

## FILE NOTE

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**SUBJECT** **Comment on the Basel Committee's consultative document *Principles for sound liquidity risk management and supervision***

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The comments in this note are divided into two sections: those that refer to the themes in and approach of the document as a whole; and those that address specific aspects of the proposed principles.

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### **General comments**

#### ***Consistency with our statutory objectives***

We believe that in general the proposed *Principles for sound liquidity risk management and supervision* (“the *Principles*”) could be implemented in a manner consistent with achieving the statutory objectives for which we must implement our banking supervisory powers.

We are currently reviewing our own approach to liquidity rules, and have found the draft *Principles* to be a useful resource.

#### ***The role of disclosure***

We support the increased emphasis that the document places on public disclosure of information by banks. Disclosure enhances market discipline on banks and self discipline by banks. Supervisors may also mitigate moral-hazard problems by using publicly-disclosed information, where available, to support supervisory analysis.

To allow the public to compare banks' disclosures, there is merit in requiring the disclosure of information on a standardised or comparable basis.

We note that the International Financial Reporting Standards (IFRS), and in particular IFRS 7, incorporate required disclosures on liquidity and liquidity risk. This will be useful for promoting the quality of disclosure on liquidity risk.<sup>1</sup>

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<sup>1</sup> The New Zealand implementation of IFRS 7, in Appendix E, adds some further requirements for liquidity disclosure to those in IFRS.  
Ref #3357557 v3.0

### ***Focus on supervisory review and supervisory involvement***

We recognise that any principles-based regime requires some supervisory assessment of how banks apply the principles. It is important, however, that in designing a regime the supervisors are aware of the moral hazard that can arise from direct supervisory involvement.

One source of moral hazard arises if, because supervisors have information that is not public, the public comes to expect a warning prior to problems or to expect government compensation if the supervisor fails to warn of and prevent trouble. Another source is that banks may be discouraged from applying a wide-ranging and rigorous approach to liquidity-risk management beyond what is required to meet any supervisory requirements.

Where supervisors cannot apply clear and objective criteria in exercising supervisory judgement and approval, there is merit in banks disclosing publicly the essential details of their internal policies, scenarios and assumptions. This provides a strong incentive for banks to ensure that internal policies are robust and are followed. It also ensures that the public has access to important information.

### ***Cross-border supervision***

The principles-based approach to guidance is valuable in part because it allows flexibility in the supervision of cross-border banks. It allows supervisors to devise an approach that ensures effective supervision for the benefit of the local economy and that still minimises any undue compliance burden through duplication or inconsistency in regulation across the countries in which a banking group operates.

We agree that host-country supervisors should understand the group position and have a good relationship with home-country authorities. This is important for host supervision of the local systemically-important operations of international banks.

Cross-border supervisory cooperation can be particularly important in cases where a bank manages liquidity separately for each location but under a common set of policies.

### ***Cross-border distress management***

In the event of liquidity stress or of a bank failure, each country's supervisor will face statutory objectives to ameliorate the damage to its own country's financial system. Those objectives might partly inhibit cooperative responses across borders. It is important to establish *ex ante* cooperative arrangements for distress management that incorporate an understanding of such statutory obligations. Equally, obligations of these kinds should be reflected in each country's rules for liquidity-risk management across borders and in the assumptions made about transferability of liquidity and funding within international banking organisations.

It would be useful to raise these matters in the document's discussion surrounding Principle 17 on cross-border supervision and supervisory cooperation.

### ***The status of Principles and of the text supporting them***

The document is likely to be widely cited in assessments of countries' liquidity regimes. Further, the document states that "The Basel Committee fully expects banks and national supervisors to implement the revised principles promptly and thoroughly", and the associated press release follows that statement with, "We will vigorously assess the degree to which the principles are implemented".

In that light, it would be useful if the document provided an explanation of the Committee's views about the status of the guidance that supports each *Principle*. For example, is it essential to follow this guidance; is the guidance simply illustrative; or is some other interpretation appropriate?

Further, the purpose of the supporting text appears to vary within the document. Often it serves to provide further guidance on what a principle means. In some places, however, the supporting text seems instead to provide general comment, observation, rationale or analysis. Here again, clarity about the Committee's preferred interpretation would help supervisors seeking to incorporate the recommended *Principles* in their regimes.

Finally, the amount of detail in the supporting text varies from principle to principle. We feel that the higher-level, principles-based, approach to guidance is more consistent with the spirit of the document than would be detailed description of processes and policies.

### ***The Committee's process for assessing implementation of the Principles***

There is an expectation that banks and supervisors should implement the *Principles* promptly and thoroughly, and that the Committee will assess the degree to which this is achieved.

Can any information be provided about how and when this assessment will take place? National supervisors could point to this information to support their efforts to secure the resources needed to update their approaches and implement any revisions.

### ***Addressing the causes of recent failures in liquidity-risk management***

We agree that an important cause of recent failures in liquidity-risk management around the world has been the inadequate implementation of basic liquidity-risk management principles. The primary response, which we take to be consistent with the document's position, should be to address the incentives that banks have to implement the principles rigorously. (i.e. Supervisors should clearly focus on the fundamental reasons why risk can become manifest, and not focus solely on addressing the particular risks that have been weakly managed in recent times.)

## **Comments on specific parts of the text**

### ***Principle 2 – liquidity-risk tolerance***

Some supervisors might find it useful to have access to technical discussion about ways of defining and measuring liquidity-risk tolerance.

### ***Principle 5 – reference to underlying risk factors that could result in liquidity demands (paragraph 33)***

Understanding the underlying risk factors, and how these can be conducive to liquidity stress, is important. It would be worth emphasising this throughout the document. Banks' monitoring should thus address the underlying macro-economic and financial-market conditions, and should not be confined to the immediate indicators of liquidity problems.

### ***Principle 6 – expertise about country-specific factors (paragraph 57)***

The paragraph says that, "For each country in which it is active, a bank should ensure that it has the necessary expertise about country-specific features of the legal and regulatory regime that influence liquidity risk management".

Similarly, we believe that supervisors – both home and host – should understand the liquidity rules and the legal and regulatory regimes in the countries in which a bank is active. This

promotes consistency of rules, where possible. It also promotes clarity about actions that supervisors would need to take in the event of liquidity stress.

This could be achieved partly through communication between home and host supervisors (Principle 17), and potentially reflected in supervisory agreements.

***Principle 9 – monitoring of available collateral at the legal-entity level (paragraph 86)***

This refers to monitoring the level of available collateral at the legal-entity level. Given the potential implications of jurisdictional borders and local regulatory requirements, this could usefully be extended to refer to monitoring available collateral by location (jurisdiction).

***Principle 10***

The document is right to emphasise that banks should analyse a range of material and relevant stress scenarios, and not just the scenarios that supervisors specify for the purposes of requiring banks to meet survival requirements. Where regulatory requirements focus on particular scenarios, there is a risk that banks can focus excessively on those regulatory scenarios at the expense of a wider range of analysis

***Principle 10 – list of stress-test scenarios to address (paragraph 97)***

Paragraph 97 states that, “A bank should consider short-term and protracted, as well as institution-specific and market-wide, stress scenarios in its stress tests, including . . .”.

The status is unclear of the subsequent list of scenarios: are these provided as examples (subject to the nature of the bank and banking system), or are they considered to be essential?

***Principle 11***

The text of the *Principle* focuses on meeting liquidity shortfalls in emergency situations; but the supporting text (paragraphs 108 – 120) refers also to other objectives and actions. Some of those other objectives could warrant explicit reference in the high-level *Principle*. In particular, communication is likely to be essential to maintaining confidence through a period of stress, but is not directly covered by the *Principle*’s reference to “addressing liquidity shortfalls”.

This could perhaps best be achieved by making the principle refer more generally to survival through periods of stress. Objectives such as maintaining confidence and addressing liquidity shortfalls could be treated as elements of that goal rather than being stated explicitly in the *Principle*.

***Principle 11 – identifying actions to take in a stress situation (paragraph 113)***

The paragraph says that “. . . the plan should set out a clear decision-making process on what actions to take at what time . . . [and] when and how to contact external parties . . .”. This seems to suggest *ex ante* identification of particular actions to take, and goes beyond setting up a framework and tools for good decision making. The focus would better be placed on the framework and tools for decision making, as is the case in much of the other discussion of contingency planning.

***Principle 14 – reference to the potential use of quantitative standards (paragraph 132)***

We agree that the use of quantitative standards might be useful for some supervisors, and that it should be acknowledged as valid.