The voice of banking
& financial services

British Bankers' Association response to EBA Discussion Paper on Defining Liquid Assets in the LCR under the CRR[1]

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services, representing members on the full range of UK and international banking issues. It has almost 200 banking members that are active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK and a range of other banks from the Middle East, Africa, South America and Asia, including China. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking activities to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management.

All of our members recognise the importance of holding a stock of high and extremely high liquidity assets of good credit quality that can be used to see a bank through a period of financial stress without giving rise to undue concentration risks, so this discussion paper is relevant to a significant range of BBA member banks.

Key Comments

Support for a globally harmonised approach

We applaud the EBA for having started the international debate by publishing this discussion paper but emphasise that our optimum solution is a global consistent approach, overseen by the Basel Committee coordinating and overseeing the assessments performed by authorities in individual jurisdictions. We encourage the EBA to promulgate its views amongst other members of the Basel Liquidity working group so that a globally approach is agreed. Implicitly where the EBA's view does not prevail this may require it to change its approach in the interests of international consistency.

Importance of EBA monitoring of Member state implementation

We envisage that there will be little opportunity for member states to deviate from uniform categorisation of asset classes. In actively traded, cross border markets there should be no need for different views of the intrinsic liquidity of different types of instrument and it will be important for the EBA to monitor this to ensure that their is no such loss of a harmonised approach.

The proposed Financial Transaction Tax will have an impact on liquidity

Should a financial transaction tax be introduced on transferable securities (we do not believe one should be) there is likely to be a significant impact on market liquidity of many of the instruments currently perceived as falling into either the high and extremely high liquidity categories. This may result in a step change in liquidity properties, which may differ by the type of underlying instrument. Ongoing review of liquidity characteristics by the EBA would have to take such factors into account.

1 http://www.eba.europa.eu/cebs/media/Publications/Discussion%20Papers/DP%202013%2001/DP-on-defining-liquid-assets-in-the-LCR.pdf

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Does regulatory approach drive market liquidity?

The success of the proposed approach should in time be assessed by how well it ranks the assumed liquidity of various types of liquid assets relative to observed market experience. So regulatory policy objectives that may discourage, or alternatively promote, the ownership of some types of liquid assets should not bias this market liquidity analysis.

Our responses to the questions posed in the Discussion Paper are in the attached annex.

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Annex

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?

We recognise the practical difficulties of obtaining transactional data. So whilst it may be simpler to just look at the period from 2008 to 2012 we do believe that <u>where longer data history is available it should be used</u>.

This is particularly important as for a significant part of the last five years markets have been subject to a number of different stresses which have resulted in novel, and welcome, responses from central banks around the world as they have sought to maintain as liquid markets as possible. However at the same time, as stresses in the system built up, acceptable levels of haircutting of collateral changed, and changed relatively differently depending on the asset class and the CCP in question. Indeed it seems likely that the level of haircutting could be used as an important indicator of the underlying instrument's liquidity.

This also raises the question of how the EBA will keep its analysis fresh, whilst ensuring that it crucially includes a period of stress. Will it undertake regular periodic reviews of the liquidity of different asset classes or does it intend to assess changing liquidity dynamics on a rolling basis? Our recommendation would be that periodic reviews are undertaken in order to provide a degree of certainty, although we understand that in times of severe stress there may be a need to undertake ad hoc assessments, as our member banks will also be doing.

We appreciate the simplicity of restricting the scope of the review to assets denominated in European Union currencies but this may distort the picture if certain asset classes are more liquid in third country currencies. This is very likely to be the case for corporate bonds and some asset backed securities denominated in US dollars as there is a wider range of different types of instrument available and dollar investors are much more familiar with the dynamics of the bond market. So excluding other major currencies such as the dollar from the analysis would potentially exclude a rich source of data. So <u>where more data is available the analysis should be extended to non-EU currency denominated instruments</u>.

It is obvious to us that such work should be carried out on an international basis, perhaps under the auspices of the Basel Committee, which would coordinate and collate information on the liquidity of instruments in different currencies, relying for instance on the EBA analysis in respect of EU currencies and US authorities for dollar liquidity information.

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?

The paper clearly recognises that the monetisation value of liquid assets can come from outright sale and/or repo transactions, yet only outright sale data will be considered due to data limitations on repos data. It is important however that some type of adjustment is made to bridge this important data gap, without which there will be an underestimate of actual liquidity value, the more so for products that on a relative basis have lesser 'sale' liquidity than 'repo' liquidity value.

We agree that it is important that to access as wide a set of data sources as possible. There may be a need to augment bank data in the initial research stage in some countries with information from the broker community or from market makers in particular instruments.

The International Capital Markets Association (ICMA) undertakes a semi annual survey of conditions in the repo market. The latest report of December 2012 is available at:

http://www.icma-group.org/assets/documents/Market-Info/Repo-Market-Surveys/No-24-Dec-2012/ICMA-ERC-European-Repo-Survey-December-2012.pdf

The ICMA report acknowledges that it has shortcomings – for instance results are not adjusted for double counting - but it does provide a useful snapshot of repo activity as far back as the year 2000.

Alternatively the Central Counterparty Clearing houses have data on repo activity, as do central banks. As we note above it would be possible to monitor changes in haircuts as a proxy mechanism for assessing liquidity. Similarly the custodian banks may have valuable information in relation to repo although as this is private, agreement would be needed from both the custodian banks and their clients before this information could be shared.

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?

We broadly agree with the liquidity metrics proposed by the EBA but believe more information is need on the EBA's approach to assessing the relative importance of components of the liquidity metric. For instance:

- How this will the relative importance vary across asset classes/positions?
- How much influence will local regulators have in assessing relative importance – we would wish to see no flexibility, in order to ensure consistency
- How will the relative asset concentration limits be established?
- It would be helpful to see a worked example to explain the proposed approach

It may also be helpful to take into account that the hedging of liquid assets with derivatives results in a daily offsetting variation margin flow which materially reduces the volatility of the monetisation value of hedged liquid assets. If this aspect is not considered, erroneous conclusions may be drawn in relation to actual market experience on the monetisation value of these hedged positions.

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?

We agree that the list of explanatory characteristics is sensible and comprehensive but as important as a snapshot will be the analysis of trends over time as explaining factors or leading indicators of shocks.

An issue arises in relation to the remaining time to maturity for ABS – is it the expected final maturity or the actual, legal, maturity date.

We note that one of the characteristics identified is a wide range of potential buyers, but it will be important too to analyse the type of buyers to identify those that might act as a herd in a stress and those that might take a less instinctive approach, even when liquidity is declining.

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

We agree that the methodology should focus on asset classes, rather than individual securities, ISIN by ISIN, but overlay an analysis of explanatory characteristics within a class to determine any further adjustments that could be necessary to identify the minimum qualitative standards. MiFiD datasets would appear to us to be the most appropriate source of data for this analysis.

An ordinal ranking could result in cliff effects at the boundary between extremely liquid and highly liquid categories but recognise that this is a construct imposed on the EBA's work by the Basel Committee requirements.

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