

Comments

On the EBA Consultation Paper "On additional liquidity out-flows corresponding to collateral needs resulting from the impact of an adverse market scenario on the institution's derivatives transactions, financing transactions and other contracts for liquidity reporting under Article 411(3) of the Draft Capital Requirements Regulation (CRR)" (EBA/CP/2013/19)

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Comments “On additional liquidity out-flows corresponding to collateral needs under Article 411(3) of the draft Capital Requirements Regulation (CRR)”

On 23 May 2013, the European Banking Authority (EBA) published its Discussion Paper “On additional liquidity outflows corresponding to collateral needs from the impact of an adverse market scenario on the institution’s derivatives transactions, financing transactions and other contracts for liquidity reporting under Article 411 (3) of the draft Capital Requirements Regulation”. We appreciate the present opportunity to share our comments.

I. General

The draft EBA standard that has been submitted for consultation purposes presents four methods for measuring additional liquidity outflows, namely a standard method, a simplified method, an internal model based method and an historical look-back approach.

First, it is worth noting that, in fleshing out the requirements set out under Article 411(3) CRR, the EBA does not wish to latch onto the provisions promulgated by the Basel Committee for banking Supervision. In January 2013, the Basel Committee published its revised LCR recommendations. In these recommendations the Basel Committee’s proposes a “historical look-back approach” for the purposes of measuring “additional outflows”. Under these recommendations, banks should use the “largest absolute net 30-day collateral flow realised during the preceding 24 months”. In Recital 110 of the CRR (previously 75f CRR), the EBA is called upon to “consider a historical look-back standardised approach as a method of measurement” during its development of “draft regulatory technical standards to determine methods for the measurement of additional outflow” (previously Art. 411(3) CRR).

In our view, this approach should be made available as a stand-alone approach also to banks within the EU. We are of the opinion that the “historical look-back approach” presents an approach the application of which is simple but which still leads to appropriate liquidity outflows. For banks, unless they opt for the “simplified method”, the approaches proposed by the EBA would result in considerable implementation costs. Even the standard method involves highly complex multi-tiered stress tests which, for banks, would incur considerable costs both during the implementation and also during the application. As a result, such banks would suffer a competitive disadvantage compared with banks in third countries which are allowed to opt for the simple Basel approach. At the same time, we are unsure whether the standard method lives up to a cost-benefit analysis, i.e. whether the additional implementation effort incurred due to the standard method can be justified by a greater degree of precision compared to the historical look-back approach.

However, the Consultation Paper does not yet mention any date for the first-time application of its proposed approaches. The CRR specifies a maximum deadline by which the EBA will have to submit the RTS draft to the EU Commission (i.e. no later than 31 March 2014). Hence, we expect a publication in the Official Journal of the European Union during the second quarter in 2014. However, we would like to reiterate our concerns over the measurement options “standard method” and “internal model-based method” which (based on the current proposals in the Consultation Paper) would be the only eligible methods for large banks: These methods would result in considerable implementation costs within banks. What is more, lest there will be unnecessary duplication of work and IT-system corrections as well as additional workload for staff, on the grounds of effectiveness and efficiency, work on the technical implementation of any of these methods could only be initialised upon presentation of the final RTS draft. Based on the foregoing, the EBA should adjust the date for mandatory first-time application of one of these two more demanding approaches in order to pay tribute to the associated implementation burden.

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Prior to the introduction of these more complex methods, phase-in options should be created. Such a phase-in would also be important for banks which currently wish to migrate to more sophisticated approaches for measuring the capital requirements for counterparty default risks of derivatives (standard method, internal model method). The CRR results in major changes particularly for the internal model method. These changes have to be taken into account when considering the implementation of a combined internal model which meets both the demands for measuring counterparty default risk as well as the requirements set out by the present RTS.

Hence, we suggest that, in order to measure the additional liquidity outflows during the transitional period, once the RTS will have come into effect, all banks should have the right to opt for the simplified method or the historic look-back approach.

We also suggest altogether waiving the need to apply one of the methods for banks with derivatives transactions that are not deemed relevant. This would also mean that such banks would not have to apply the simplified method, either.

For technical reasons, we feel that the time needed for implementing the standard method will be approximately 1-1.5 years (cf. presentations on Q8). As a result, the earliest point at which banks that are not eligible for use of the simplified method may opt for the standard method will be 1 January 2016 (unless, by that time, the respective bank will be in the process of obtaining supervisory approval for an internal model method aimed at measuring counterparty default risks).

II. Specific Comments

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?

However, additional liquidity requirements for instruments where already an initial margin (e.g. trades with CCP) has been provided will suffer a double counting of collateral. These contracts should be excluded from the additional collateral requirements according to article 411 (3), since the initial margin serves the purpose of article 411 (3) already. The initial margin of the CCP is tailor-made for these contracts. Alternatively the initial margin should be deducted in the calculation of the additional collateral requirement.

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 an alternative specification.

Article 1(2) of the Consultation Paper specifies the inflows and outflows that have to be taken into account when measuring additional liquidity outflows.

In our view, basically, the specification of payment flows that have to be taken into account is sufficiently clear.

Nonetheless we would appreciate to get some examples that illustrate the interaction of the LCR positions “Net known derivatives payables/receivables” and the additional liquidity outflows corresponding to collateral needs defined in this consultation paper.

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E.g.

1. short call option on a non financial major index company, out of the money (strike 100, underlying 80), maturity within 30 days, provided initial margin 5, calculated potential liquidity outflow from adverse market scenario: 7
2. same as 1, but in the money (strike 100, underlying 120).
3. same as 1, but maturity > 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.

n/a

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

Article 1(2) lit. (c) RTS sets out that banks may not combine the methods for measuring the additional liquidity outflows for all their relevant transactions. Art. 1(2) lit. d RTS sets out that banks may not return from the standard method to the simplified method; neither may they return from the internal model method to the standard method or the simplified method.

In our view, on the grounds of the principle of proportionality, a partial use of the methods should be permissible. For instance, banks using the standard method should be granted the option of applying the simplified method to individual risk factors where the exposure of the transactions stays below a certain threshold.

Furthermore, we hold the view that there ought to be a clarification, i.e. that in the event of a partial use of the internal model method for the purposes of measuring counterparty default risk, the remaining portfolio which is not covered by the partial use shall qualify for use of the standard method (or for the simplified method). Under the EBA's current proposals, this is not an option. As a result, a number of banks will not be able to use the internal model method. In consequence, even if a very small proportion of positions were not covered by the internal model method, institutions would be obliged to revert to a less risk sensitive approach.

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?

First of all we would like to point out that - contrary to the EBA's assessment - the standard method does not constitute a “simple” stress test. In our view, merely the measurement steps specified in Article 1(1) lit. a and b are in line with conventional RTS stress tests which means that their implementation effort would remain within reasonable bounds. We hold the view that the following eight measurement steps are highly complex and lead to but a negligible deterioration of the results. Hence, there should be a re-

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view whether from the point of view of a cost-benefit analysis it would make sense to increase the intensity of the stress scenarios slightly whilst at the same time clearly reducing the computational burden.

Under the provisions of Article 2(1) lit. a RTS, first and foremost, banks are held to re-value each transaction and contract against each of the scenarios and risk factors provided in Annex I. In lieu of a re-valuation against each of the scenarios and risk factors listed in Annex I, we would appreciate a clarification in the regulatory text that every transaction or every contract in this respect will only have to be re-valued with regard to the significant risk factors of the underlying and the stress scenarios which are relevant in this regard. Already the first example listed in the explanatory section illustrates this point: In lieu of a re-valuation with a view to other risk factors such as commodities or interest rates, a share call option will only have to be re-valued regarding the exposure factor “equity” either in the upward or downward scenarios for listed shares in the OECD or non-OECD markets or for unlisted (“all other equity”) shares. We would appreciate a clarification, i.e. that any risk factors shall only have to be applied to the derivative's underlying.

Art. 2(1) lit. b RTS reads: “Within the risk factor ‘interest rate’, this selection shall be made for each currency.” We would appreciate a clarification as to which currencies this section refers to (all of the bank's transaction currencies or all of the currencies listed in Annex I: EUR, USD, JPY; GBP, SFR). In our understanding, this requirement would be more suitable for the “exchange rate” risk factor.

We would like to understand what the rationale for the mentioned scenarios is. Have these changes of risk factors ever been observed in the past? Fixed interest rate shifts of 130bp (OECD countries) and 230 bp (non OECD countries) within 30 days seem not appropriate for current trade cycle phase with yields close to zero. Furthermore, the scenario for interest rates above 10 years is unclear. It is mentioned “a flat curve is assumed”. Does this mean that there are no in-/decrease in rates, or do the same change apply as for 10years (i.e. +/- 100 for OECD and 150 bp for non OECD countries)?

In our understanding, the risk factor “credit risk” is meant to capture special interest rate risks. In order to avoid inconsistencies, at this juncture, the same method should be applied as in the risk factor “interests”. By way of analogy, for certain credit spread classes, there should be a specification of spread expansions.

We would like to point out that the aggregation to “margin sets” involves a major degree of technical effort. Hence, regarding the standard method, we recommend that the latter may be implemented also without having to distinguish between “outside” and “inside of a margin set” (if needs be even without the possibility of netting inflows and outflows).

We would like some clarification regarding other risk factors. It should be made clear, that risk factors like volatility, which are expressed as a percentage do not increase/decrease by an absolute shift of +/- 20% but rather subject of a relative shift (e.g. 25% volatility will be shifted to 30% and 20% respectively.)

Additionally, we would welcome it if the scenarios were geared towards scenarios from bank's already existing internal market price risk models. These have already achieved supervisory approval and are accepted as realistic values for various stress scenarios.

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Q6. What 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?

Basically all options are affected by multiple risk factors. E.g. equity option: price and volatility of the underlying. The standard method neglects the interconnection of volatility and underlying price/rate. Volatilities and the shift of the risk factors of the underlying should therefore be combined. (Interest rate shift and volatility shift should be combined rather in one scenario than in two independent scenarios).

Q7. How do you view the restriction in paragraph 3 that only additional inflows of assets of extremely high liquidity and credit quality 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 current regulatory requirements with regard to derivatives will lead to an even stronger increase in collateralisation by derivatives. As a result, also collateralisation by securities will become increasingly important. In the framework of derivatives transactions, along with securities of “extremely high liquidity”, also securities of high liquidity (or worse) are widely used as securities. As a consequence, the securities quality is reflected in the safety margins which are being deducted. This affects both inflows and outflows. Hence, we would like to suggest that the standard method shall not only admit securities of extremely high liquidity as inflows.

What is more, the implementation of the review of the requirements envisaged under Article 2(3) RTS (“usable inflow”) will be difficult. This is due to the fact that the classification as “liquid asset in accordance with Art. 404(1) CRR” will usually be made downstream in separate systems (i.e. it will not be made in market price risk systems). Hence, across all margining sets, this would mean that when using securities collateral, banks would have to apply the conservative assumption that inflows cannot be netted. This will lead to a clear reduction in the benefits inherent in the standard method. At this juncture, a non-automated identification of the securities which can be netted would incur a considerable amount of manual labour. Hence, this is not a viable option. As a result, in order to avoid using the classification as highly liquid assets pursuant to the LCR as a fall-back option at this juncture, we would like to advocate in favour of lowering the eligibility criteria for netting of securities collateral. For instance, using the economic safety margins would be a viable alternative that could be applied across all securities classes.

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.

We would like to reiterate our caveat highlighted already under the General Comments section, i.e. that the implementation and the ongoing application of the standard method would incur considerable costs. Given that the bulk of the implementation work can only be initialised upon publication of the final RTS, we believe that the implementation period will last between 1 and 1.5 years. Hence, the earliest point at which the standard method can thus realistically be used is as of 1 January 2016.

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The cost for implementing the standard method clearly exceeds the “historical look-back approach” suggested by Basel – in the absence of adding any significant decision-useful information for an assessment of the liquidity risk position. The deployment of this method would be welcomed (at least for a transitional period) given the fact that the “historical look-back approach” is currently already being implemented in the context of Basel III monitoring.

To be somewhat more specific, every currency requires a single scenario, a large number of scenarios must be calculated. This requires significant investments in IT infrastructure. Due to the specific requirements of this RTS this calculation must be set up additionally to currently used scenarios and cannot re-use results of internally used models. The RTS should allow combining some risk factors (as mentioned in Q6). Furthermore it should be allowed to calculate the required results by sensitivity analysis and omit full revaluations for every risk factor. Especially, if derivatives are used for hedging purposes or back to back traded only, a very large number of scenarios should be avoided.

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

At the present point in time, any comment on this matter would be premature on the following grounds:

- Currently, there are no methods for the purposes of carrying out a short-term market value simulation using the parameters specified here
- The simulation of the worst case scenario which is based on the results of the above simulations was not implemented in the systems, either (not even by way of analogy)
- The aforementioned issues surrounding the capturing of a) margining sets and b) extremely high liquid assets would incur a major implementation burden.

A one-off manual measurement of the impact of the standard approach on the LCR would be an extreme cost driver; hence, at least for the time being, this is not an option. Furthermore, because the correlation of different risk factors is completely neglected, the calculated results of a well balanced portfolio with highly correlated currencies (e.g. EUR and DKK or NOK and SEK) will show inadequately high results.

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?

ERM II currencies should be excluded from the calculation of a FX rate shock

Q11. Are there any aspects of the standard 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?

n/a

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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.

n/a

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?

n/a

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?

n/a

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?

One *conditio sine qua non* for the use of internal models for the purposes of measuring the additional outflows should consist in the use of the internal model method in order to measure the capital requirements for counterparty default risk. In our view, also banks using internal models in order to measure the capital requirements for market risk should be allowed to use this method. In order to determine the potential future liquidity requirements by providing cash collateral, banks use internal VaR models (for instance in the context of a delta normal approach or the variance covariance method). The EBA requirements would lead to a situation where banks relinquish models that have stood the test of time; alternatively, they would be forced into management on the basis of two models.

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

Possible adjustments could be

- extend IMM model coverage to all trades as defined by Article 411 CRR,
- enhance EPE model to set up required statistical methods to analyse cumulated collateral paths for each margining set,
- extend aggregation layer for additional margining results.

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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.

n/a

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

n/a

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?

n/a

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 hold the view that a separate measurement of the additional outflows at the consolidated group level would be unfeasible. Hence, we agree that an aggregation at the level of the solo entity of the additional outflows is the only realistic option. However, it remains unclear whether individual banks are entitled to use different methods for calculating the additional outflows or whether their outflows would subsequently have to be added up for the purposes of a consolidated report. At this juncture, we would like to point out that smaller subsidiaries featuring a fairly moderate derivatives portfolio should be entitled to use the simplified method or the historical look-back approach.

Furthermore, it is worth noting that, where this is the case, there needs to be a clear instruction on how to handle intra-group derivative transactions. Given that the LCR will have to be calculated both at the solo entity level and at the consolidated level, in theory the standard method would have to be applied twice (including and excluding intra-group transactions). Hence, we would welcome it if intra-group derivative transactions were generally exempt from the calculation of the additional collateral outflows (i.e. this waiver should also apply to the LCR at the level of the individual bank).

Q21. How would you like to see the historical look-back approach calibrated? Please provide details together with a justification.

Q22. 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?

We explicitly welcome the fact that the historical look-back approach shall be admitted as an additional, stand-alone method or, at least, as a fall-back option / as a transitional alternative during a forthcoming incremental application. In this respect, please cf. also our general comments above for a more detailed discussion.

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The calibration should be geared towards the BCBS provisions published in January 2013. This is due to the fact that banks are already implementing these provisions as part of their Basel III monitoring. In our view, there is no evidence for the theory that a divergent implementation would lead to “better” or “worse” data. Instead, as a result of the adjustments to the system architecture that would become necessary, it would merely result in renewed implementation costs.

Q23. 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?

Whilst we are well aware of the fact that a historically calculated figure will not necessarily cover all the uncertainties of future developments to a sufficient degree, we still hold the view that a figure that has definitely occurred in the past constitutes a better management tool than figures determined on the basis of an approach that was drawn up under major time pressure. Hence, we advocate in favour of a solution where the historical look-back approach shall be admitted at least during the implementation stage of the more complex methods, i.e. its use should be permitted at least up until 31 December 2015. After all, the historical look-back approach takes into account the historical changes to the bank's derivative portfolio almost by default. This is due to its underlying method and it is its main USP compared to more complex methods, such as the standard method.

One alternative way of injecting additional dynamism into the result measured by means of the historical look-back approach would consist in rounding this ratio out by using an additional parameter which is based on the banks' derivative portfolio. Hence, the appropriateness of the result could be double-checked by comparing the portfolio (e.g. in terms of size, structure etc.) at the point in time where the ratio is being determined by means of the historical approach with the current portfolio. As an alternative choice, prior to being factored into the LCR, the figure could be adjusted on the basis of a parameter (mark-up or discount) that reflects the relation between the historical portfolio and the current portfolio.

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?

n/a

Yours faithfully,
On behalf of the German Banking Industry Committee



Dr. Martin Lippert



Dr. Silvio Andrae