ABI Associazione Bancaria Italiana

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Mr. Giovanni Carosio
Chair
CEBS
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CEBS Consultation Paper (CP28) on "Liquidity buffers & Survival periods"

Dear Mr Carosio,

In order to draft the position paper of the Italian banking system, on the Consultation Paper 28 (CP28) on Liquidity buffers & Survival periods ABI conducted a formal, co-ordinated survey of the various views and proposals on the consultation document issued by CEBS on 07 July 2009.

Based on the comments received and the outcome of an interbank working group, ABI has drafted the enclosed position paper for the consideration of national and international supervisor authorities.

Yours sincerely,

Giovanni Sabatini
General Manager

RK 8100

ENCLOSURE

Position Paper on CEBS CP28 "Liquidity Buffers & Survival Periods"

October 2009

POSITION PAPER

Introduction

We are pleased to have the opportunity to comment on the "Consultation Paper on Liquidity Buffers & Survival Periods".

We believe that, as envisaged in the proposed guidelines, the concept of liquidity buffer should be developed over a two-phase (one week and one month) survival period and a corresponding two-tiered definition of eligible assets, with only cash and cash-near assets[1] qualifying for the shorter end of the survival period and a broader set of liquid assets allowed for the longer end. The alternative choice of defining a single-tiered (one month) survival period and restricting the composition of the buffer only to cash and cash-near assets (mostly, governments bonds) would distort the bond markets and entail higher costs for banks, as well as potentially negatively affect their lending.

Assuming that the driver of the liquidity buffers composition is the central bank eligibility, an increase might occur in the concentration and the cost of holding such eligible assets.

We also note that the proposed guidelines do not explicitly state whether central bank eligible assets may be part of the longer end of the liquidity buffer, even if they are not marketable (as may be the case for bank loans or, under systemic stress, asset-backed securities). In this respect, we do believe that a portion of the buffer *should* be allowed to be made up of such assets, provided that -given the framework of the central bank operations/facilities- a bank can reasonably assume to be able to generate liquidity from them and provided that the bank's buffer remains adequately diversified.

[1] In the wording of the proposed guidelines, "assets which are both highly liquid in private markets (including in stressed times) and central bank eligible".

In particular, with regard to the definition of assets that should be eligible to a liquidity buffer for a one month period of stress in a combined idiosyncratic and market-wide scenario, market participants' answers to the following questions would be most appreciated:

1) If the composition of liquidity buffers was to be restricted to assets that are both highly liquid in private markets (including in stressed time) and central bank eligible:

1.1 Would you foresee any shortage of eligible assets, such as government bonds, or any increase in the concentration or cost of holding such assets? Any impact on less liquid assets?

Answer

We believe that the ratio of outstanding eligible liquid assets against the overall banking system funding gap should be carefully estimated well before any decision is taken towards a definition of the banks' liquidity buffers.

The focus should be in particular on the stock of tradable liquid government bonds, since these will clearly represent the bulk of the narrower class of "highly liquid in private markets and central bank eligible" assets. Will there be enough government bonds to guarantee a one-month survival period for all the European banks? This issue is very much about supply/demand imbalances and it is important that it is tackled in a dynamic, as opposed to static, fashion. The supply of government bonds may in fact be abundant now, but it might significantly decline in the coming years due to potentially restrictive fiscal policies undertaken by the governments. The buffer-driven demand for government bonds might also significantly change over time, if the banks adjust the whole structure of their balance sheets to the new rules.

One of the most obvious consequences of narrowing the eligible assets class will be the widening of the gap between the liquid and the less-liquid bonds, both within the same bond class (i.e. on-the-run vs off-the-run government bonds) and between different bond classes (corporates vs govies). This could potentially have an impact on the allocation of the available funds to the different borrowers (see Answer 2) below).

1.3 What conditions, if any, should be fulfilled in your view before a narrow definition could be applied, without undue side effects? (for example: availability of collateral, transition arrangements including its length, etc.)

Since we are discussing a radical narrowing of the assets eligible to the buffer here, we think that any decision should include a long transition arrangement (between 12 and 24 months) to allow the banking system to readjust to the new requirements and to allow the readjustment to occur without generating any disruptive supply/demand imbalance in the specific markets for these assets.

Indeed, we believe that an appropriately long transition period should be provided for, even if a decision is taken to reject the narrow hypothesis in favour of a wider two-tiered class of eligible assets.

2) Would you consider that a too narrow definition of assets eligible to the buffers could entail a possible sub-optimal allocation of means from a macro-economic perspective? Would you see a risk of wrong incentives? Please specify, if observations/expectations refer to particular markets.

Answer

The most likely consequence of narrowing the definition of the eligible assets would be the generation, through time, of two tiers of marketable bonds: the first one composed of highly liquid and mostly government assets with a steady underlying demand, and the second of radically less liquid non-government or off-the-run government bonds.

Spreads between these classes would be wider than otherwise, and that would have an impact on the funding costs of the “second tier” issuers. This “crowding out” effect will benefit government issuers and penalize non-government – especially corporate – issuers: the funds available to the latter issuers would be scarcer and more expensive.

Bank bonds will also probably fall victim to this “crowding out” effect. Indeed, there is a risk that the new liquidity rules make bank bonds relatively more expensive (by diverting the demand in favour of government bonds) at a time when, due to the very same new rules, banks may be willing to issue more bonds in order to lengthen the maturity of their liabilities in order to reduce their maturity mismatches. This could potentially reduce the availability, and increase the cost, of bank loans to customers.

3) How would you assess the reference to central bank eligibility for the purpose of specifying which assets should be eligible to the liquidity buffers?

Answer

A bank may be able to generate liquidity under stress from central bank eligible assets, even if such assets are not marketable (as, for example, may be the case for bank loans or, in a systemic stress situation, asset backed securities). The bank may in fact use those assets as collateral, either to participate (more or less aggressively) in the central bank(s) refinancing operations or to apply for the central bank(s) standing facilities (whereby, in many jurisdictions, a bank can obtain unlimited cash if it only provides enough collateral).

When this is the case, it should be made *explicit* that, at least *to a certain extent*, central bank eligibility *per se* (i.e. without marketability) implies eligibility at the longer end of the buffer. To what extent, it is difficult to say. In this respect, we agree with the proposed guidelines: "banks will have to demonstrate adequate diversification in the total composition of the buffer so as to guarantee to supervisors that they are not relying too heavily on access to central bank facilities as their main source of liquidity".

We also believe that a bank should maintain close contacts with its supervisory authority when setting the amount of central bank eligible assets but not necessarily include marketable assets in the buffer, as well as for any other aspect related to the composition of the buffer.

Other Questions.
a. How does the return on liquid assets compare to the return on less liquid assets? Do you anticipate a (significant) impact on ROE?

Answer

The return on less liquid assets is obviously higher than the return on assets that are part of the narrower buffer definition. A strict interpretation of the liquidity buffer could negatively impact ROE, forcing a bigger part of a portfolio towards assets with lower returns that could be only partially compensated with greater yields earned on non-eligible asset.

b. Do you believe that CEBS's proposals could lead you to restrict your lending capacity or increase the cost of financing for borrowers?

Answer

If the assets eligible for the buffer will be restricted to those which are "highly liquid in private markets and central bank eligible", it may well be the case that the CEBS's proposals will end up restricting banks' lending capacity and/or increasing the cost of financing for our borrowers, as a result of two factors:

(i) due to the "crowding out" effect described under Answer 2), *ceteris paribus* a bank's medium-long term cost of funding will probably become higher;

(ii) the composition of our liquidity portfolio would be shifted to lower yielding assets, decreasing the bank's overall margin returns.

Should a less restrictive definition of eligible assets prevail, one should expect the impact of the CEBS's proposals to be significantly milder or immaterial, since the two above-mentioned effects would lose relevance.

c. Do you foresee any impact of these proposals on your business models or activities? Do they present any level playing field issues with competitors other than credit institutions?

Answer

Since Italian banks have traditionally maintained a very safe liquidity profile, the introduction of the proposed liquidity guidelines is not expected to radically affect banks' behaviour or business model (except for what is already explained under Answer b.). Clearly there is an 'opportunity cost' if a bank holds cash and liquid assets because they offer a low return, reflecting both their low risk and the market demand for these collaterals. We do not see any level playing field issues

d. Do you consider that these Guidelines can help to restore confidence in the interbank market? To improve funding costs?

Answer

In our view, new liquidity guidelines and capital rules, together with other measures that are already in place, have the potential to stabilised confidence in the interbank markets.

This process may well lead to some decrease (*ceteris paribus*) in the cost of interbank funds for many banks. We doubt, however, that this can be a relevant phenomenon for Italian banks, which have continued to be perceived as safe by the market throughout the entire crisis and have generally maintained access to interbank funds at comparatively low costs.