government bonds) these assets should be recognised for inflows considering the majority of this type of collateral is accepted under the definition of HQLA's. This collateral tends to be in the form of government bonds, agencies, corporate bonds and RMBS. As noted, these all currently qualify as HQLA's. We would recommend these inflows are accepted with appropriate haircuts as already determined.

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 BBA has no comments.

Q9. What impact in terms of liquidity coverage requirements do you foresee of the application of the standard method on your institution?

More clarity will need to be provided to the points raised in this paper before we are able to answer this question.

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?

The BBA has no comments.

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?

The CP does not take into account the use of margining, in the sense that all derivatives are to be accounted for, whether or not they are subject to margining. The problem with this approach is that it overestimates the level of risk the derivatives pose to the firm in any given scenario.

It should also be noted that selecting from pre-defined scenarios increases the risk that this is seen as a process only rather than requiring specific thought and analysis. It would be better for firms to be able to proactively manage their scenarios based on changing market landscape.

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.

The BBA has no comments.

Q13. What impact in terms of your institutions liquidity coverage requirement do you foresee for the application of the simplified method? How would this compare to the 5% threshold that is specified in paragraph 1 article 3?

The BBA has no comments.

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?

The BBA has no comments.

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 would refer you to our answer for question 2 where we detail the items which we believe should fall within scope of the EPE model. We feel it would be prudent for the EPE model to utilise stressed market parameters in the simulation. The calibration for this stress should be based on a combination of the market parameters used in simulation and the confidence

level. We would suggest a confidence level range of 95-99% depending on whether stressed or current market parameters are utilised within the model.

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

We would suggest a number of adjustments required to the current internal approach (based on an EPE model).

- (i) The current EPE model does not consider exchange traded derivatives; these would need to be bought into the simulation.
- (ii) The current internal EPE model considers counterparty level netting, while the proposed model requires netting on a margin set level basis.
- (iii) The proposed model requires that all variables that impact the value of transactions are included within the calculation, while the current internal approach does not capture all risk parameters, for example, volatility skews.

Some adjustments may be required to the treatment of secured financing transactions and collateral already posted (if this is allowed to be included within the scope of this model as explained in response to Q2 above).

- (iv) The model needs to incorporate a level of materiality to ensure only significant variables are utilised in the model.

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 BBA cannot give a definitive answer as the costs will vary from firm to firm. However, as a general point firms will need at least 2 years to implement the methodology.

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

More clarity will need to be provided to the points raised in this paper before we are able to answer this question.

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?

We can understand the thinking that VaR may provide benefits for splitting counterparties. However, this will only be relevant to firms who are able to utilise this approach to VaR, which we feel would very much be a minority.

We feel that a simulated EPE model would be the better approach for most firms when they approach model additional collateral outflows. VaR is primarily used as a metric to capture potential capital losses, which may not represent liquidity outflows. Any VaR based approach

would also need to consider the distinction between collateralised and uncollateralised trades as well as counterparty specific aspects.

Based on this we think it may be a useful option for firms with the capability to use a model based on VaR, but it should not be compulsory.

Q20. Do you foresee any difficulties in calculating the consolidated estimates? If so, what are these difficulties and why do they arise? How material are they? What would be an appropriate alternative treatment?

We have not identified any difficulties.

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?

Calibration of the historical look-back approach would need to consider a stress period (e.g. 2008/09). A key limitation with quantifying additional liquidity outflows with historical data is that it may not represent the risk attached to current positions and operational arrangements. Another issue is that liquidity resilience (as measured by the LCR) should be appropriate to current positions which are unlikely to be represented by a historic scenario. As such, we feel this may not be the most appropriate method to capture additional liquidity outflows for complex portfolios.

It could potentially be an option for firms with very simple portfolios, although it would need to be accompanied by a stressed add on. However, the model would need considerable reworking if this was to be an option.

Q22. Is the method sufficiently resilient against potential future changes in volatility and against potential future changes in the size or characteristics of a bank's derivative portfolio? If not why and how could any such deficiency be addressed?

The BBA has no comments.

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 BBA has no comments.

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?

The BBA has no comments.