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**EAPB comments on the EBA discussion paper “Defining Liquid Assets in the LCR under the draft CRR” – EBA reference EBA/DP/2013/01**

Dear Madam or Sir,

The EAPB welcomes the opportunity to participate in the EBA discussion concerning the definition of liquid assets in the LCR according to the draft CRR.

**EBA discussion paper on the definition of liquid assets**

We welcome the EBA's intention to provide institutions uniform and easy-to-use criteria for differentiating between assets of high and extremely high liquidity and credit quality. The definition of these assets is to be based on the respective asset class and on certain explanatory characteristics, such as the external rating of a security or its issue volume.

We similarly welcome the fact that institutions are not going to be forced to apply themselves the liquidity metrics studied by the EBA in the context of its planned empirical analysis. The criteria contained therein are based for the most part on data currently only available in a rudimentary form for securities traded on stock exchanges.

The general disadvantage of using liquidity metrics is that they can change over time. This could result in a change of the ranking of the "liquidity" of individual asset classes or the dividing lines used to differentiate between the high and extremely high liquidity and credit quality of transferable assets. The analyses need therefore to be regularly repeated by the EBA.

It cannot be demanded of the institutions that they assume responsibility for checking the liquidity classification on the basis of the liquidity metrics. The costs for such a measure

would be prohibitively high for the institutions and could also lead to major competitive distortions.

There is a risk that the proposed approach could jeopardize the level playing field since e.g. the same bond could have different classification due to differences in analysis and changes over time. It would be useful if EBA could create a database which attaches e.g. each bond a specific identifier code similar to the ones used in the database maintained by the ECB. Such a centralized database would help to establish a level playing field whilst reducing the operational requirements for banks to a minimum and ensuring a consistent implementation throughout member states and institutions.

Liquidity is in general very intangible, hard to predict and difficult to quantify. Since each period of liquidity stress has its own characteristics, future scenario will not necessarily produce the same type of stressed assets. Therefore more qualitative factors should be added for asset classification.

## **The methodology proposed by the EBA for determining liquid assets**

The empirical analysis of the criteria proposed by the EBA would first and foremost lead to higher costs.

With regard to the first step of the analysis proposed by the EBA (the establishment of a ranking of asset classes related to certain liquidity metrics), it remains unclear for which asset classes or sub-classes the analysis is to be performed. It is moreover unclear which liquidity indicators will be used in the analysis. As noted by the EBA itself, the liquidity metrics would need to be assessed across all asset classes. This would significantly reduce the range of applicable liquidity metrics.

In addition the analysis would – at best – give each liquidity criterion a (its own) ranking. In our opinion, one should not assume that each criterion will produce the same ranking. This will inevitably result in the question which liquidity criterion should be given preference when rating the liquidity of asset classes. As it seems impossible to directly observe the liquidity of individual asset classes, the EBA makes use of a variety of criteria representing – in their opinion – a suitable indicator of liquidity. This assessment is based however solely on plausibility considerations.

It would have been much more to the point to have first selected the criterion representing the "best" indicator of the liquidity of the asset classes under examination. As this cannot be determined in advance, the EBA would have to randomly determine which indicator is to be used.

A further problem is that the first step of the EBA analysis solely ranks asset classes according to their liquidity. Such a ranking means that there is no way of determining which asset classes rank as "liquid" in the sense of the CRR. Even if individual asset classes (for whatever reason) were to be seen as "liquid" by the EBA, the only use of the ranking would be to make a statement on the liquidity of equally liquid or more liquid asset classes. Finally, it is the EBA itself that has to decide over threshold values for the dividing line between "liquid" and "illiquid" assets.

There is also no theoretical foundation on how to deal with exceedances of the set threshold values (for instance in the event of data integrity problems, chance variations, exceptional peaks, the number of allowable exceedances in relation to the considered historical period, etc.).

Problems also arise through the data selected by the EBA for the analysis. In our opinion the exclusive focus on dealer or over the counter (OTC) markets prevents the gaining of a complete picture of the liquidity of the securities being looked at. Similarly the sale of a security in the context of a repo transaction presents an excellent opportunity for institutions to generate liquidity without central bank involvement in times of crisis. In practice, repo markets can be even more important than dealer or OTC markets for generating liquidity. The disregard for these markets constitutes a core weakness of the planned analysis.

The transaction databases established on the basis of the provisions of the Markets in Financial Instruments Directive (MiFID) and maintained by the national supervisory authorities further contain solely the prices and volumes of securities traded in one specific country. As noted by the EBA, bid–ask spreads would then have to be ascertained using a model–based methodology. It is well–known that this is associated with certain fundamental problems. It seems that the EBA wants to depend on Roll's (1984) "effective spread estimator" for estimating effective bid–ask spreads. Even if this estimation approach is widely used, it still has a number of weaknesses.

Our general impression is that major importance is given to bid–ask spreads by the EBA. We would therefore like to point out that this indicator is at best only of importance for dealer or OTC markets, but not for generating liquidity via repo markets. Moreover the ascertained bid–ask spreads are to a great extent dependent on:

- which data sources are used, insofar as data is available at all (comparing data from different sources leads to different results),
- when the analyses are performed (this is of major importance as data can vary greatly in the course of a period),
- whether the analyses are performed at security level or issuer level,
- which historical period is used for the analyses.

The methodology proposed for the second step of the analysis (a further subdivision of asset classes on the basis of certain explanatory characteristics of securities) involves problems similar to those of the first-step analysis. Here as well, different liquid subclasses can only be ranked. No decision can be taken on when a characteristic of a liquidity indicator can be deemed "liquid" or "illiquid".

## Alternative proposal for defining liquid assets

In our opinion, the empirical analysis planned by the EBA involves considerable problems. We would therefore like to put forward an alternative proposal for defining highly liquid and extremely liquid assets.

For **liquid assets** the general criteria for liquid assets set forth in Art. 404.3 CRR would initially apply. Five criteria are listed there (items (a) – (e))

- a) not issued by the institution itself,
- b) eligible central bank collateral,
- c) price easy to be determined,
- d) listed on a recognised exchange,
- e) market liquidity.

With regard to the determination of the market liquidity of assets, our proposal is to base this on the "**repo eligibility**" of a security or on the existence of a sufficiently liquid dealer or OTC market for this security.

In our opinion, "repo eligibility" is to be seen as given when the security is usable as collateral on a standardised repo market (such as the GC Pooling® of the Eurex Repo® or the London Clearing House) or when it can be otherwise proved that Central Counterparties (CCPs) are available for the repo transaction. Due to the collateral, these transactions can

also be readily carried out when credit lines are reduced in times of crisis. The criterion of market liquidity is to a great extent objectified through using standardized repo markets as a base.

Even if a security does not have "repo eligibility", it would still count as liquid under the CRR when a sufficiently liquid dealer or OTC market is available. In our opinion, this is always the case when the security has:

- a rating of at least A– (e.g. Standard & Poors)
- and the issue volume is at least 250 Mio. EUR per issue (or with covered bonds, relative to the total issue volume of a standing issuer).

When referring to the repo market one must keep in mind the current discussion around the potential introduction of a financial transaction tax. As the actual outline of such a tax is burdening the repo market heavily, potential implications of this legislation must be taken into account.

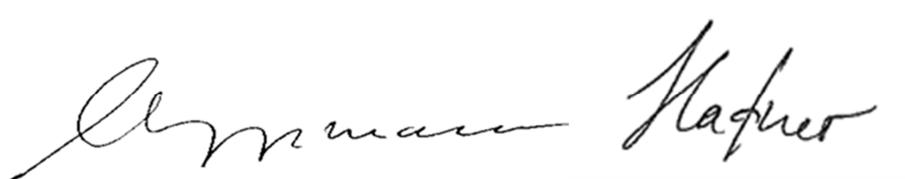
For defining **assets with extremely high and high liquidity and credit quality**, we propose using the two criteria "CRSA credit rating" (or a similar rating) and "issue volume". Securities should only be defined as assets of extremely high liquidity and credit quality when they are classed as having a CRSA credit quality step 1 or a similar rating.

In our opinion, an asset (when not already recognised as a government bond under Art. 404.1.c CRR) can be seen as an asset of extremely high liquidity and credit quality when the issue volume is higher than 500 Mio. EUR. Assets with a credit quality step of 1 and an issue volume of at least 500 Mio. EUR would therefore qualify as securities of extremely high liquidity and credit quality, whereas the other liquid assets would be classed as items with high liquidity and credit quality.

In addition to the assets recognized under Article 404 CRR we would like to emphasize the importance of other asset categories not yet identified under the aforementioned article. Assets such as public bank bonds, agency bonds and local government bonds should be judged by the same liquidity standards as those specifically mentioned in Article 404 CRR.

Should you have additional questions or comments, please do not hesitate to contact us.

Best regards,

Two handwritten signatures in black ink are shown side-by-side. The signature on the left is 'Schoppmann' and the one on the right is 'Hafner'. They are enclosed in a thin black rectangular border.

Henning Schoppmann  
EAPB

Sandra Hafner  
EAPB

*The European Association of Public Banks (EAPB) represents the interests of 36 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.*