Association for Financial Markets in Europe

Consultation Paper Response

Draft Regulatory Technical Standards on additional liquidity outflows 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

14 August 2013

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the EBA's recent consultation paper on Draft Regulatory Technical Standards on additional liquidity outflows 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'). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

Observations and responses to questions

Scope (Questions 1 - 4)

- With regards to flows that are included/excluded from the model we feel that (i) Flows from maturing derivative trades captured in accordance with CRR Article 422(6) and (ii) Flows from changes in the value of collateral already posted captured in accordance with Article 233 of the CRR should both be included within the scope of the RTS, as disaggregating these aspects makes little sense.

(i) Derivative trades maturing within the specified time horizon will already form part of the trade population for this RTS, excluding these trades from the population could be difficult and would mean that any MTM changes on these trades may not be captured.

(ii) Changes in the value of collateral already posted will be the main source of additional collateral outflows for secured financing trades. Quantifying liquidity requirements due to a decline in the collateral value under a different scenario may not provide a holistic or consistent approach to capture the liquidity outflows.

- We appreciate that both of these flows will be captured separately within the LCR/CRR (paragraphs 116 and 119 in Basel 3 or Articles 422.6 and 423.2 in the June 2013 CRR text). However, in our view it would be more appropriate to include these items within the scope of this RTS.

- In order to capture all collateral outflows in a consistent manner, we propose that institutions should be allowed to capture the above outflows within their "Additional Collateral Outflows" model. To the extent these outflows are captured within the "Additional Collateral Outflows" model, institutions should be allowed to exclude (or adjust) them from the outflows captured within paragraphs 116 and 119 of the LCR or Articles 422.6 and 423.2 in the June 2013 CRR text. The permission for this treatment can be managed as a part of a waiver for the "Additional Collateral Outflows" model.

- We would like to seek clarification on the treatment of contingent collateralised trades, e.g. uncollateralised derivative transactions that require collateralisation following a multi notch downgrade as defined in the LCR/CRR text. We believe these transactions should be considered within the scope (i.e. considered as collateralised) of this RTS so that potential changes in MTM of these trades can be captured.

- In addition we would like to have further clarification on the treatment of trades that cannot be captured by the default methodology used by the firm, e.g. certain exotic derivative structures may not be captured by the EPE model. The drafting of this ITS would appear to suggest that, where certain trades fall outside the scope of the internal model population, the EPE method cannot be used at all. This approach is unnecessarily stringent and would lead to extremely penalising outcomes. It would therefore be appreciated if the EBA could confirm that this is not the intention. Consequently, an alternative approach is required to capture the additional liquidity outflows not within the scope of a bank's internal model, i.e. application of the standardised methodology for these trades – Such an approach is incorrectly construed as 'cherry picking' when in fact, in the vast majority of circumstances, a mixed internal model and alternative method will lead to a more conservative outcome.

Standard Method (Questions 5-10)

- The proposed methodology is a departure from agreed-upon Basel standards or any known proposal from any other jurisdiction. This gap may adversely affect EU institutions or encourage a shifting of risk to non-EU entities.
- Incorporating outflows as a result of positive shocks is inconsistent with other aspects of LCR and historical liquidity events and will unnecessarily penalize banks with portfolios which are protected on the downside.
- The proposal may also result in outflows which are (1) significantly greater than outflows under the 24-month look-back approach and (2) unsupported by historical evidence.
- The proposed method also appears to be unduly burdensome and complex and will require a build of various new scenario calculations. Furthermore, the parameters defined under the Standard Method such as the inclusion of inflows from only extremely high quality liquid assets, netting at risk factor level and daily net margining may lead to fairly punitive treatments.
- The application of a single haircut for all types of commodities could also be relatively punitive for organisations that deal only in certain types of commodity. A possible solution to this might be to extend the risk factors by commodity type, i.e. to have a stress parameter for each of precious metals, base metals, energy and agriculture.
- For the reasons noted above, we would advocate giving firms flexibility in adopting an alternative, more flexible approach for computing collateral outflows, as noted later in this response.

Internal Model Based Method (Questions 15-16)

- As a prudent measure, we feel that the EPE model should consider the use of stressed market parameters. The calibration for this model should be based on a combination of the market parameters used in the simulation and the confidence level. Therefore, we feel that a range of 95%-99% confidence level should be considered for this model depending on whether stressed or current market parameters are utilised within the model.
- We propose that the EBA consider an alternative method for calculating the additional liquidity outflows for derivatives positions using an EPE model as follows:

    1. Consider the entire population of uncollateralised derivatives and those with "weak CSAs" (e.g. One-way CSAs or CSAs with restrictions on re-hypothecation), including settlement balances, and determine the largest increase in MTM (with the appropriate level of confidence) on these transactions using a similar simulation approach.

2. Assuming that all such trades are hedged with collateralised trades (derivatives or secured financing trades) and the firm is market risk flat, the largest increase in MTM provides a proxy for the losses on the collateralised trades.

3. To address the flat market risk assumption, an additional liquidity outflow driven by the firm's actual market risk exposures can be captured e.g. using the firm's VaR measure (scaled up to the appropriate time horizon).

- We believe the above alternative approach is more appropriate for the following reasons:

  - Existing EPE models are primarily built to capture potential future changes to credit risk exposure, rather than collateralised exposure. As such, most institutions will require significant adjustments to their existing EPE models in order to capture the correct trade population (e.g. including exchange traded derivatives) and correct netting set (i.e. capturing information at "Margining Set" level). In light of significant adjustments that may be required to existing EPE models, we feel that the alternative approach discussed above may provide a cost efficient and consistent approach for capturing the additional collateral outflows.

  - This is a holistic model, which implicitly considers the additional liquidity outflows from derivative transactions and secured funding transactions under the same scenario, without the need to consider a decline in the value of securities/collateral posted separately.

  - Under certain circumstances this approach yields more conservative results. For example, if a repo trade is hedged with a short risk collateralised derivative, the proposed approach by EBA in this RTS may result in a liquidity inflow from the collateralised derivative if the underlying asset decreases in value, while not recognising an outflow from the decline in value of the repo collateral in a consistent manner (assuming a decline in the collateral posted is not captured within this model as per this RTS). The alternative approach that we have suggested would result in no inflow and hence may be considered prudent.

- In the meantime, it is not clear what levels of regulatory permission will be required for firms to be able to make use of the Internal Model Based Method. We consider that in addition to firms with full IMM approval being eligible to apply the Internal Model Based Method, firms with diverse and large derivative portfolios that have IMM approval over some but not all of their positions should still be eligible.

- AFME and its members would be interested also in understanding the extent to which the EBA has ascertained whether firms would be able to use their credit models to perform the necessary calculations under the internal model based method. If firms are not able in practice to make use of these models then the approach is not likely to be workable.

Historical Look Back Method (Question 21)

- A key limitation with quantifying additional liquidity outflows with historical data is that it may not represent the risk attached to current positions and operational arrangements. However, while this may be a crude mechanism, it is relatively simple to calculate, taking less time to implement, and it generates a value against which firms can begin holding liquidity. Consequently, firms should still be given the flexibility to adopt this method until a potentially more rigorous standard can be agreed upon.

Proposed Alternative Approach

As noted in each of the above sections, the proposed methodologies outlined by the EBA are less than perfect and should not be rushed into without further consideration. Therefore, we advocate the following alternative approach:

- Give firms the flexibility to adopt the Basel Historical Look Back Method, particularly for those firms with operations in multiple jurisdictions and/or those firms who would otherwise be required to adopt the Standard Method, as this allows for a standardised method which Basel was hoping to achieve.

- Consider other approaches through a quantitative impact study (preferably in coordination with other supervisors) for a period of time which is sufficient to evaluate the ability of firms to perform any calculation and the size of the values generated.

- If a particular firm or that firm's supervisor feels that the Historical Look Back Method does not capture the full extent of its potential collateral outflows, a more stringent approach can be suggested during the equivalent of an annual ILAA/SREP review process.

Timing and frequency of reporting

- Clarification would be appreciated as to the timeframe for the implementation of the requirements and the frequency of calculation that will be required, e.g. monthly, quarterly etc.