



To: EBA

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Comments on EBA's discussion paper on Defining Liquid Assets in the LCR under the draft CRR

The Association of Danish Mortgage Banks (Realkreditrådet) and the Danish Mortgage Banks' Federation (Realkreditforeningen) welcome the opportunity to share our views on the proposed methodology and scope of EBA's analysis leading to the definitions of high and extremely high liquidity of transferable assets for the purpose of the LCR including suggested haircuts.

General comments

Before responding to the questions stated in the discussion paper, we would like to express our approval of the evidence based approach of the two step methodology proposed by EBA.

In general, we are comfortable with the methodology proposed which, in our opinion, strikes a fine balance between academic rationale and real-life observations. We also welcome the willingness to consider differences in liquidity across jurisdictions / markets (including different explanatory characteristics) within each asset class in the analysis. Further, we also would like to express our support of the willingness to consider additional parameters and alternative data sources than already proposed in the discussion paper.

This said, we would like to stress the need for exercising due caution when applying a methodology based on metrics and explanatory characteristics.

More specifically analytical properties of metrics and explanatory characteristics can vary in strength and relevance over time i.e. due to changing market conditions, structural changes in the financial sector (i.e. the introduction of a Financial Transaction Tax) or behavioral mechanisms. In example, a single asset class market may consist of many uniform specific ISINs where all are not necessarily widely traded all time, but where the price on these ISINs inevitably follows the most liquid ISINs.

Actually, regulatory definition of liquid assets may lead to market distortions with potential negative self-reinforcing impacts on the market liquidity and relative prices of these assets. Therefore, the criteria used to differentiate between assets might distort relative competitiveness among issuers – even in between issuers of the same asset class. In example, a criterion such as issuance size will favor larger institutions and markets and will establish entry barriers in the regulation.

Further, some of the metrics proposed such as ratings and time to maturity might expose the model to cliff-effects and practical implications due to assets changing liquidity status over

time due to "simple model mechanics" respectively. This can potentially jeopardize financial stability. It is important that liquidity labels do not change abruptly from one day to another. These concerns calls for EBA to prefer market level rather than issuer and ISIN level and to prefer different haircuts over different liquidity label. Differences and changes in liquidity label might have to large market impacts as haircuts are very different (0, 15 and 100%) and because of imposed caps on level 2 assets.

Therefore it is imperative that ongoing qualitative judgment should be appropriately applied to ensure, that the quantitative measures are correctly and precisely defined and applied.

The discussion paper does not cover the very important aspects of the future reassessments of the liquidity definitions and proposed arrangements and timeframes for phasing in/out of assets changing liquidity status.

It is imperative that the frequency of evaluation of the liquidity definitions and phasing in/out arrangements for assets shifting liquidity status are respecting both statistical and real-life needs. We would be pleased to offer our opinion on such matters and hope that EBA will consult the industry on these issues with the same open-mindedness as is the case with the rest of the methodology.

Question 1:

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 chosen 5-year observation period includes the worst financial crisis seen in newer history. Since it is the intention of the new liquidity standards to ensure, that financial institutions will be able to withstand liquidity pressure under periods of market stress, we find the chosen observation period to be an appropriate sample period for the first analysis even though additional data of good quality are available for some asset classes.

Question 2:

Do you have additional data sources to suggest? Specifically, can you suggest a source of repo data and gold that would fit our needs?

A considerable repo market for Danish covered bonds exists. Transaction data for this market is not included consistently in the MiFID datasets. We refer to Nasdaq OMX Copenhagen for data on repo market transactions backed by Danish covered bonds.

Question 3:

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?

In general we agree with the list of liquidity metrics under consideration. We believe it is important to base the assessment on several metrics since focusing on individual metrics might give the wrong picture.

For instance may a low turnover ratio not be a sign of low liquidity. On contrary e.g. covered bonds are often held as a safe asset, thus the turnover can be low. What's important in a stressed scenario is that someone is willing to buy your bonds, regardless of whether it has been traded recently. Hoarding of extremely highly liquid assets can also influence and potentially violate the criteria for previously extreme highly liquid bonds as an unintended consequence.

What will price stability be based on – spreads or absolute levels, this can lead to a very different outcome on the analysis for the time period over the worst part of the credit crisis.

Furthermore, price stability should be viewed in the light of investors desire to pay the extra costs of getting the ability to liquidate assets in specific markets. For instance, a widening bid-ask spread may indicate a well functioning and liquid market-response to external shocks to the market i.e. from a change in the monetary policy of the central banks. In example, the bid-ask spread of Danish covered bonds, which are based on *trades*, widened substantially during the recent financial crisis whereas bid-ask spreads for other markets, based on *quotes*, where not widening as much. Actually, Danish covered bonds continuously traded in large quantities during the crisis, with the "cost" of experiencing a widening in spread as was the case for sovereigns as well¹.

"Remaining time to maturity" is included as a measure of liquidity both with respect to the negative effects on liquidity in relation to "lock in" effects for shorter maturities and increasing uncertainty (credit risk, duration etc.) for longer maturities². However, e.g. 30-year callable Danish covered bonds traded successfully during the financial crisis, among other things, due to the far lower expected duration of the bonds. Therefore it is imperative, that the analysis of EBA is flexible enough to recognize the differences within liquidity - also for long termed products.

Regarding shorter maturities it is worth noticing that e.g. short termed covered bonds are used in institutions' liquidity management today due to their liquidity characteristics (almost cash). We do not see any good reasons why this should be changed through new regulation. In relation to lock-in effects, the metric also can be very misleading and arbitrary, i.e. a new 2-year bond is typically more liquid than an old 10-year bond that has 5 year remaining time to maturity. We believe that recent activity in a bond (last tap, auction, buy-back less than 1 year ago) is more important than maturity.

If inappropriately applied, "Minimum outstanding volume of the assets" will violate level playing field, favourizing larger issuers and larger markets. This calls for a market view rather than an issuer or ISIN view.

¹ The relative better performance of covered bonds in Denmark compared to government bonds are described in the study by Dick-Nielsen, Gyntelberg and Sangjill (2012) also referred to in the discussion paper.

² Referred to in the fictitious example regarding prejudgment of outcome of the EBA empirical analysis (page 9 in the discussion paper):" ..RMBS rated AAA and with a time-to-maturity of at most x years are of highly liquid and credit quality assets."

Question 4:

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?

“Presence of a large number of market makers” is only relevant if the market making can be enforced or is backstopped by reliable buyback commitments from the issuers. We believe that markets with a few strong market makers are more liquid than markets with many small and uncommitted market makers.

“Trade via additional platforms and markets” is probably irrelevant for covered and corporate bonds because these markets are typically OTC/phone markets. An alternative characteristic could be the availability of a benchmark index for the market.

“Wide range of potential buyers” should be specified further. For instance, the Danish covered bond market includes a borrower driven demand for buy back or (par) prepaying bonds. Such features must be properly accounted for as they together with tap issuance support market liquidity. We believe that it is important to have a reliable domestic buyer base as well as interest from international investors.

“Credit ratings” can introduce cliff effects in the LCR liquidity portfolio and market values potentially are reduced due to market reactions of a downgrade. In addition, overly reliance on ratings would contradict the intention of a move towards a decoupling of regulation and ratings, which were one of the drivers behind the creation of a new regulatory framework.

“Issue size” inevitably favours both larger institutions and markets, and is an effective entry barrier. It would be misleading to assume a general relation between size and liquidity, when analysing the liquidity of assets.

Question 5:

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

In general, we are comfortable with the methodology suggested by the EBA being anchored in quantitative evidence. Still, due to its very quantitative approach it is imperative, that the methodology will be due to an ongoing managerial judgement and qualitative analysis. Additionally, the methodology also must cater for new entrants to or innovation within the industry which will have difficulties fulfilling the requirements of some of the measures proposed i.e. proven price stability and minimum outstanding volume of the assets. Any purely quantitative measurement should be complemented by qualitative data as interviews with leading market makers and investors in the relevant asset class.

The analysis should be done on a specific asset class and jurisdiction/market level basis to take into account the very different liquidity of the same asset class in different markets.

Given the importance of recognizing variations of liquidity within asset classes it is also very important, on the other hand, not to disperse national markets with assets of varying liquidity i.e. by assigning different liquidity statuses to different parts of the market. This would expose

the market to severe cliff effects that would exaggerate the price variations compared to the economic realities. Instead graduations of haircuts could be applied within markets.

We would be pleased to elaborate on our comments, if so requested.

Yours sincerely

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