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July 28, 2008

Mr. Stefan Walter  
Secretary General  
Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Dear Mr. Walter,

The International Organization of Securities Commission (“IOSCO”) Technical Committee Standing Committee on the Regulation of Market Intermediaries (“Standing Committee 3”) welcomes this opportunity to comment on “Principles for Sound Liquidity Risk Management and Supervision” (“Basel Liquidity CP”) published in June 2008 by the Basel Committee on Banking Supervision (“BCBS”) for public consultation.

While we recognize that the principle focus of the BCBS is on banks, we note that the introduction to the Basel Liquidity CP states that “this guidance focuses on liquidity risk management at medium and large complex banks, but the sound principles have broad applicability to all types of banks.” We understand that “all types of banks”, could be interpreted to include investment firms, to which IOSCO has relevance. Investment firms are subject to liquidity risks similar to those of medium and large complex banks by virtue of being active in the same wholesale and capital markets.

IOSCO established the Task Force on the Subprime Crisis in November 2007 and the IOSCO Technical Committee published a final report (“Subprime Crisis Report”) in May 2008. Based on one of the recommendations in the Subprime Crisis Report, the IOSCO Technical Committee asked Standing Committee 3 to assist and supplement the work undertaken by the BCBS.

In this context, Standing Committee 3 is providing you with the following comments and provides input on the BCBS Liquidity CP, as noted below.

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## **1. IOSCO work related to liquidity risk management by firms**

First, I would like to draw your attention to IOSCO work related to the subprime crisis and liquidity risk management.

### (A) The Subprime Crisis Report

As mentioned above, the Subprime Crisis Report was published in May 2008. Inadequate balance sheet liquidity, *inter alia*, is addressed in the section entitled “Firm Risk Management and Prudential Supervision.” It was observed that firms that experienced greater difficulties tended not to align their treasury functions with their risk management processes, or may have based their contingency funding plans on incomplete or inaccurate information or faulty valuation practices, and concluded that many investment banking firms had inadequate balance sheet liquidity even when adequately capitalized. In addition, in terms of the quality of disclosure by firms, issues relating to off-balance sheet entities and liquidity puts are discussed in the same section of the Subprime Crisis Report.

### (B) IOSCO Report “Sound Practices for the Management of Liquidity Risk of Securities Firms”

The IOSCO Technical Committee published the report, “Sound Practices for the Management of Liquidity Risk of Securities Firms” (“IOSCO Sound Practices Report”) in 2002. The content of the IOSCO Sound Practices Report is broadly consistent with that of the BCBS Liquidity CP in the sense that the IOSCO Sound Practices Report discusses the identification, measurement, monitoring and management of liquidity risk, and it emphasizes the importance of adequate stress testing and scenario analysis, and high level management of liquidity risk.

## **2. Inputs and suggestions on the Basel Liquidity CP**

On the Basel Liquidity CP itself, I have received the following inputs and suggestions from my colleagues for your consideration:

### (A) General Comments

There should be more discussion of the role and importance of confidence in firm liquidity. Simply put, during a time of stress, a firm’s inability to maintain confidence threatens the firm’s survival, notwithstanding the strength of its liquidity risk management or the size of its liquidity cushion and capital. Usually, the two are related, but the events at Bear Stearns are instructive in how confidence, or the lack thereof, can quickly take on a life of its own. Similarly, there may be insufficient emphasis in the Basel Liquidity CP on the challenges of avoiding negative signaling during a time of stress, when maintaining confidence is most important. While having a contingency funding plan (CFP) and a range of alternative funding sources lined up to deal with a crisis is better than not, the strong pressure to avoid appearing weak means that effectively a range of liquidity enhancing actions may not be accessible when needed most — *e.g.*, tapping a committed backup liquidity facility may actually precipitate a broader liquidity crisis. In addition, the tools available to supervisors to remediate a bank’s liquidity position are very limited, especially during a time of stress. An “early warning system” (Principle 15), while good in theory as a supervisory tool, could easily become a trigger point for a crisis of confidence. The same could be said for the supervisor-mandated remedial actions listed under Principle 16. A greater emphasis on “prevention” — *i.e.*, ongoing supervisory engagement with those responsible for liquidity risk management — may be preferable or a good compliment to those principles.

In addition, prudential valuation of assets is a key determinant of the liquidity position of investment firms. In this regard, it should be noted that accounting standards are generally written for the purpose of informing capital market investors, and not to foster stability in the financial markets. That is, accounting standards are not a liquidity metric. Nonetheless, we believe that any document produced by the BCBS on liquidity risk management must clearly reference the importance of accurate asset valuation. One issue that needs to be addressed regarding fair value is that too few firms may be marking their asset values; and those that do may be marking too slowly. There is no question that recent market dislocations were exacerbated and prolonged by market participants suddenly realizing that they were carrying assets at prices that were no longer close to fair value and subsequently marking down such assets. Supervisors should therefore seek to ensure that supervised firms apply appropriate valuations. In the long run, this could foster more effective liquidity risk management.

Moreover, the Basel Liquidity CP advocates qualitative and quantitative disclosure of liquidity positions. However, we should be aware that, in addition to the benefit of increased disclosure on market discipline, liquidity disclosures have the potential to be misunderstood by the market at large, due to the subjectivity involved in their interpretation.

#### (B) Specific Comments

As one of the lessons from the Bear Stearns event, with respect to Principle 14, our view is that assessments should not just be periodic, *e.g.*, once a month or quarter, but “ongoing.” Also, we feel that it is important to be a little more specific about what a supervisor can and should do if it is concerned about a firm’s liquidity position. Therefore, we suggest modifying Principle 14 to read as follows:

“Supervisors should ~~regularly~~ perform a comprehensive assessment on an ongoing basis of a bank’s overall liquidity risk management framework and liquidity position to determine whether they deliver an adequate level of resilience to liquidity stress ~~given the bank’s role in the financial system~~ and, if found to be inadequate, advise the bank to, among other things, consider seeking longer term financing and/or reduce its illiquid positions.”

Under Principle 14, the proportionality principle is described, particularly in paragraph 131, for the broad applicability of the liquidity principles. We agree in principle that regulators should be cognizant of the importance of particular institutions to the international financial system. An ongoing and comprehensive assessment of all institutions, regardless of their size, complexity and systemic relevance would cause an undue burden not only for most institutions but also for supervisors as well. That said, one Standing Committee 3 member questioned whether there is a realistic and fair way to hold firms to different standards. The concept of the proportionality should not be interpreted by the firms that regulators hold firms of less systemic importance to a lower standard. This will be more applicable, especially when we think of investment firms.

Paragraph 71 links “a bank’s repayment ability” to “a bank’s capital cushion.” These risks further conflate capital and liquidity – two distinct topics that the Basel Liquidity CP should work hard to distinguish.

Paragraph 123 indicates that banks should have “marketable” assets (as opposed to just “cash and high quality government bonds”) for “insuring against less severe, longer duration stress events”. We would suggest the following change:

“123. With respect to the composition of its liquidity cushion, a bank should hold a core of the most reliably liquid assets, such as cash and high quality government bonds or similar instruments, to guard against the most severe stress scenarios. For insuring against less severe, longer duration stress events, a bank also ~~should~~ can hold unencumbered liquid assets which are marketable (*i.e.*, can be sold or used as collateral in sale and repurchase agreements) without resulting in excessive losses or discounts.”

The Basel Liquidity CP appropriately highlights liquidity risk measurement tools, reporting, etc. However, it appears to assume that treasury departments have full visibility into all of the liquidity risks being borne by their banks. This is not the case, especially for banks with decentralized liquidity management. While we recognize treasury’s role within an institution’s organizational structure as management issue to be decided on an individual basis by the respective institution, it may be helpful to emphasize that treasury involvement in business unit activities may help ensure greater completeness of liquidity risk capture, which is better addressed in the liquidity pricing section. If this comment does not fit in this section, the point may be addressed in a more general way in the context of the general Principle 3 by referring to a close coordination of treasury functions to liquidity risk management incorporating information on all relevant business activities.

### **3. IOSCO Future Work**

In accordance with the recommendations of the Subprime Crisis Report, Standing Committee 3 will continue to work on liquidity risk management and liquidity standards and will conduct a survey covering members’ experiences. IOSCO would like to continue its good communication with the BCBS in this regard.

The comments we have provided herein reflect a general consensus among the members of Standing Committee 3 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

I hope the BCBS finds the input and suggestions useful.

Sincerely yours,



Tokio Morita  
Chairman  
The Standing Committee on the Regulation of Market Intermediaries  
IOSCO Technical Committee

Copy: Christopher Cox, Chairman, IOSCO Technical Committee  
Greg Tanzer, IOSCO Secretary General