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Berlin, 16<sup>th</sup> April 2010

## **ACI-Germany comments on BCBS CD 165: “International Framework for Liquidity Risk Measurement, Standards and Monitoring”**

We appreciate the idea of releasing new regulations on a consultative basis first and therefore, as an association of market practitioners are more than willing to contribute to this consultation. For more details on our association please refer to the appendix 2 or to our website “[www.aci-germany.de](http://www.aci-germany.de)”.

### **General remarks**

#### **1. There is a need to adjust liquidity regulations**

Liquidity is certainly an aspect which was neglected by some market participants. The dimension of the recent crisis and its impact on liquidity was definitely underestimated by all parties involved. Therefore, it is necessary to improve the international regulations on liquidity by the supervisors. But before focusing on any possible aspect of liquidity which may cause shortfalls, one has to acknowledge that the crisis had many reasons, most of them are outside the regulation on liquidity.

#### **2. Main reasons for the crisis**

Too much and too cheap liquidity, last but not least provided by the central banks, was one of the main reasons for the speculative bubble seen in the last crisis. A lack of transparency in risk/return correlations, off-balance sheet risk-taking and a still missing harmonization of international accounting standards facilitated a higher risk exposure by some market participants. Credit assessments were sometimes solely based on (in parts disputable) external ratings. Record low credit spreads combined with a fierce competition for return on equity contributed to the increase in risky investments.

#### **3. Risk taking as an inherent mission of the banking system**

Maturity transformation is one of the core tasks a banking system has to fulfill within an economy. By nature of the business the maturities of assets and liabilities are driven by supply and demand. Clients always tend to borrow long-term (e.g. mortgage and consumer loans) and lend short-term (e.g. savings and term deposits). If banks are prevented from efficiently redistributing and taking adequate liquidity risk in form of liquidity gaps this will result in a partial malfunctioning of the banking system. The consequences will be a shortage in term credit supply and even reduced economic growth.

#### **4. Central banks always have to act as lender of last resort**

Nationally and in there global coordination, central banks have proven their ability to stabilize markets and to act as the lender of last resort. A global systemic crisis like the last one can only be mastered if central banks act in exactly this way. Individual banks cannot prepare themselves for the impact of a systemic crisis of that degree without having central banks on their side right from the beginning. Moreover, forcing banks to stay liquid for one year without any additional measures imposed by the central banks will change the role of the banking system dramatically. As stated before a credit crunch and reduced economic growth might be the consequence of such a regime.

#### **5. Need for a coordinated global answer by regulators**

As the crisis has rapidly become a global one, only a globally coordinated response by all regulators can be the right way to contribute to better regulation. The way regulators have acted so far ended in a sort of confusion. There are too many different national and international proposals (Basel Committee, CEBS, FSA, EU commission) on their way, with conflicting targets and overlapping time schedules leading to an overregulation. A well organized and concerted procedure starting at the BCBS and filtering down to the individual jurisdictions would have been expected.

#### **6. Practical solutions are in place; an extended regulation should build upon**

The crisis has also shown that there are banks which already have adequate liquidity management systems in place. These banks were able to cope with the observed liquidity shortages. It goes without saying that there is a need to adjust some of the parameters and to change the reliance on some products/markets. But especially the knowledge about the specific parameters (markets, products, customers, risk profiles) of a single bank helped these banks to quickly react to the unforeseen aspects of the crisis. So the necessary adjustments can easily be made (and are partly being made already) within the existing frameworks. A radical change to a new liquidity regime or an additional demand to fulfill many new regulations on top is not only cumbersome but abandons the principle of managing and reporting (including supervisory reports) out of one system/tool. Applying a 'one-size-fits-all' regime would lead to less quality and often misleading information compared to building upon an existing framework to manage liquidity.

#### **7. One-size-fits-all versus principle-based regulation**

With business models substantially differing across the banking industry, the proposed '**one-size-fits-all**' approach to funding and liquidity risk management does in our view not address institution, market and country-specific liquidity risks and could expose the entire banking and financial system to greater risk if implemented. It would be more beneficial to the financial system if minimum requirements/standards were established only in a 'core set of regulations/rules' while, at the same time, more room or leeway for banks to account for their individual assessment of their specific liquidity risk supervised by local regulators (like implemented in the German §10 Liquiditätsverordnung (Liquidity Regulation))

## **8. Quality overrides quantity**

There is a lot of data which can be collected and reported to the supervisors. But in the end it is highly questionable whether the magnitude of data requested will lead to a better understanding of the liquidity risk involved. In our view, the quality of a liquidity management system is driven by its fit to the individual business model rather than by the quantity of information delivered. Thus, a regulation based on the individual management system and its reporting should be the preferred solution (at least for globally operating institutes which are exposed to a certain degree of liquidity risk).

## **9. Creating a level playing field by comparable international standards**

The goal of international harmonization and comparison of institutions could be jeopardized by national discretion and room for interpretation of proposed rules. With the implementation of some rules being at the discretion of national supervisors, the room for regulatory arbitrage and reducing transparency and comparability across institutions in different jurisdictions are certainly possibilities. Therefore, regulators further need to ensure that rules are interpreted and applied consistently by financial institutions to safeguard comparability of results even within a single jurisdiction.

For consolidated banking groups, intra-group aspects have to be considered.

The impact of different accounting standards on the proposed ratios (e.g. with respect to the netting of positions) needs to be considered to ensure comparability between financial institutions.

## **More specific remarks to the proposed standard**

### **1. Full disclosure against regulators – Public disclosure is questionable**

To provide liquidity information to the regulators in time and with full disclosure is a must. Regulators should receive regular information and should be contacted once negative trends for liquidity are foreseeable. Thus measures can be taken before a situation deteriorates.

On the contrary, a public disclosure on liquidity can be counterproductive. Liquidity figures reported to the public can easily be misinterpreted and even cause liquidity problems to a bank not exposed to a liquidity shortage in the beginning. Explaining the reporting data and its variation could also raise some questions why an institute is elaborating on liquidity in more detail than before. So a bank can easily become a target for unfounded rumors, which can lead to a self-fulfilling prophecy.

### **2. Crowding out of bank debt by public sector debt**

Considering the parameters of the proposed standard financial institutions might have to hold a lot more sovereign debt as liquidity reserve. Bank debt will no longer be held by financial institutions, which will cause a sharp decrease in the long-term liquidity exchange. This entails the danger of a crowding out for non-sovereign debt instruments in general.

### **3. Huge supply of long-term bank debt – shrinking investor base**

The proposed standard would result in a huge necessity to issue long-term debt by financial institutions. Combined with the aforementioned crowding-out effect the refinancing of banks will at least be more expensive, if manageable at all. This would also have an effect on non-financial corporates, either directly via increased loan/issuance costs or indirectly (for bigger companies) via less demand for corporate paper in the capital markets. This will be aggravated by the shrinking investor base for non-sovereign debt caused by the definition of liquid assets in the standard.

In addition, often conflicting and contradicting regulatory approaches currently being discussed (e.g. French regulation reduces average duration from 90 to 60 days on money market funds or US regulation obliges fund managers to be liquid at least 30% of the outstanding in less than 7 days and decreases WAL from 90 to 60 days), global liquidity imbalances between financial institutions required to borrow long-term and asset managers that must invest short-term could be created. Thus exposing the entire financial system to much higher risks. Financial institutions could scramble and compete for limited amounts of long-term liquidity while getting flushed with short-term liquidity from asset managers. The ensuing dichotomy between increased requirements for long-term liquidity and excess short-term liquidity could be dangerous for financial institutions and the financial system as the market for liquidity could no longer function properly.

### **4. Competition for retail deposits will increase price sensitivity**

We appreciate to emphasize the role of retail deposits as stable funding. However, by setting too tight parameters the competition for deposits will grow and the intrinsic value of retail deposits might shrink through an increase in its price sensitivity. Additionally, applying the same parameters to all financial institutions cannot reflect the individual characteristics of the deposits placed with a single bank. An individual setting of parameters, based on historical data, seems to fit much better.

### **5. Asymmetric treatments across the banking industry**

In a number of instances the rules are asymmetric, such that the aggregate impact across the industry captures outflows, but fails to recognize that there will be corresponding inflows across the system. The final calibration of requirements needs to recognize this. (Example: Committed facilities extended to FIs receive a 100% run-off while facilities obtained from FIs receive 0% recognition as inflows.)

### **6. Tough time schedule reduces the quality of the QIS**

To a large extent, the results delivered into the QIS will have to be based on assumptions and estimates as the requested data granularity is not readily available in the reporting systems. The timeframe for the QIS (end of April 2010) is too tight to implement necessary system upgrades. QIS results and final ratio specifications derived from it will therefore depend too much on qualitative and possibly varying assumptions made by the participating banks.

## Special remarks on the LCR

### **Function of the liquidity buffer (Paragraph 21):**

According to the proposals, banks are expected to meet the requirements of the LCR continuously. Therefore, the liquid assets cannot be used to generate liquidity in times of stress without a breach of the regulatory standard, which has to be disclosed. It should be clarified under which circumstances banks can liquidate the assets in the liquidity buffer and what consequences would arise from such a breach of the regulatory standard.

### **Proposed scenario (Paragraph 22):**

The proposed scenario consists of elements which are – even in the worst case considered – too unrealistic. The BCBS condensed all negative repercussions across the financial sector, which happened over a 2-year time horizon and which only some individual banks might have experienced within a “30-day doomsday scenario”. (e.g. three-notch rating downgrade within one month.)

### **Differentiation by currency (Paragraphs 33 and 84):**

The requirements of paragraph 33 in combination with the statements that banks shall not rely on central bank funding (paragraph 84) and wholesale flows have a zero roll-over assumption seem to indicate that a liquidity buffer is needed in each currency even if Central Bank A accepts collateral denominated in currency B (e.g. Fed accepts EUR collateral). Paragraph 33 is not very clear as you would only calculate the LCR in one currency but maybe your local regulator wants to know it on single currency level as well. To avoid any ambiguity the proposal should make it very transparent that intra-group aspects regarding all currencies have to be considered.

### **Definition of liquid assets (Paragraphs 35ff):**

It is not clear whether the proposed 50% limit for corporate and covered bonds in the overall stock of the liquidity buffer should be applied before or after haircut.

The definition of liquid assets focuses strongly on the credit risk of the eligible assets. We believe that a high degree of diversification within the liquidity buffer is equally important to avoid any kind of risk concentration. We therefore strongly support a wider definition of liquid assets.

Given the strict rules of central banks the definitions for central bank-eligible assets in general combine strong credit ratings and a high degree of liquidity. As a result central bank-eligible assets should automatically be eligible for the liquidity buffer. The differences in credit quality can be addressed by appropriate haircuts which should be derived from stressed market data.

The proposals expect banks to hold 50% of the liquidity buffer in assets which meet the criteria of the narrow definition of liquid assets. This would also lead to a concentration of certain public sector issuers in the liquidity buffer, i.e. significant concentration risk. To support a better portfolio diversification the 50 % requirement should be abolished. The maximum risk weighting to qualify for the narrow definition of liquid assets should be in-

creased to at least 20 % and government guaranteed bonds issued by banks should be included.

With regard to assets issued by banks, we admit that this could theoretically increase the systemic risk. Nevertheless, we are convinced that a functioning interbank market is important for the reallocation of liquidity within the banking sector. Given the actual initiatives to strengthen the resilience of the banking sector it will become less likely that assets issued by banks will be unmarketable in times of stress. Therefore we strongly support the inclusion of assets issued by banks to the liquidity buffer. To avoid artificially inflated liquidity in the system (i.e. banks issuing assets to one another) we recommend limits for single name bank exposures within the liquidity buffer.

The rationale for applying a 20-40% haircut to bonds that have seen no price moves greater than 10% over the course of 10 years seems not appropriate (also: how would bonds without a history of 10 years be treated?). Equities, gold and other precious metals are not eligible as liquid assets. This treatment is too restrictive and cannot be justified by the experience made during the crisis. These assets should be recognized as inflows.

It is our conviction that these new liquidity risk standards will significantly impact funding. The key question in this consultative document relates to the definition of liquidity and what types of assets might fulfill the criteria to be qualified as liquid. From a practical point of view only government securities will satisfy the features requested. We strongly believe that such requirements will tie-up significant volumes of high quality securities. Overall both, the cash and the repo markets, will be prone to high stress such as for government securities. Additionally we'd like to point out that at this stage many government assets from the Eurozone will not fulfill the proposed criteria and therefore discriminate this government debt as well as putting additional stress on the issuing countries. Taking these considerations into account we doubt that the available free-float in such assets will satisfy the demand from all financial institutions. This will generate new risks in the market due to the impaired liquidity in such assets.

We feel that the criteria to determine the liquidity value of assets are highly theoretical and therefore extremely difficult to implement. There should be an internationally harmonized and published positive-list of securities accepted as liquid assets. There should not be any room for interpretation.

Last but not least we feel that by focusing on the asset quality only, the standard neglects market-infrastructure impacts. Anonymous CCP trading and settlement systems linked to the Eurosystem have proven to enable a certain degree of liquidity to remain available but will not fully give remedy to a stress scenario situation.

#### **Retail outflows (Paragraphs 41ff):**

The classification of retail deposits leaves room for interpretation of rules which will hamper the comparability of ratios across institutions and jurisdictions (e.g. definition of relationship-based accounts, investor sophistication/ definition of HNWI, etc). Run-off ratios prescribed by the BCBS only represent minimum ratios and are subject to the discretion of national supervisors (particular where a classification of stable deposits is not possible).

**Lack of differentiation of wholesale deposits (Paragraphs 45ff):**

The proposed LCR rules specify a 100% run-off factor for deposits of financial institutions, fiduciaries, beneficiaries, conduits, SPVs. This treatment is very harsh and does not reflect the experience made by most banks during the crises. More importantly, this proposal ignores the operational nature and hence the relative stickiness of funds that banks receive in the course of their clearing and settlement business (clearing balances) as well as fiduciary activities and should be reviewed. It punishes transaction banking activities which are vital for any economy, not of a speculative nature and have not played any destabilizing role in the recent crisis. The proposed treatment will significantly increase the cost of these services, could lead to a further concentration and could increase systemic risk in the clearing and settlement industry. As a special case it has to be considered that some institutions (under normal course of business and not as an emergency measure) operate under public guarantees. Such guarantees have to be accepted as additional insurance instrument, i.e. the loss of funding should not be assumed for funding under public guarantees.

All of the above should have severe implications and repercussions for the interbank market (see details in appendix 1). In conclusion, we are of the opinion that any new obstacles limiting or jeopardizing the 'free flow of liquidity' across the world should be avoided or, at least, be subject to a very rigorous and detailed analysis on what their negative effects would be. Neither seems to have been applied here.

**Secured funding run-off (Paragraph 58):**

In the LCR, a 100% outflow will apply on secured funding transactions (maturing within 30d) backed by illiquid and less liquid securities. At the same time no liquidity value will be assigned to the underlying asset received out of the maturing secured funding transaction. This results in an inconsistent treatment of those assets that are generally eligible for inclusion into the additional assets buffer under section A2 of the LCR as it implies that they have no liquidity value. In contrast, however, they are being recognized as additional buffer asset and granted a liquidity value if funded on an unsecured basis. The rules should be reviewed in this regard to eliminate the apparent inconsistency.

**Draws on committed credit and liquidity facilities (Paragraph 66):**

According to the proposals, banks have to hold liquid assets for 10% or 100% of committed credit facilities depending on the type of client and for 100% of committed liquidity facilities. These factors are not supported by historical data. Furthermore, we see a lack of differentiation of liquidity lines to different customers. Whereas conduits and SPVs may have drawn up to 100 % of the committed lines during the recent crisis other customers (i.e. US-Municipalities or corporates) have drawn only very limited amounts. Hence we recommend a further differentiation by customer type for committed credit and liquidity facilities as well as the usage of stressed historical data to calculate the required liquidity buffer.

## Special remarks on the NSFR

We generally welcome the introduction of a Net Stable Funding Ratio as a way to promote the medium and long-term funding of assets and hence to strengthen the balance sheet structure of credit institutions.

We have however a number of comments regarding the definitions applicable to available stable funding and required stable funding.

The rules are partially ill-conceived. E.g. for NSFR purposes a covered bond issued by a bank will lose its eligibility as available stable funding once the remaining maturity is less than 1 year. At the same time the cover pool will remain to require stable funding, even though the cover pool assets may also mature within one year. To keep the NSFR stable this would imply that the cover pool assets would have to be refinanced twice for one year. A similar issue exists for loans that are refinanced by dedicated funding from agencies such as KfW on a fully matched basis.

Equities are not recognized as liquid assets. This treatment is too restrictive and cannot be justified by the experience made during the crisis. Likewise, gold and other precious metals are not recognized as liquid assets. These assets should be recognized as in-flows for the LCR and should not require term funding under the NSFR.

One of the key objectives for prudent liquidity risk management in banking is to develop relationship driven, stable and diversified funding sources, both with retail and wholesale clients (funding diversification). The definition of 'stable' and 'less stable' funding and the respective ASF does not appropriately recognize the value of a well diversified funding base. The ASF factors should give credit to banks where the national regulator has satisfied itself that even in stress scenarios as defined by the Committee, relationship driven and diversified funding sources are mitigating a bank's liquidity risk exposure.

### **Treatment of open market operations (Paragraph 84):**

It is unclear how open market operations (OMO) will be treated for the purpose of the NSFR calculation. With respect to borrowings from central banks in general, any new regulations should NOT stigmatize them in any environment or case. We welcome the fact, that the BIS committee recognizes regular market operations as stable funding.

### **Definition of ASF factors (Paragraph 86):**

The Available Stable Funding Factors applied to stable funding categories like stable retail deposits or wholesale funding provided by non-financial corporate customers are not reconcilable to the related factors of the identical items in the definition of the liquidity coverage ratio (LCR). This may be due to the different time horizons of both the NSFR and the LCR. Nevertheless, it should be documented with empirical evidence how the Basel Committee has defined the factors. Alternatively, each banking organisation should have the possibility to use its own proven estimates. (e.g. stable retail deposits get an availability factor of 85% in the calculation of NSFR (see No. 86) but receive at least a 7.5% run-off factor in the calculation of LCR (see No. 41).) Similar discrepancies



between NSFR and LCR factors can be observed for Required Stable Funding Factors (see No. 89).

Liabilities with embedded options, which would reduce the expected maturity to less than one year, will not receive a 100% ASF Factor. As mentioned for LCR, it needs to be clarified that funding that is callable by the issuer does not fall in the scope of the NSFR.

Capital as defined by the global capital standards of BCBS excludes goodwill and other capital deduction items. To avoid double counting, the same deduction items should also be excluded from the definition of total assets of RSF.

#### **Classification of stable and less stable deposits (Paragraph 86):**

Furthermore, the framework suggests to differentiate between stable and less stable retail deposits and deposits provided by small business customers as defined in the LCR. Less stable deposits are e.g. deposits which can be withdrawn quickly or foreign currency deposits (see No. 41). On the other hand, stable deposits contain deposits in transactional accounts and deposits from customers which have other established relationships with the same bank and make the deposit withdrawal therefore highly unlikely (see No. 41). The necessity of this differentiation should be proved with empirical evidence by the Basel Committee because the implementation would be highly complex in organisational and technical terms for each individual bank.

We recommend that liabilities to institutions which form a joint liability scheme ("Haftungsverbund") should be considered as stable retail deposits, i.e. such deposits with a remaining maturity of less than one year should receive a factor of 85%. Due to the joint liability scheme sector a high renewal rate can be demonstrated.

#### **Too narrow definition of liquid assets (Paragraph 89):**

The paper recommends that only bonds issued by public sector entities, covered bonds and corporates bonds with a minimum rating of A- can be regarded as "liquid", i.e. with a Required Stable Funding of less than 100%. The proposal is highly detrimental to other issuer categories such as banks. It is true that the liquidity of bank bonds was impaired during the last financial markets crisis. We think however that this does not preclude which categories of issuers might be affected in future turmoils (cf. the latest sovereign debt crisis). The exclusion of bank bonds will make it more difficult and costly for banks to fund themselves as the issues cannot be used any more as liquidity reserve by other institutions. We recommend using the central bank eligibility as a guiding principle for allocating a RSF factor of less than 100% to securities or at least the eligibility at organized repo platforms ("GC Pooling"). Another route could include setting a cap at the maximum share of bank bonds in a bank's liquidity reserve in order to limit the systemic risk.

### **Treatment of mortgage loans (Paragraph 89):**

We think it is unrealistic to assume that all loans to retail clients having a residual maturity of less than one year will be prolonged with a factor of 85%. If mortgage loans fall in this category, the factor should distinguish between roll-over loans and fixed rate loans. For the latter the factor should be adjusted to 0% because the experience shows that a retail client having fully repaid his/her mortgage loan usually does not take up a new mortgage loan immediately.

### **Treatment of corporate loans (Paragraph 89):**

Applying a 50% RSF factor to loans maturing within 1 year for large non-financial corporate clients will inevitably lead to a rise in their short-term borrowing costs, as banks will need to get additional term-funding. Furthermore, the treatment of corporate debt under the NSFR (i.e. no stable funding requirement as soon as it falls below 1 year) compared with the above described treatment of corporate loans, will encourage disintermediation and move liquidity risk outside banks and outside regulated frameworks.

### **Fully matched funding with negative impact on loan costs**

More generally we think that the introduction of the NSFR will ultimately force banking organisations to match fund their long term assets with long term liabilities, i.e. capital market issuance. This will be specifically the case for wholesale funded institutions. This may lead to the following unwanted effects: The ability of the banking sector to provide the real economy with long-term funding will then ultimately depend upon the appetite of debt markets to absorb bank bond issuance. Large corporates may have the option to issue long-term debt on their own, but this rule could be detrimental to the long-term funding of small and medium-sized enterprises (SMEs). At minimum there is a risk that this rule could lead to increased long-term funding costs for the German "Mittelstand".

## **Proposal: Standard and Advanced Approach**

As mentioned at the beginning we agree to the need to adjust the current liquidity regulation. However, internationally operating banks with a big liquidity exposure by the nature of their business should be enabled to further develop and expand their existing liquidity management frameworks rather than switching to a standardized model. Too rigid quantitative requirements imposed by regulators will reduce incentives for banks to use and develop internal risk models and tools.

Therefore we propose a two-tier model for liquidity similar to the one for the equity calculation within the Basel II-framework.

The current proposal (after some modifications) could serve as the **standard approach**. An **advanced approach** should allow for internal liquidity models, which have to be approved by the regulators (similar to the process defined in § 10 Liquiditätsverordnung in Germany).

# Appendix

## 1. Implications for the interbank market

Central banks and governments have put in a lot of efforts to revitalize the interbank market by improving liquidity, extending duration and restoring trust among market participants. The BCBS paper seems to be counterproductive to these goals in a number of ways.

- ☐ Under certain (severe) scenarios, interbank liquidity could very well be limited but it will not be zero
- ☐ Banks would typically start reducing the duration of their lending before cancelling their credit lines and shutting down their trading activities
- ☐ With these proposals implemented, banks across the entire spectrum could not get any benefits from wholesale funding liquidity beyond its maturities when determining their LCR
- ☐ No differentiation among banks is made even though substantial differences in business model, market access, etc. exist
- ☐ WSF would become very unattractive as a funding source, even more so as the liquidity buffer could not hold any securities from financial institutions
- ☐ In addition, the 30-day horizon would force banks to lengthen their duration with only limited supply available
- ☐ With the importance and attractiveness of the interbank market being significantly reduced by these proposals, banks would need to shift their focus to central bank and long-term funding (from capital markets)

**HOWEVER:** The Basle paper stresses the fact that central bank funding should not be seen as a reliable funding source. Moreover, financial institutions as a key investor in long-term funding (capital markets issuance) are penalized by not being able to use these securities as part of their liquidity buffer.

Considerations to limit currency exposures within the financial industry could lead to less liquid FX markets further jeopardizing the banks' ability to effectively distribute liquidity to where it is required

## 2. Background information on the ACI Germany

The ACI Germany is an association of practitioners working in several areas of financial markets. The above comments have been made mainly by the ACI Germany working groups "Asset Liability Management", "Money Market and Liquidity Management" and "Repo/Securities lending/Collateral".

Liquidity is one of the key aspects in the day-to-day business of our members and liquidity has been a constant issue during many (including the most recent) meetings of the aforementioned working groups. There is a common understanding of the basic principles of the management of liquidity risk. We believe in a principles-based approach rather than in a "one-size-fits-all" model.

The recent market developments have once again shown that liquidity risk is heavily dependent on the business model, type of customers, products and markets in which an institute operates. Even within our working groups we have a heterogeneous background, representing a variety of business models and this has driven our answers to the questions as well.

sign. Georg-Heinrich Sieveking  
President ACI-Germany