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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Group Treasury
5th Floor
280 Bishopsgate
London, EC2M 4RB
Telephone: +44 (0)20 7085 6617
Facsimile: +44 (0)20 70856593
Ron.Huggett@rbs.com

Principles for Sound Liquidity Risk Management and Supervision

The Royal Bank of Scotland welcomes the opportunity to respond to the above-named paper which was published on June 17th 2008.

Our detailed comments are set out on the following pages but in summary we are in broad agreement with the principles set out in the paper. In summary the process is fourfold:

- A bank must be able to readily determine its contractual liquidity position.
- A bank should then overlay that view with assumptions about normal behaviour
- It should then undertake stress testing by reviewing how the normal assumptions change under the various stress scenarios.
- Given the results of the stress tests the bank can assess its current level of liquidity provision, establish the cost of contingency arrangements and compare that cost of insurance and the associated liquidity risk levels to its risk appetite and profitability goals.

With this information available, the Board can agree with senior management the strategy the bank is to adopt.

The BIS principles support this approach and we believe they will assist financial institutions, regulators and central banks to maintain robust liquidity policies, procedures and systems in both normal times and in times of stress.

If you have any questions on our submission please contact my self or Bill Rickard (+44 (0)20 7085 6387 (bill.rickard@rbs.com)

Yours faithfully

Ron Huggett,
Deputy Group Treasurer
Royal Bank of Scotland Group

Principle 1: A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system.

We agree that a bank should manage its liquidity position in a prudent manner.

We also agree with the concept of holding a stock of liquid assets against a range of stress events. It is important, however, to reflect on what constitutes the highest quality of liquid asset. In considering this, the authorities must recognise that eligibility as collateral at central banks in both normal and stressed times will be a consideration. Para 9 argues that banks should not rely on central bank support in times of stress. We would counter that whilst this may be true for a bank specific event, where there is a risk to the system as a whole then the banks will need to have support from the central banks. Systemic problems are, after all a shared problem between the private and public sectors.

Principle 2: A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.

Agreed. It is important that the tolerance level is understood at all levels of the bank.

Banking remains, at its basic level, the business of borrowing short and lending long. In expressing liquidity risk tolerance a bank will therefore be balancing prudence against profitability and this is clearly an issue of the utmost importance to the Board. There is an ongoing challenge to articulate the risk tolerance in such a way that all levels of management can readily comprehend the trade off between risk taking and profit making.

Principle 3: Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.

Agreed

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 (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.

This does imply a need to educate customers regarding how liquidity issues impact product pricing. Given the complexity involved this may not be straightforward and an industry wide initiative will be required

There is an implicit suggestion that internal transfer pricing also includes the cost of liquidity. This is to be encouraged but tax authorities will need to be brought on board where such pricing is cross border.

Furthermore internal charging should be introduced carefully to ensure that it encourages the right behaviour and does not create an atmosphere of internal cost avoidance. Charging is only one way, after all, to encourage the right behaviour.

Principle 5: 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.

We welcome the detailed paragraphs underlying this recommendation which take the lessons of the recent market turmoil into account. We would, however, make the point that materiality is a factor to be considered when gathering the information.

Principle 6: A bank should actively manage liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.

Whilst we agree with the principle and agree that intra bank flows must be tracked and controlled, we would highlight the possibly conflicting goals of regulators and globally managed banks in the management of liquidity. The former are mandated to protect depositors in their jurisdiction whilst the latter are seeking to support depositors throughout their global operations. Regulators are therefore more likely to want local pools of liquidity whilst global banks may wish to hold a central pool of liquidity which can be moved to units in temporary need. If banks are prevented from moving liquidity around their organisation by unreasonable regulatory constraints there is a danger of creating trapped pools of liquidity, with the possibility that the bank is unable to support, say, a subsidiary which is suffering a (temporary) liquidity problem. In such an event there is the danger that the problem spreads to the rest of the bank thereby creating the very crisis which the regulation is trying to avoid.

We believe the problem is not insurmountable if regulators establish a form of understanding on how global banks are to be regulated – e.g. via “colleges of regulators” – and if global banks are prepared to articulate the contingency plans in respect of cross border support.

It is probably worth making a distinction between jurisdictions whose currencies are readily traded and those where the liquidity of the currency is lower.

- In normal circumstances banks might reasonably expect that forex flows freely for the major currencies and that this continues even if there is a bank specific event. That is not to say a bank should take no notice of large cross currency exposures and have a policy for the levels of such exposures with which it feels comfortable. In assessing the currency(ies) in which the bank might hold its stock of liquidity, the bank is likely to rely more heavily on assets denominated in the freely traded currencies. It is true that in certain *market* events even the major currencies may not trade smoothly but, again, in such circumstances the private and public sectors will need to work together to tackle the crisis.
- "For the less well traded currencies it might be more prudent to mitigate liquidity risk through self sustainability, rather than place overreliance on centrally held group resources which are potentially restricted in their availability due to a mixture of geopolitical, regulatory and financial market constraints." We do accept that local circumstances must be taken into account particularly for the less frequently traded currencies.

Principle 7: A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

Again we agree with this proposal. It is important in our view that a bank recognises what capacity it has in normal times and then reviews how that capacity will change in the differing stress scenarios it

undertakes. From that analysis a bank should be able to determine if it is overly reliant on anyone source of funds when assessing its liquidity risk tolerance and then to take steps to reduce that risk.

Principle 8: 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.

Intra day exposures are supported by collateral placed into settlement systems and controlled by close monitoring of the payments through the settlement systems. The amount of collateral required is based on exposure to the flows of a group of counterparties allowing for the off-setting nature of the portfolio effect and the market best practices (e.g. in the UK 50% of the values need to be processed by noon and 75% by 2.30pm). Whilst this can increase and decrease during the day, a bank should utilise experience of the normal flows, the communication processes with relationship managers and clients to forecast large intra payment needs (i.e. have processes in place to manage peaks), and have controls to ensure the exposure to any one counterparty does not exceed intra day limit for that counterparty. This latter ensures that, if one counterparty were to become insolvent intra day, the contagion impact is restricted to the agreed intra day credit limit and not the totality of all payments processed on behalf of that counterparty during the day.

It is clear that a bank will have a minimum need for collateral to support its settlement activity and that this should be seen as separate from any liquidity buffer held against stress events. However, banks may choose to put more collateral into the payments systems than the minimum it needs to support the systems to enable fast processing of larger payments particularly where market conditions are running normally. There is a danger of forcing banks to treat ALL collateral in payment systems as ring-fenced i.e the minimum it needs plus discretionary amounts. If this happens banks may look to minimise collateral in settlement systems and this could slow down the settlement process.

This risk could be further exacerbated if banks look to recover the cost of intra day liquidity through charging those counterparties who are, for example, time sensitive

Principle 9: A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor the legal entity and physical location where collateral is held and how it may be mobilised in a timely manner.

Collateral is used in a variety of ways e.g.:

- to support settlement systems
- in repo/reverse type transactions
- to reduce credit exposure on e.g. derivative transactions
- to support central bank facilities
- as a buffer of liquidity

It is clear that a bank must be able to identify what collateral is available to generate liquidity in times of stress in the same way it must be aware of any collateral calls that occur in such times.

Principle 10: A bank should conduct stress tests on a regular basis for a variety of institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.

Before any stress test can be undertaken a bank must first collect data on a contractual basis from across all its businesses. Once that has been done the bank should set out how it expects normal behaviour to impact the resulting liquidity risk. These normal assumptions should be clearly documented and can be based on historical data – since, by definition, they represent what customers have done previously. Stress testing will then take those normal assumptions and tailor them to the particular stress scenario being tested. Some stress information can be readily based on historical observation – e.g. volatility of the value of collateral – whilst others will, of necessity, be based on subjective assumptions. The important thing is that the normal assumptions are used as a starting base and the movement away from the norm is recorded together with the underlying argument for the move.

Stress testing of more likely scenarios helps design contingency plans. For example, a one or two notch downgrade of long term credit ratings will highlight additional collateral calls under contractual arrangements and require the bank to consider what business lines continue to make sense.

More severe stress testing is linked to the level of liquidity risk tolerance a bank might have. For example, in stressing a run on retail deposits a bank might decide it will have a liquidity buffer sufficient to meet, say, a 1% daily outflow over a 1 month period but not a 2% per day buffer. Another extreme example might be that it will hold a buffer equal to 50% of wholesale funds maturing in the next x number of days but not 75% etc.

One other advantage of running such stress tests is to determine whether the position is improving or worsening.

Principle 11: A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust.

Agreed

Principle 12: A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding.

Liquid asset values can reduce in a market event, no matter what the quality of the assets is. This also needs to be factored in when evaluating the liquidity buffer.

Regulators should recognise that some assets can be regarded as liquid in many scenarios but only a very few will be liquid in all circumstances.

- An illiquid asset is placed in the maturity ladder at its final maturity date, whereas a proportion of the value of a liquid one will be brought forward in the ladder - usually to the very short term: overnight to 1 week. The remainder of the asset's value will be left at its final maturity date
- As stress tests are undertaken so the "haircut" might be increased to recognise the increasing "forced sale risk".
- In extreme scenarios the only buyer or repo counterparty left to a bank will be the central bank. This implies that the extent to which an asset is acceptable as collateral by central banks will influence what a bank includes in its liquidity buffer. Therefore, if it is not clear what will be eligible (in market stress events, in particular) it becomes more difficult for a bank to manage its liquidity buffer cost effectively.

It is also worth pointing out that any liquidity generated by sale or repo of the liquidity buffer must be capable of being used in any of the jurisdictions in which the bank operates. Where this is not the case – in countries with “non fungible currencies”, for example, or where regulation prevents ready cross border funds flow - a bank will be forced to hold a local pool of liquidity.

Public disclosure

Principle 13: 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.

There is a need to balance public disclosure of quantitative information with confidentiality. In setting regulatory quantitative measures it is recognised that one size does not fit all and therefore the publication of any quantitative measure is open to misinterpretation. Furthermore, in stressed conditions a bank’s contingency plan will expect to make use liquidity buffers to supply liquidity. If a bank is forced to publish how it has used those buffers there is the possibility that observers assume that the bank has a problem. The buffer then becomes the minimum level of liquid assets it must have – i.e. the liquidity buffer is no longer liquid!

The role of supervisors

Principle 14: 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.

Principle 15: Supervisors should supplement their regular assessments of a bank’s liquidity risk management framework and liquidity position by monitoring a combination of internal reports, prudential reports and market information.

Principle 16: Supervisors should intervene to require effective and timely remedial action by a bank to address deficiencies in its liquidity risk management processes or liquidity position.

Principle 17: Supervisors should communicate with other 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.

Whilst we broadly agree with the above four principles we would add one other comment. Regulators will have a unique view of how banks manage liquidity across their jurisdiction and will also be able to discuss that with regulators from other jurisdictions. From that information they should be able to determine best practice and to apply a “comply or explain” approach when challenging banks who they believe to have sub-optimal policies.