

Comments on "Principles for Sound Liquidity Risk Management and Supervision" June 2008 - Draft for Consultation from the Basel Committee on Banking Supervision

Japanese Bankers Association

The Japanese Bankers Association would like to express its thanks for this opportunity to comment on the "Principles for Sound Liquidity Risk Management and Supervision" Draft for Consultation published by the Basel Committee on Banking Supervision.

It is hoped that the following comments will assist the Basel Committee as it works to finalize the principles.

General Comments

Our understanding is that the principles presented in this market consultation represent a review of existing liquidity management principles in light of both the results of a survey on countries' bank liquidity risk management supervisory practices and the financial market turmoil that began in mid-2007. We are basically supportive of this.

The intent behind our comments is to bring further clarity to the principles and to express the opinion that the hurdles should not be set too high above those of our current practices.

In particular, with respect to Principle 4 (*"a bank should incorporate liquidity costs, benefits and risks in the product pricing, performance measurement and new product approval process for all significant business activities"*), we understand the reasoning behind the wording, however would advocate that this issue be rethought if the intent of the Basel Committee is to seek quantitative requirement. We are cognizant of the need to consider liquidity costs in product pricing and performance measurement. However, we do not think it rational to present only quantitative approaches as guidance for regulatory authorities, because doing so would necessarily exclude other approaches (for example, techniques that qualitatively consider these factors from the perspective of liquidity risk governance). We would like the expression to be amended to something more flexible that would allow for multiple options in light of the objectives of this principle.

Individual Points (Ordered by the Principle)

Principle 4: Governance of liquidity risk management

A bank should incorporate liquidity costs, benefits and risks in the product pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

- Quantitative incorporation of liquidity costs, etc. in pricing and performance measurement

As stated in the "General Comments" section, we ask the Committee to rethink the wording in Principle 4 that says, "a bank should incorporate liquidity costs, benefits and risks in the product pricing, performance measurement and new product approval process."

Paragraph 6 states, "*The implementation of the sound principles by both banks and supervisors should be tailored to the size, nature of business and complexity of a bank's activities.*" We understand this to mean that implementation and administrative approaches at individual banks are allowed to reflect conditions at the bank, including the nature of its operations and investments, its geographical characteristics, the currencies it uses, the existence or lack of liquidity cushion and other aspects of its risk profile.

However, the wording in Principle 4 as it stands now will be interpreted as allowing no option other than "quantitative" incorporation of liquidity costs, benefits and risks. We would therefore like the expression to be amended to something more flexible that would allow for multiple options in light of the objectives of this principle.

Principle 5: Measurement and management of liquidity risk

<p><i>A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.</i></p>

- Factors to be considered in practical liquidity risk management

Paragraph 26 identifies the following factors (to be considered in practical liquidity risk management): "*vulnerabilities to changes in liquidity needs and funding capacity on an intraday basis; day-to-day liquidity needs and funding capacity over short and medium-term horizons up to one year; longer-term, fundamental liquidity needs over one year.*" We would like to confirm the meaning of the underlined portion.

Rather than forecasting and managing future funding gaps in an "aggregate" approach by means of liquidity risk management, we interpret this as instructing banks to monitor and manage in advance the structural gaps in their operation of funds and fund-raising from broader Asset Liability Management (ALM) perspectives (for example, 3-year average maturity for assets vs. 1-year average maturity for liabilities). We would like to confirm our understanding.

- Control of potential cash flows relating to commitments, etc.

Paragraph 30 says, "*A bank should identify, measure, monitor and control potential cash flows relating to off-balance sheet commitments and other contingent liabilities.*" We would like to confirm the meaning of the underlined portion.

It is possible, for example, to ultimately control cash flows by reviewing commitment ceilings. We would like to confirm that we are correct in our understanding that the objectives of this paragraph could be achieved solely through reviewing commitment ceilings.

Principle 8: Measurement and management of liquidity risk

<p><i>A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.</i></p>
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- Prioritization of payments in intraday liquidity position management

Paragraph 76 states, "A bank should adopt intraday liquidity management objectives that allow it to a) identify and prioritise time-specific and other critical obligations in order to meet them when expected." We recommend that the underlined wording be rethought.

We understand the need for care in making large value funds settlements, however for large value transactions that span multiple banks it is not realistic for a single bank on its own to prioritize and settle beginning with its largest payments. Rather, prioritization is only meaningful if, for example, all banks participating in the payment system assign the same priorities so as to minimize the impact on the payment system as a whole. We would therefore like to see this wording amended so as to better reflect the perspectives of the payment system as a whole.

- Steps to achieving intraday liquidity objectives (No. 1)

At the end of Paragraph 78 it says, "A bank should ask key customers, including customer banks, to forecast their own payment traffic to facilitate this process." We would like the wording "as appropriate" or something similar added.

We understand the idea of monitoring payment traffic for all major customers and using it in the bank's own cash flow management during times of emergency, however we do not consider this realistic during times of normal market operation. We would therefore like to see the wording "as appropriate" added here.

- Steps to achieving intraday liquidity objectives (No. 2)

We would like to confirm that Paragraph 78 does not require international banks to have constant, centralized monitoring of liquidity for all currencies and regions, rather it requires these banks to create management systems for each type of transaction or payment system (more specifically, detailed breakdowns by currency and region).

Principle 13: Public disclosure

<p><i>A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.</i></p>
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- Explanation of centralized and decentralized structures

We would like to confirm the intent behind the wording in Paragraph 127: "A bank's description of its liquidity risk management framework should indicate the degree to which the treasury function and liquidity risk management is centralised or decentralised. A bank should describe this structure with regard to its funding activities, to its limit setting systems, and to its intra-group lending strategies."

We understand this to mean that there should be a qualitative indication as to whether systems for liquidity risk management within the group are "centralized at a single point" (a single central business unit manages all liquidity risk gaps on a total basis) or "decentralized" (gaps due to operation of funds and fund-raising are managed in a decentralized manner at individual locations).

- Disclosure of quantitative information on liquidity positions

We recommend a very cautious attitude with respect to the disclosure of quantitative information on liquidity positions (for example, funding mismatches) required in Paragraph 128. Figures will vary widely depending upon the assumptions made regarding assets and liabilities, and this information also constitutes proprietary or confidential features.

Even were banks to disclose figures based on appropriate, subjective assumptions, this would not provide information for objective decision-making, nor is there any reason to believe that it would meet the objectives of this paragraph. The act of disclosure would, however, potentially place a bank

in a disadvantageous business position. In addition, there are no uniform standards as to what constitute appropriate assumptions regarding assets and liabilities either among banks or among countries (for example, core deposits), so disclosure at this time would potentially invite misunderstanding and confusion in the market.

Furthermore, the benefits for ordinary investors would not be of a significantly higher level than what can be inferred from existing financial statements, while the financial institution would incur greater reporting burdens and other demerits. We therefore request sufficiently cautious consideration of this principle which takes account of costs vs. benefits. At the very least, we believe that the matters to be disclosed should not be defined by regulatory authorities' decree, rather that appropriate disclosure be determined by individual banks in dialogue with the markets.

Principle 14: The role of supervisors

Supervisors should regularly perform a comprehensive assessment 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.

○ Maintenance of sufficient levels of liquidity as insurance against liquidity stress

Paragraph 130 states, "*b) maintain a sufficient level of liquidity as insurance against liquidity stress.*" thereby requiring banks to provide for liquidity during times of stress. On this subject, we think there should be additional clear statements of the methods and goals used by supervisors and central banks to maintain minimum levels of market function assumed during times of stress.

For example, if sound banks are barred from liquidating safe assets during times of stress, banks will be required to prepare liquidity up to their maximum individual liquidity gap. Meanwhile, if there is no clear indication of the degree of liquidity to be supplied during times of stress by the central bank, there is the potential for bank liquidity risk management to become extremely irrational.

○ Banks that pose the largest risks to the financial system

Paragraph 131 says, "*[Supervisors] should more carefully scrutinize banks that pose the largest risks to the financial system and hold such banks to a higher standard of liquidity risk management.*" We would like to confirm the intention behind the underlined portion.

We would like to confirm our understanding that "*banks that pose the largest risks to the financial system*" should be determined as a comprehensive evaluation of the bank's size, business model and degree of funding severity.

Principle 17: The role of supervisors

Supervisors should communicate with other relevant supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management. Communication should occur regularly during normal times, with the nature and frequency of the information sharing increasing as appropriate during times of stress.

○ Sharing of collateral by home country and local supervisors

Paragraph 143 describes the sharing of information between home country and local supervisors. However, we would like to see this go beyond the sharing of information to create stronger coordination among regulators and central banks in the framework for the supply of funding during times of stress, for example with the sharing of collateral (for instance, use of Japanese government bonds deposited with the Bank of Japan to withdraw US dollars from the US Federal Reserve Bank).

When performing stress tests, enormous costs will be incurred to create systems that ensure liquidity across all currencies in high-stress environments, which could potentially lead to excessively conservative management. Coordination among supervisors and central banks during times of stress so that there is an expectation of currency swap agreements or other equivalent measures between currencies would potentially be of significant utility in the management of funds liquidity, and we would like to see studies move forward towards the achievement of this goal.

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