

# Comments

## On the EBA Discussion Paper “On defining liquid assets in the LCR under the draft CRR”

Contact:

Silvio Andrae

Telephone: +49 30 20225-5437

Telefax: +49 30 20225-5404

E-Mail: [silvio.andrae@dsgv.de](mailto:silvio.andrae@dsgv.de)

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

Coordinator:

German Savings Banks Association  
Charlottenstrasse 47 | 10117 Berlin |  
Germany

Telephone: +49 30 20225-0

Telefax: +49 30 20225-250

[www.die-deutsche-kreditwirtschaft.de](http://www.die-deutsche-kreditwirtschaft.de)

## Comments “On defining liquid assets in the LCR under the draft CRR”

On 21 February 2013, the European Banking Authority (EBA) published its Discussion Paper entitled “On defining liquid assets in the LCR under the draft CRR”. The German Banking Industry Committee (GBIC) hereby gladly seizes the opportunity to share its respective comments.

### I. General

The GBIC welcomes the EBA’s plans to provide banks with uniform criteria that are simple to implement for the purposes of assessing liquid assets. The “Expected output of the EBA analysis” (page 9) clarifies that the definition of these assets shall be based on the respective asset class and on certain explanatory characteristics such as the security’s external ratings or its issuance volume.

In our view, however, the definition of liquid assets constitutes a major challenge. This is especially owed to the fact that this issue is still a matter of intense debate in science and academia. At present, it remains unclear which assets shall subsequently be deemed liquid assets. This is due to the difficulties surrounding the approach outlined by the EBA as well as the paucity of data. Hence, from our point of view, a renewed discussion with the banking industry of the final definition developed by the EBA on the basis of the methodology presented in the Discussion Paper is indispensable. In this regard there seems to be a particular need to analyse the impact of such a definition on the LCR. Said analysis ought to take place by means of impact studies. This applies in particular whenever EBA’s definition constitutes a significant departure from the classification currently used under the qualitative impact study (QIS).

Also the data chosen by the EBA for the study are a source for concern. In our view, the exclusive focus on spot markets (exchange-traded or over-the-counter) facilitates only limited coverage of the liquidity of the securities under investigation. For instance, also the sale of a security during repo transactions presents banks with an excellent opportunity of generating liquidity outside of the central bank even during times of crisis. In practical reality, more likely than not, repo markets will be even more important for the purposes of liquidity generation than spot markets. Neglecting these markets constitutes a major flaw in the proposed analysis. We appreciate the stated constraints that the EBA has experienced in obtaining a sufficient data set, however we strongly emphasize the need for data on collateral eligibility and haircut levels from tri-party clearers and the largest of EU institutions conducting secured financing transactions to be incorporated into the ultimate analysis. This is important in particular for repo business traded in an organized market with a central counterparty, such like Eurex Repo (GCPooling). There should be an agreement with the clearer on asset classes or issuer types that should be considered as liquid assets.

We welcome the fact that there are no plans to force banks themselves into using the liquidity metrics that are being reviewed by the EBA in the framework of the envisaged empirical analysis. The criteria listed hereunder are largely based on data the present availability of which is extremely limited even for exchange-traded securities. Hence, banks would either be incapable of meeting such a requirement or compliance would incur a prohibitively high cost.

There shall and must not be any obligation for banks to use the liquidity metrics in order to carry out an independent review verifying that the liquidity classification is up-to-date. Any such single-handed analysis obligation for banks would not only result in prohibitive costs for banks themselves (c.f. above) but it would also be inefficient in economic terms and create considerable competitive distortion.

One further additional downside of using liquidity metrics during the analysis envisaged by the EBA consists in the fact that the metrics may change over time. Consequently, the ranking of the liquidity inherent in individual asset classes or the parameters defining high liquidity or extremely high liquidity and

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credit quality may change. As a result, the EBA needs to repeat such analyses in regular intervals (or ad hoc).

On the whole, we feel that linking the proposed liquidity risk metrics to an ordinal ranking of securities classes seems to be a major challenge and we doubt its practical feasibility.

Furthermore, the differentiation between liquid and illiquid securities categories triggers undesirable side effects. As Banks will start to sell illiquid assets the definition might result in cliff effects and herding behaviour which, in turn, might incur additional market turmoil. This could be avoided by using a broader definition of liquid assets.

Generally speaking, the liquidity-based categorisation of securities should be simple and transparent. Notwithstanding the foregoing, in order to ensure a uniform categorisation, we would welcome an ISIN list of liquid assets (including haircuts) which the EBA ruled out. Potentially, the EBA could delegate the task of drafting such an ISIN list and regularly updating it to the central banks. Already today, central banks publish similar lists (for instance the ECB’s file of eligible collateral). However, the ISIN list should not be exhaustive.

In line with the mandate contained under Article 481(2) CRR the Discussion Paper explicitly focuses on transferrable assets of extremely high liquidity and credit quality. However, the CRR covers further assets eligible for LCR recognition as liquid assets (e.g. under the provisions of Article 404(1)(1) lit dc.). There should be a clarification that the defining criteria proposed by the EBA do not refer to these additional assets.

In this respect EP, Council and Commission have especially agreed to include CIUs if they only invest in liquid assets (Art. 404(5) CRR). However, this is a problem because CIUs often hold short term bank deposits predominantly to settle cash flows. Disqualifying CIUs on the grounds that these entities hold short term deposits at banks would effectively rule out CIUs as liquid assets. After all, in order to meet the ESMA requirements for an appropriate liquidity management also during times of stress CIUs have to hold sufficient liquidity. For this reason, if no solution for this problem has been found in the CRR, short term bank deposits held by CIU’s investing in liquid assets ought to be regulated by the EBA in the form of a derogation rule

The EBA holds the view that “evidence that a certain asset class is liquid in a specific EU jurisdiction does not imply that the same asset class would be liquid in all EU jurisdictions” (page 8). We have difficulties in comprehending the rationale behind this reasoning. In our view, freedom of capital movements within the EU generally ensures that assets can be converted into cash equally fast everywhere in the EU. When assessing an asset’s liquidity, it should be sufficient that an asset held can be sold or pledged at any point in time in any random European market. Access to at least one market translates into the assets’ fungibility. Notwithstanding the foregoing, it would be possible that certain asset classes will be assessed differently under different jurisdictions therefore incurring a different treatment.

By way of analogy, the same applies to the currency aspect. On page 9 of the Discussion Paper, the EBA points out that “only assets issued in EU currencies will be assessed”. Whilst this may be appropriate for analytical analyses it should not mean that assets denominated in a different currency will be deemed per se illiquid.

Last but not least, we would like to suggest synchronising the proposed methodology for classifying liquid securities with other regulatory initiatives taking place in this context. Especially the proposed financial

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transaction tax legislation will have severe negative repercussions on the liquidity of repo markets. Likewise the transaction tax will have direct negative effects upon transactions on spot markets. Therefore minimum trade volume of the assets, average volume traded and average trade size respectively, maximum bid-ask spread, just to name some. This will affect the pool of available liquid assets. Furthermore, as market makers rely on liquid repo markets the negative effects of the transaction tax on spot markets will be reinforced by the reduced liquidity of repo markets. Thereby these regulatory requirements will tend to reduce the number of market players and market makers. Regulatory initiatives like Solvency II may affect the range of potential buyers and hence would have an impact on the set of liquid assets.

Furthermore, we would like to draw the EBA’s attention to the degree to which the repo market is relying on the concept of collateral baskets. Liquidity of the repo markets will be impacted in a very negative way if such a basket is deemed as non liquid as soon as one of the basket’s potential constituents is not liquid by the EBA’s definition. We ask the EBA to assess the ramifications of this “worst to deliver” problem thoroughly.

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### II. Specific Comments

*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?*

The period of time chosen by the EBA is the stress period that led to the Basel III LCR regulations. It coincides with market periods that were marked by extreme stress and high volatility. Hence, more likely than not, the results of the analysis are fairly robust and conservative. If securities have been liquid during that period (not only in spot markets but also in repo markets) they should qualify especially for the LCR. However, we would like to emphasize that the period under observation merely reflects one specific stress scenario which might manifest itself differently in future.

Furthermore, during the crisis, some assets suffered a reduced capacity to generate liquidity (e.g. as a result of haircut widening or price movements), but they did not cease to be liquid. In fact many assets experienced a sustained capacity to generate liquidity, but just at lower levels compared with pre-crisis; much of which can be contributed to a heightened risk management and increasingly prudent approaches to collateral management. Therefore, data constrained purely to a stressed period might indicate that such assets are relatively illiquid in comparison to their peers and yet the asset has a proven sustained capacity to generate liquidity throughout all periods.

Hence, in general, we would prefer a longer period of observation. Longer data series might compensate for unusual market volatility and provide a more realistic view of the aforementioned exceptional situations. Should individual jurisdictions be able to draw upon longer data histories, it would be meaningful to use these data. Furthermore, an analysis of data series in a number of currencies would be helpful.

Last but not least we like to point to the fact that the explanatory power of historical data in the context of defining liquid assets is generally biased due to the fact that the definition will become a self-fulfilling prophecy. As banks will start to buy assets that are liquid under the LCR these assets will automatically become more liquid. From our point of view this is another reason for using a broader definition of liquid assets.

*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 see a need for a diversified analysis that draws upon a wide variety of available data sources. This is a *conditio sine qua non* for a sound review. The usage of MiFID data as a transaction based data base for debt securities seems reasonable. However, when using the data source it should be borne in mind that these transactions are also based on a host of different data sources.

Besides, the transaction data bases kept by national supervisors (along with other data which cannot be used for the purposes of the forthcoming analysis) merely contain the prices and volumes of the securities traded under one jurisdiction. As a consequence, (in line with EBA's observation) for instance bid-offer spreads could be derived by means of a model-based method. This is known to incur a number of fundamental problems. Apparently, when estimating the bid-offer spreads, the EBA wants to use the “effective spread estimator” (by Roll, 1984): Although this estimator is widely used it is still surrounded by a number of particular problems. These problems especially result in the event of a positive covariance of the price changes. In this case, in order to determine the bid-offer spreads, a number of arbitrary assumptions need to be made. Furthermore, Roll's model fails to eliminate the actual daily bond price fluctuation.

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tuations (triggered, for instance, by a strong movement of the yield curve). This might distort the results considerably. Furthermore, the use of models not commonly used by banks can lead to wrong management decisions which in the worst case can even intensify financial crises. Hence, in lieu of theoretical models, when it comes to asset classes featuring offer-bid spreads that are available through the index provider Markit (iBoxx indices) the latter should be used.

#### *Data sources for sales in repo markets*

As has already been pointed out in the general comments above, the sales handled over the spot markets only cover one part of securities' liquidity. We believe therefore that it is imperative that the EBA gives due and equal consideration to the ability to raise finance against an asset, and not just the ability to monetize an asset via outright asset sale. Therefore additional data sources for debt securities should be considered. Although we admit that the availability of that data is limited, we believe that there are a number of other data sources that the EBA should be considering, including the following:

- Data from third party providers which frequently receive trade information from market participants could be used. This could be clearing agents (e.g. LCH, Clearstream, Bank of New York etc.) or third party data provider like Bloomberg or Markit. Hence, the EBA should contact the corresponding trading platforms and investigate ways in which the data existing on these platforms could possibly be used for the purposes of determining the liquidity of securities.
- Repo data covering ECB eligible collateral can be obtained from EurexRepo. They publish the GCPI index family based on turnover in the GC Pooling ECB basket (DE000A0AE077) and the GC Pooling ECB EXTENDED basket (DE000A0WKKX2). Brokertec (ICAP) and MTS (majority owned by LSE) publish the RepoFunds Rate daily repo index for Eurozone sovereign bonds.
- Furthermore, the following tri-party repo providers (Euroclear, Clearstream, Bank of New York Mellon, JP Morgan) should be able to supply information on collateral eligibility, collateral use and haircut levels.

The European Repo Council (ERC) of the International Capital Market Association (ICMA) is already implementing initiatives and working groups discussing liquidity issues of repo business hence it is worth to involve respective members into the analysis and to check with them on work already done. They also conduct semi-annual surveys of the repo market in Europe which might be useful for the analysis. Together with these organisations, the EBA should jointly investigate ways and means to obtain additional data.

Should central counterparties not be able to present the appropriate information, we suggest that the EBA could contact a selection of the largest European financial institutions to gather information on acceptable repo collateral and ability to raise funding/funding volumes against it. We also suggest that the EBA contacts ICMA and ISLA for additional data they may also be able to obtain.

#### *Data sources for gold market sales*

Most gold transactions are over the counter (OTC) and therefore extremely difficult to obtain data on. This obstacle should not however stand in the way of enabling EBA to conduct a thorough analysis into the liquidity value of gold. The World Gold Council will undoubtedly have a range of sources that they can make available. We would also highlight the efforts of the Bank for International Settlements (BIS), which

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has tried to compile derivative volumes globally, notably including gold. Their studies (conducted tri-annually) offer detailed daily total amounts of OTC gold spot and swaps contracts etc.

#### *Data sources for ABS sales*

For additional data on ABS we suggest that the EBA surveys the largest of European institutions for their own internal data with regards to asset backed security volumes and traded prices. As it will be difficult to reconstruct data on ABS we would like to advise the EBA to contact the Clearing-Houses. Nevertheless, from our point of view it will hardly be feasible to reconstruct data on bid/ask spreads. This applies even more as an aggregation of this metric at the level of asset classes is highly problematic due to the heterogeneity of the ABS market. Last but not least the eligibility of ABS as collateral at a relevant central bank is an important determinant for their liquidity. In this respect data could be obtained from the ECB and other central banks in the EU.

*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 liquidity metrics are supposed to be used in order to assess the asset classes and sub-classes. This way, the EBA prejudices the outcome of the analysis, i.e. at which point an asset shall be deemed liquid. However, in the final analysis, the derivation metrics are exclusively based on analysis of plausibility considerations. Apart from this, under the suggested approach, the EBA will eventually also have to define as of which level of one or several liquidity metrics an asset shall be deemed liquid. This is another issue which cannot be resolved by the envisaged analysis. As a consequence, already at this juncture, the EBA will have to make an arbitrary assessment.

In principle, the selection of the liquidity indicators should always focus on the short-term capacity of converting securities into cash with little or no loss of value. In our opinion, this is the case when it comes to assets eligible as security for Central Bank borrowings and securities which are recognised as collateral in a standardised repo market. In the opinion of the German Banking Industry Committee, any answer to the question concerning which specific indicators should be used in order to determine said market liquidity of an asset during the LCR [computation] should accommodate the aforementioned caveat.

One further fundamental problem arises if and when the individual liquidity metrics should, for instance, be linked by means of a scoring approach. We fear that the combined usage of all the metrics might lead to an “over-fitting” (the potential result being that only German government bonds remain in the liquid asset class). Therefore, the precise calibration of acceptable parameters for these metrics must be approached carefully so as to not deliver a result which eliminates many assets which are fundamentally considered liquid in the market, but fail to meet a ‘litmus test’ of metric compatibility. Hence, the EBA should consider carefully the choice of eligible liquidity metrics and their respective, mutual combination.

The EBA primarily refers to market based liquidity metrics within the meaning of the CRR. Below, we would like to address the individual metrics in greater detail.

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From our point of view the selection of the liquidity metrics should especially bear the following aspects in mind:

- The data sources that are being used, if and when available (comparable data from different sources lead to different results);
- The point in time when evaluations were made (for instance the evaluation time plays an important role because data may vary considerably over time) and
- The historical period of time that was used for the analyses; there is no theoretically ideal historical time period which ought to be preferred. After weighing the pros and cons of histories with differing lengths this means, that different periods of time would be justified. However, it is worth noting, that different periods of time yield different results.

#### *a. Minimum trade volume of the assets*

We doubt that this is a sufficient criterion for assessing the liquidity of securities (provided the expression “minimum trade volume” refers to a fungible denomination).

#### *b. Minimum outstanding volume of the assets*

For the “minimum outstanding volume of the assets” similar considerations apply as for the “issue size” (see Q4).

#### *c. Transparent pricing and post-trade information*

No comment.

#### *d. Credit quality steps referred to in Part Three, Title II, Chapter 2 (credit ratings)*

We hold the belief that this criterion is fit for purpose when it comes to assessing liquidity. Presumably, good credit ratings will increase the likelihood that the asset will be acquired by an investor planning to hold it on a long-term basis. In order to obtain the necessary credit lines, a new investor needs a good credit rating. Otherwise, an investment into a broad and deep secondary market will be impossible. Furthermore, in combination with the repo eligibility, it is being ensured that the collateral underlying the repo will be recognised as valuable and sound also over a longer period of time and that the requested haircuts will be moderate. In the final analysis, securities with a good credit rating will also feature satisfactory price stability.

#### *e. Proven record of price stability*

We believe that a reliance on mark-to-market volatility as an indicator of asset liquidity should be avoided. In reality, banks with sound risk management practices will hedge volatility risk away reasonably easily via interest rate swaps, futures, CDS etc. Furthermore, most banks will margin transactions daily and this brings into question the usefulness of price volatility as a real liquidity indicator.

Under the current proposals, liquidity should be assessed on the basis of excess volatility. In our view, in such a case, the main problem [consists] in the definition of the respectively applicable benchmark. Fur-

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thermore, the proposals would have to clarify how the different root causes of volatility should be differentiated from each other (particularly singling out the flight-to-quality).

#### *f. Average volume traded and average trade size (trade volume / number of trades)*

Basically, the trading volume, trading size and turnover ratio are useful criteria for assessing liquidity. However, this hinges on the availability of a fully comprehensive, transparent dataset as the basis for the analysis.

What is more, although the trading volume of a specific security can be a useful indicator of how buoyant an asset's liquidity might be, it is important that the metric is used in the correct context. For example, a market for which there are 2 sellers and 2 buyers will have a trading volume of 2. A second market for which there are 4 sellers and 4 buyers will have a trading volume of 4. These markets have the same relative liquidity value attributed to that security but the absolute trading volumes differ substantially. Furthermore, when calculating the total trading volume metric, the time interval must be appropriately set so as to capture the liquidity effect of quarter end when many banks sell of large proportions of liquid inventory to meet balance sheet constraint requirements. For the turnover indicator, the price ascertained should be an average traded price as opposed to the end of period, for a more representative view.

Furthermore, we would like to share the following comments on the liquidity metrics listed under Annex V:

- *Dollar depth*: we question the meaning of this indicator and the value it adds in calculating the mid-point of the best bid and ask price.
- *Number of transaction/order per time unit*: We express extreme caution at the utilization of this metric; the number of transactions is not necessarily an indicator of an asset's liquidity. For instance during periods of stress, banks tend to stockpile liquid assets and the number of transactions will be comparatively low, due to reduced supply. The number of orders may be equally low as prices rise in the course of excess demand. This indicator would therefore be extremely difficult to adjust in order to facilitate a comparison between asset classes. Furthermore, the metrics are unlikely to add any depth to the analysis which is not already covered by indicators 1 and 2.

#### *g. Maximum bid-ask spread*

In general, we gain the impression that the EBA attributes major importance to the bid-ask spreads. Hence, we would like to point out that this indicator is at best relevant for spot markets. However, this does not apply to the generation of liquidity through repo markets which is preferred by banks. We also question the precise use of the "highest bid" and "lowest ask" as inputs into some of the metric's calculation, and whether this will generate a truly representative view. An average bid-ask indicator for specific time intervals might represent a more useful alternative. Furthermore, bid-ask spreads are intended to be real time indicators of asset liquidity and therefore snap shot data is unlikely to offer a full picture.

Furthermore, the computed bid-ask spreads depend to a major extent on whether the computations are being carried out on the level of the security or on the level of an issuer or of an asset class. Assessments at the level of the individual security are very susceptible to special effects (for instance treatment of new issues, lack of objective database, incomplete time series, volumes held on a permanent basis by long-term investors etc.); if there is an assessment at the level of the issuer it remains unclear, on the basis of

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which nomenclature the information of individual securities should be aggregated into an overall statement; different possible approaches would lead to inconsistent results at this point.

Furthermore, simply examining the bid-ask spreads of five different asset classes and classifying the asset classes experiencing the widest spreads as illiquid would be an ill-considered approach, if the asset has a proven record of remaining a viable source of liquidity throughout periods of stress.

Regarding the absolute spread/log absolute spread: the lowest ask and highest bid will be in some regards driven by limit orders, and will not be representative of the levels at which assets can be traded.

Relative or proportional spread calculated with mid price: as per our previous comment on dollar depth, with this indicator we fail to see the added value of using 2x bid-ask spread divided by the sum of the bid and ask prices.

#### *h. Remaining time to maturity*

We refer to our comments in Q4.

#### *i. Minimum turnover ratio (trade volume / outstanding volume)*

Cf. our comments on lit. f.

Furthermore, we would like to share the following comments on the liquidity metrics listed under Annex V:

Concerning the liquidity ratio 1 and 2, we would like to point out that asset return and liquidity exert an inverse relationship i.e. the most highly liquid of assets experience low returns due to their liquidity premium. Hence, the usefulness of LR1 or LR2 is not immediately obvious to us. Furthermore, these ratios will not account for the effect of ‘market jumps’ i.e. where an asset’s trading levels are altered following a public announcement.

*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?*

In our view the approach at the second level of the assessment (further breakdown of the asset classes on the basis of certain characteristics of explanatory variables) is largely identical with the one employed at level one. Accordingly, the ensuing problems are of a similar nature. This approach, too, at best allows coming up with a ranking of subclasses featuring different levels of liquidity. This assessment does not allow characterising liquidity metrics that will define liquid or illiquid assets.

Also, the dependencies of some characteristics are worth noting; e.g. the lesser the range of potential buyers the more are banks inclined to reduce market making and availability of additional platforms and markets. Consequently, this will weaken the liquidity of an asset (class). Therefore, the inclusion of repo markets relevant criteria as outlined in Q4 is essential.

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We would like to share the following comments on the explanatory characteristics suggested by the EBA:

### *a. Issue size*

We would like to reiterate that, essentially, we view the issue size as a useful liquidity indicator. More likely than not, an increase in the issue size will go hand in hand with an increase in the volume that can be traded freely on the market. By virtue of a high issuance volume, the issuer has proven the liquidity of the issuance. When accompanied by a good rating, this broad investor base can usually be taken for granted also in future.

However, we would like to point out that there is sound evidence for the fact that even securities with an issuance volume of less than EUR250 million during a repo transaction can be converted into cash at any point in time (provided the issuer or, moreover, the issuance features the right rating). By way of example, we would like to mention the securities issued by Germany’s Federal States or Pfandbriefe (German type of covered bond). Partly, they feature a lower issue size. However, by turning to the ECB /Eurex, they can be converted into liquidity at any point in time and feature a low credit risk.

### *b. Collateral eligibility*

We believe that collateral eligibility at a relevant central bank is a crucial indicator which should be absolutely indicative (i.e. assets which are CB eligible in normal times are to be considered liquid), but not an exhaustive (for example, the liquidity value of gold and equities should not be ruled out by central bank eligibility). Furthermore, also eligibility as collateral in a standardised repo market or other repo markets with a proven record of high-volume repo transactions constitutes a suitable criterion. From our point of view, this criterion is fit for purpose. This is due to the fact that repo markets allow banks to generate liquidity outside of the central bank also during stress periods. Due to the collateralisation, even if credit lines are reduced in view of unfolding crises, these transactions can still be implemented fairly well. More specifically, this prevents emergency sales where their liquidity requirements force banks into accepting high discounts from the market value or into realising temporary hidden liabilities. Particularly if there was a systemic liquidity or confidence crisis, the impact of these emergency sales would potentially be further amplified by corresponding balance sheet losses thus enhancing pro-cyclical effects. Last but not least, the market liquidity criterion is being operationalised if it is predicated on standardised repo markets.

### *c. Credit rating*

As already mentioned this is a universally accepted indicator of asset liquidity, with a fundamental relationship between better rating and the ability to monetize a security being observed across all assets. Caution should however be taken when setting a credit rating threshold as many lower rated assets are considered relatively liquid. In particular, credit quality assessment on an instrument level should not be relevant for instruments that are issued by quasi government agencies as the credit should be based on the government, especially where there is no available external rating.

As an example it could be questioned whether the regulatory framework (and in particular the liquidity framework) should give external credit ratings the same weighting as other factors. Many European economies including Germany have strong companies with an excellent credit and issuance track record although they are not externally rated. In case for the rather rare examples of unrated multinationals such as SAP AG the belonging to a stock index should be considered as a compensating criteria for liquid-

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ity (alternatively a shadow rating as generated by the Bundesbank). The shadow rating would further allow to assess other externally unrated and potentially liquid companies as e.g. the top end of the German Mittelstand.

### *d. Remaining time to maturity*

In the asset characteristics, the influence of the criterion “remaining time to maturity” depends to a major degree on the prevailing market conditions. Although at the end of the time to maturity sales will decline, the bank’s focus when assessing the liquidity of a security held by the bank will be on the buyer side. However, for buyers / investors short maturities are more attractive than long maturities. Hence, we feel that this criterion is inappropriate. The influence of the remaining time to maturity also depends on the asset class. In order to facilitate a fundamental liquidity assessment of a security with universally valid outcomes this criterion would therefore merit an in-depth review. Furthermore we feel that the question whether a bond is issued before the most recently issued bond of a particular maturity (off the run issue) is of greater importance for the liquidity than the remaining time to maturity. In addition, we question the relevance of this factor for quasi government instruments as the instruments will bear similar credit risk as sovereign debt.

The following points could be taken into consideration:

### *e. Date of issuance*

This can be seen as an important factor for asset back securities, since the crisis product and asset classes have developed significantly. From an underwriting perspective, the differences between legacy commercial mortgage backed securities and new issue commercial mortgage backed securities are clear and profound. In addition to simpler structures, less pro-forma underwriting and *pari passu* loans, the composition of the loan pool is significantly better. Leverage ratios, subordination, and borrower requirements have all improved dramatically.

### *f. Thickness (i.e. tranche in question as a percent of the deal)*

While the Discussion Paper covers the distinction between senior and junior securities, the concept of “thickness” of an ABS tranche could also be considered.

Partly, the “general explanatory characteristics” highlighted in the Discussion Paper which refer to the market structure would merit a critical review. In practice, quantifying the criteria “presence of a large number of market makers”, “wide range of potential buyers” and “transparency” is hardly possible for market participants. In this context, no mandatory threshold values should be stipulated. Instead, it is advisable to use haircuts.

We also suggest that the EBA should consider including assets that are a constituent of major market indices or for which there are active derivatives and index markets (e.g. Futures, CDX, I-Traxx, etc). This is an important perspective to gain as, whilst some debt securities may appear to be less fungible than equities or commodities, their presence in collateral baskets or indices can allow them to trade on an equal footing basis.

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

The method suggested by the EBA gives rise to considerable issues. Below, please find a more detailed explanation of our respective concerns.

As regards the first stage of the EBA analysis (ranking asset classes on the basis of certain liquidity metrics) the asset classes or asset sub-classes for which this analysis should be carried out initially remain opaque. The objective of ranking asset classes based on their liquidity requires an explicit definition of liquidity. However, the EBA fails to provide such a definition. Furthermore, it remains unclear which liquidity metrics should be used for the assessment. The EBA itself points out that it should be possible to calculate the liquidity metrics for each and any asset class. As a result, the range of available liquidity metrics would dwindle.

On page 7 of the Discussion Paper, the EBA quotes the draft CRR provisions pursuant to which the EBA is requested to review a series of asset classes with a view to their suitability as high or extremely high liquidity assets. In this context, we should like to emphasize that the asset classes to be assessed should not be confined only to those specified under draft Article 404 CRR. Furthermore, we feel that an inclusion of the asset class uncovered bank bonds is vital: This is due to the fact that, especially a comparison to other securities allows important conclusions with regard to their liquidity.

Furthermore, when defining the asset classes under review, there should be a closer analysis of national idiosyncrasies. For instance, whilst the German Pfandbrief is ranked as a covered bond, in terms of its rules, however, it is by no means comparable to the other covered securities in Europe which are listed in the same category.

Furthermore, it is worth considering that the envisaged analysis will have to be updated by the EBA on an ongoing basis. This is due to the fact that, over time, the value of liquidity metrics for certain asset classes may be subject to change. Secondly, also the metrics and characteristics underlying the first analysis would have to be updated by the EBA on a continuous basis. Last but not least, subject to the principle of proportionality, the outcome of the analysis, i.e. the criteria should be publicly accessible to all banks within the EU.

Furthermore - ideally – the assessment would provide a rank (of its own) for each liquidity metric. However, it is highly unlikely that every criterion will produce the same ranking. Hence, the EBA will automatically have to face the question which liquidity indicator should be prioritised for the purposes of defining the liquidity of asset classes. However, this problem cannot be resolved by means of the method pursued by the EBA. At this juncture, a fundamental methodological question arises: Given that the liquidity of individual asset classes apparently does not lend itself to direct observation, the EBA uses a host of metrics which in the EBA's view present an appropriate indicator for liquidity. However, this assessment is exclusively based on plausibility considerations.

It would have been more constructive to first clarify which metric presents the "best" indicator for the liquidity of the asset classes under observation. Given that this cannot be determined ex ante, the EBA would sooner or later eventually have to determine which indicator should be used. In our view, this problem cannot be bypassed by mathematical combination of different ratios, for instance by means of a scoring approach.

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One further problem consists in the fact that the level one EBA analysis – ideally - merely categorises the asset classes based on their liquidity. This ranking does not allow determining which asset classes should be seen as “liquid” within the meaning of the CRR. Even if individual asset classes (for whichever reasons) should be deemed as liquid by the EBA, the ranking would only allow statements concerning the liquidity of the equally liquid or more liquid asset classes. Also at this point, the EBA will eventually have to define a certain characteristic of a liquidity metric (one or several, mathematically combined liquidity metrics) as a dividing line between “liquid” and “illiquid” asset classes.

The definition of threshold values dividing liquid from illiquid assets lacks any theoretical basis. Hence, eventually, this categorisation will have to be made in an arbitrary manner. Furthermore, there is no theoretical basis for handling cases where the defined thresholds are exceeded (e.g. when there are problems surrounding data completeness, arbitrary fluctuations, unique peaks, number of permissible overruns in relation to the historical period of time under observation etc.).

Furthermore, it remains unclear whether statements on liquidity concerning a period of a single day (or less) shall also apply to time periods of 30 days. The ranking does not allow any differentiation of the possibility to turn the assets into ready cash as a function of the size of the items which need to be realised.

As expected outcome the EBA gives a rather straightforward classification (page 9). If the EBA’s analysis reaches such a conclusion, we would urge the EBA to step away from the complex system of characteristics and stick to such a simple classification. As one possible solution and in view of said application problems we would like to submit an alternative to the EBA approach that can be used for bonds. It is a simple proposal which allows defining liquid assets in general as well as, more specifically, assets of high and extremely high liquidity. Our proposal is based on established asset liquidity criteria which can be easily determined and which are widely accepted by market participants. Potentially, this approach reaches the same results as the EBA assessment. The only difference consists in the fact that it is a leaner approach.

First, liquid assets are subject to the general criteria for liquid assets laid down under Article 404(3) CRR draft (lit. a to e) which lists the following five criteria:

- a) Unencumbered and no own issue;
- b) Eligible as collateral for Central Bank borrowings;
- c) Simplicity of price determination;
- d) Stock exchange listing;
- e) Market liquidity.

The definition of criteria a), b) and d) is comparatively unambiguous. In our preliminary understanding criterion c) (“simplicity of price determination”) is deemed to have been fulfilled if the adequacy of the market prices of the relevant asset appears plausible on the basis of standard price determination models with assessment factors that are readily observable (as opposed to complex non-standard models with valuation factors that can only be determined by means of approximation) or, moreover, if pricing on the basis of such models is possible.

In our view, the market liquidity criterion under Article 404(3) lit (e) CRR draft requires further specification. Pursuant to the present language, assets have to be tradable on active outright sale or repurchase agreement markets with a diverse number of market participants, a high trading volume and pronounced market breadth and depth. However, the CRR remains silent on any further, more specific details of the market liquidity criterion.

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When determining assets’ market liquidity, we suggest focussing on a security’s “repo eligibility” or the existence of a sufficiently liquid spot market for this security. In our view “the repo eligibility” criterion will always have been met if the security is admitted as collateral in a standardised repo market (e.g. GC Pooling® of the Eurex Repo® or London Clearing House) or if it can be proven differently, that central counterparties are available for the repo business. The German Banking Industry Committee holds the view that this criterion is fit for purpose. This is due to the fact that banks can go through the repo market in order to generate liquidity outside of the central bank also during times of crisis. The collateralisation means that these transactions can be carried out smoothly even if credit lines have been reduced due to crises. More specifically, emergency sales are avoided where the sheer liquidity need may force banks into accepting major discounts from the market value or into realising temporary hidden liabilities. Especially in the event of a systemic liquidity crisis or of a confidence crisis, the impact of these emergency sales would potentially be amplified in a pro-cyclical manner by corresponding balance sheet losses. Last but not least, the market liquidity criterion is being operationalised if it is predicated on standardised repo markets.

In the absence of a security’s repo eligibility, if there is a sufficiently liquid spot market, the CRR stipulates that said security should still be regarded as liquid. In our view, this will invariably be the case if the security possesses a

- Minimum rating of A- and
- The minimum issue size amounts to EUR250 million (or, in the case of covered bonds based on the total issue volume of a regular issuer).

For the purposes of defining assets of extremely high and high liquidity and credit quality, we suggest using two criteria “credit risk standardised approach credit quality step” (or a similar rating) and “is-sue size”.

In our view, the credit quality step assigned to the security under the Standardised Approach to credit risk (Art. 481(2) lit. d CRR) constitutes an important indicator not only of the credit quality. Based on the latter, it also serves as an indicator of an asset’s liquidity. More likely than not, a good credit rating increases the likelihood of an acquisition by an investor seeking to hold the security on a long-term basis. In order to obtain the necessary credit lines, a new investor needs a good credit rating. Otherwise, an investment into a broad and deep secondary market will be impossible. In combination with the repo eligibility it is furthermore being ensured that the repo’s securities will be deemed as valuable and sound over an extended period of time and that the requested haircuts will be only moderate. In the final analysis, more likely than not, securities with a good credit quality will also feature satisfactory price stability; after all, market players will be less prone to use them in a speculative manner. Only those securities should be allocated to the assets of extremely high liquidity and credit quality which are assigned a credit quality step of 1 under the Standardised Approach or which feature an equivalent rating.

We suggest using the issue size as the second criterion for the definition of assets of extremely high and high liquidity and credit quality. More likely than not, an increase in the issue size will go hand in hand with an increase in the volume that can be traded freely on the market. By virtue of a big issue size, the issuer has proven the liquidity of the issuance. When accompanied by a good rating, this broad investor base can generally also be taken for granted in future. Usually, one issuer issues several comparatively large issues with different terms to maturity meaning that based on these curves, issuer-specific (benchmark) interest rate curves can be drawn up thus increasing the simplicity of the price determination and

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the transparency of the price determination / post trade information requested under the CRR. Besides, lower valuation certainty leads to lower bid / ask spreads.

We hold the view that an asset (which is not already recognised as a security within the meaning of Article 404(1) lit. c CRR) should be deemed an asset of extremely high liquidity and credit quality if its issue size exceeds EUR500 million.

Assets with a credit quality step of 1 and an issue size in excess of EUR500 million can hence be seen as securities of extremely high liquidity and credit quality whilst other liquid assets are assigned to the category of high liquidity and credit quality assets.

### III. Miscellaneous

One comment on Annex 5: Survey of liquidity metrics:

Formula #9 contains an error and should read as follows:

$Sln(t) = \ln(pask(t) / pbid(t))$ ; as a consequence, it would essentially be identical with #12.

Rationale:  $\log_b(xy) = \log_b(x) + \log_b(y)$   
 $\log_b\left(\frac{x}{y}\right) = \log_b(x) - \log_b(y)$

Yours faithfully,  
On behalf of the German Banking Industry Committee



Dr. Martin Lippert



Dr. Silvio Andrae