BAFT-IFSA
ONE VOICE FOR THE INTERNATIONAL BANKING COMMUNITY

April 16, 2010

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: *International framework for liquidity risk measurement, standards and monitoring*

Ladies and Gentlemen:

BAFT-IFSA is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global financial community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT-IFSA member banks have a high interest in preserving the safety and soundness of the global financial system.

BAFT-IFSA welcomes the opportunity to comment on the consultative document on liquidity published by the Basel Committee on Banking Supervision (Committee), entitled *International framework for liquidity risk measurement, standards and monitoring* (consultative document). BAFT-IFSA member banks, representing major transaction banks globally, are broadly supportive of the framework for a quantitative liquidity regime contained within the consultative document. We note with concern, some of the details specifically relating to the treatment of Wholesale Operational Corporate and Financial Institutional Accounts in the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). Our comments outlined to the Committee are limited to issues in the consultative document specifically related to transaction banking.

Introduction:

A number of concerns arise for banks active in transaction banking in the recommendations of the Committee in the consultative document. If the liquidity proposals are adopted as currently configured, we believe there would be a significant impact on the provision of transaction banking services, in large part stemming from the increased cost of funding as the contribution of transaction account balances to structural funding is discounted and banks turn to alternative and

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more expensive sources. We anticipate that service prices would increase as a result of the increased cost of funding these activities, bank profitability and returns to equity investors would be diminished, and banks would choose to exit or reduce their investment in these service lines, which would reduce the quality and variety of transaction banking services offered.

With banks assessing a lower value to institutional deposits, liquidity will be redirected to non-bank vehicles, who in turn will fund assets the banks can no longer fund. Banks will be effectively disintermediated, with large liquidity pools held by unregulated entities, a result that directly contradicts stated objectives. Creating increased reliance on debt and capital markets to meet funding requirements also seems contradictory if the objective is to ensure ongoing operations through internal funding mechanisms in the event of a market disruption. Finally, if adoption is not uniformly enforced in local markets, international banks will be disadvantaged and transactional flows may be diverted to banks that may not be equipped to comply with the higher standards of compliance, not to mention liquidity and capital, required to support cross-border settlements.

We strongly support global coordination between regulators and the standard application of liquidity risk measurement practices across jurisdictions. A more standardized approach will enable banks to achieve more quickly the systemic risk goals envisioned by the consultative document by promoting simpler models for managing liquidity across markets. Harmonization of liquidity metrics is also essential to ensure a safer and less complex financial system for all participants.

BAFT-IFSA is concerned, however, about potential unintended consequences on the macro-economic environment as a result of the introduction of higher liquidity standards along with tighter capital standards. The potential compounding effect of these tighter standards should be approximated if possible, as any increase in liquidity costs incurred by banks will be largely passed onto the customer in the form of increased costs.

We believe that with respect to the differentiation in regulatory treatment, the current recommendations place undue emphasis on client segment, while not sufficiently acknowledging the purpose, characteristics and macroeconomic value of the underlying flows. Specifically, we believe the liquidity derived from the transactional banking activities of non-personal client segments have been treated inconsistently and are undervalued as a source of structural funding, resulting in unnecessary burdens for the transaction banking industry, despite its importance for international trade and economic recovery.

Consequently, we respectfully request the Committee to consider differentiating transactional accounts, and the liquidity derived from the provision of transaction services, from discreet wholesale funding activities typically managed within the bank treasury and trading units. We also request that the Committee apply consistently, low run-off factors across all client segments, small, medium and large corporates as well as financial institutions, reflecting the common

nature of the underlying drivers of flows through their operating accounts. Such differentiation will accommodate a binary approach to valuations on both sides of the balance sheet, recognizing the relationship-driven, stable nature of operating accounts in contrast to the more fluid and portable nature of interbank borrowings.

While consistent and generalized run-off factors can serve to eliminate imbalances in treatment across jurisdictions and participants, an advanced approach, administered within proscribed formulaic guidelines, is aligned with current practice and gives recognition to the diversity of business portfolios across institutions. Therefore, we encourage the establishment of an optional "advanced" approach for determining institution- and portfolio-specific run-off factors, Available Stable Funding (ASF) factors and operational balances levels. Additionally, the Committee should consider recognizing the low risk nature of trade related contingent liabilities in the Net Stable Funding Ratio via a harmonized treatment across national regulators.

Background:

Transaction banking service businesses facilitate and enable the administrative and operational activities surrounding the management of short-term cash, payments, securities issuance, trading and settlement, and cross-border trade for corporate and bank clients. The nature and scope of transaction banking varies across different banking organizations, but most definitions feature some common components.

Almost all transaction activities under the broad headings of cash services, securities services, and trade finance are performed over current accounts, which may or may not have interest payable on the balances. As an intermediary in the global commercial and financial flows of corporates and institutions, bank transaction services businesses provide the pipes through which trillions of dollars in global settlement flows travel. These flows naturally give rise to operating and reserve account balances maintained with a service provider or infrastructure in current and other depository accounts. In addition, transaction banks offer an array of linked liquidity management tools and short-term investment options to support retention of cash reserves from clients. For additional information on the composition of these three categories, please see the appendix to this position paper.

A transaction bank will typically have large volumes of activity for each of these three components and these activities are most likely to be initiated electronically by the clients, and are highly automated with very high straight through processing rates. Many of these activities are difficult and costly for bank clients to move because of the electronic linkages and workflow processes that are established between the banks and their clients. As a result, the balances associated with these transaction banking activities are considered highly stable liquid assets.

BAFT-IFSA emphasizes that it is the activities and relationships of transaction banking services that drive the generation and stability of the balances. It is important to note that there is little

difference in the behavior of financial institutions and corporates in terms of transaction banking services, as the underlying drivers and influences are similar.

Issues:

1. Financial Institution Balances

BAFT-IFSA believes that balances held by financial institutions within the context of a transactional relationship should be differentiated from interbank funding activities and afforded similar treatment as deposits maintained within other segments, particularly where the underlying transactional nature and drivers of balance inflow are of a similar nature. The framework recognizes and provides consideration where deposits are specifically needed for operational purposes and this consideration should be extended across all segments, including financial institutions as defined in the document We believe that a formulaic approach can be used to establish the level of core balances for operational balances related to transaction banking for any single portfolio based on historic simulation over a period of time.

Transaction banking businesses generate on-balance sheet cash balances as a byproduct of cash and securities settlement, custody, trust, agency and other services. These balances are typically spread across multiple markets, client segments and legal jurisdictions adding diversity to the portfolio. Balance increases are largely influenced by growth in transaction processing volumes and business conditions, in addition to specific products and programs designed to assist clients in managing cross-border flows. The underlying dynamics of the transaction and the nature of the process, coupled with mismatches in timing of settlements, retention of liquidity buffers, prefunding and balance requirements, drive the inflow and contribute to the overall stability of the cash portfolio.

While market conditions can influence product preferences and size of flows, experience suggests that cash inflows and outflows, payments and receipts, supporting ongoing business processes continue unabated throughout business cycles. As an example, clients who utilize corporate trust services must adhere to the trust or agency agreements to determine the uses and movements of their funds. Funding flows outside of the agreements are generally not permitted and, on a portfolio basis, the high volume of flows creates a core level of balances.

The balances related to the settling of trades in the depository receipt business, for example, are very stable. Clients who are seeking sponsored depository receipts must transact with the firm who sponsored the program. This firm is the sole-provider of liquidity for these shares and as a result the balances related to this business are predictable and have a pre-negotiated component.

With custody accounts, settlement for sales transactions will be between two to five days after a trade date, so there is frequently a core balance in the settlement account. Regulatory

requirements in some countries for purchase transactions demand pre-funding through the clearing bank well before the settlement date. These prefunding requirements are often at or before the trade date and global custodian clients will typically leave a liquidity buffer to ensure that there is no risk of failed trades.

Stock transfer services have a stable source of balances relating to dividends, unexchanged merger funds and escrow services. Checks relating to dividends often are not cashed, providing a pool of deposits until escheated. Unexchanged merger funds are another source of stable funding. These funds can remain with the firm for an extended period when shareholders do not execute the required paperwork in a timely manner. Escrow funds often relate to transactions which are long in duration. The cash movements surrounding these transactions are governed by the agreement and cannot be moved liberally.

These activities – corporate trust, depository receipts, custody and stock transfer--are all services used by corporations and financial institutions.

Servicing investment funds also generate stable cash balances. The clients serviced by this business generate operational and investment cash. Operational cash refers to the funds needed for the daily operations of the fund. This includes cash related to subscriptions, redemptions, foreign exchange and margins. Investment cash is money related to the fund's investment strategy. These funds generally require a high degree of liquidity and are predictable.

For correspondent clearing accounts, financial institutions will typically maintain one main account with their counterparty banks and may use these accounts for other purposes, *e.g.*, surplus funds held with other banks, miscellaneous expenses, and to maintain foreign exchange positions. Client banks usually nominate one bank as their "concentration bank" for their incoming payments, where they generally instruct their counterparties to pay into their account for all commercial receipts in that currency. Within a correspondent banking relationship, financial institution accounts incorporate both internal settlement flows and, indirectly, the transaction flows of their clients, both personal and non-personal, as they pass through the clearing bank.

Clients are often unable to completely match business-related cash inflows and outflows. This mismatch requires clients to maintain cash balances to meet payment requirements as they come due. Clients also maintain a deposit balance to avoid overdraft charges and to take advantage of the earnings credit they receive on these balances. Earnings from these balances can be used to reduce costs relating to their banking activities. The cost and scope of opening accounts and linking clearing systems also ensures that clients will maintain a portion of their liquidity with the correspondent bank.

Furthermore, due to size, market share and technology, some financial institutions are systemically relevant in respect to the fact that clients cannot move business to other institutions easily. Consequently, this makes their balances a reliable source of funding even in stress situations.

The balances associated with transaction accounts of financial institutions behave in very similar ways to corporates and, as suggested above, with the level of underlying business activity of the client. Indeed, the balances associated with an insurance company receiving premiums and paying claims behave in a similar way to a Third Party Banks Foreign Currency Clearing Accounts and Custody and Settlement Accounts for a Broker Dealer. The inflow and outflow of transaction volumes in these accounts are typically high in terms of their number and value, but even with these high transaction volumes, clients maintain core balances in their accounts to maintain liquidity buffers (to avoid reputational risk) and hold excess liquidity in these accounts (for convenience).

2. Client Size

Although the size of individual flows and volatilities across accounts may differ, BAFT-IFSA believes that the absolute size of a business is not the sole determinant of the stability of operational transaction account balances at either the account or portfolio level. Therefore, the stable portion of wholesale deposits, as established through accepted statistical methods and analysis, should be treated in the same way as balances from small business customers, receiving a minimum run-off and a maximum ASF factor consistent across all segments. Analysis has shown that transaction business cores exhibit similar behavior patterns to retail cores and as such should receive the same or an essentially similar run-off and ASF factors.

We are confident that due to the nature of the business transactions and the fact that transaction processing for larger clients is so embedded technologically with their core bank service provider, operational balances associated with these activities stay with the bank for a reasonable period of time, notwithstanding a significant downgrading of the bank's public credit grade rating.

Adding to balance stability is the relative durability of the client relationship. Cash management and securities settlement relationships are maintained over many years and business cycles. Due to the intricacies of settlement and electronic linkages, clients generally select a service provider for a longer term.

A large portion of the balances generated by transaction activities are relatively insensitive to daily interest rate movements as their primary purpose is to facilitate the ongoing transaction flows Excess working capital and reserves, however, may be prone to shift to optimize return. Employing practices similar to those utilized in the retail and small business segments,

transaction businesses will gauge sensitivities and adjust accordingly to retain and attract incremental balances.

The clients utilizing these product lines make use of investment alternatives consistent with their stated guidelines and objectives. As such, bank depository products provide an attractive and liquid investment option, especially if linked to transactional processes where they may be easily accessed if needed. Local market preferences also influence investment selection. In Europe and Asia, for example, clients generally prefer bank deposits over a comparable money market fund or other financial instrument for the perceived safety and liquidity. In many emerging markets, and coincidentally the U.S., market practice is to maintain balances in lieu of billing fees. Finally, due to tax and other regulatory considerations affecting cross-border flows, clients will elect to hold liquidity buffers with local operating subsidiaries until feasible to repatriate. All of these factors contribute to the core liquidity held in the form of bank deposits in these regions and markets.

Finally, notwithstanding the characteristics of any single relationship or service, the balance pool created by these businesses is a dependable source of bank funding on a portfolio basis. This consistency is created by the large number of clients and accounts, non-correlated nature of the individual flows, global dispersion and specific transaction considerations. The balances generated by these businesses are predictable on a macro level and generally increase in times of economic uncertainty and growth. Also, these businesses have an underlying growth component directly correlated with economic trends. As transactions increase in the marketplace, so does the balance level associated with that activity.

Even though bank transaction businesses may have different business models, client segments, geographical and business mixes, the balance portfolios generated by the underlying transactions are stable and liquid. Due to these variations in mix between servicers, applying uniform and generic assumptions may not be entirely appropriate and assessments provided by banks internal systems are more consistent with the current capital adequacy framework.

There are various methodologies that banks use to determine the level of balances considered core or stable within each of their portfolios and the associated run-off and ASF for such deposits. The methodologies chosen depend in some cases on the perceived or actual volatility of the underlying portfolio balances. For stable portfolios, banks may use historical simulations that give a confidence variance on a daily balance over a determined period. For more volatile balances, the establishment of core percentage would often be based on the minimum recorded daily balance over a determined period potentially adjusted for the current balance level. Using these methodologies, banks can determine a range for the stable core balances in each portfolio. Ultimately the actual range will depend on the number of clients, accounts, client concentration, geographic dispersion, interest rate agreement with the client and correlation between movements in individual accounts that will be bank portfolio specific.

In summary, for all the considerations discussed in the preceding sections, BAFT-IFSA believes that the Committee should – with respect to the proposed uniform treatment ("standardized" approach) – recalibrate factors based on a consistent treatment of operational balances across non-SME Corporate and Financial Institutional Clients. Additionally, we suggest that Wholesale Corporate and SME clients be subject to a consistent minimum run-off and a maximum ASF factor, provided the wholesale portfolio does not exceed certain concentration limits. Furthermore, the Committee should consider establishment of an optional "advanced" approach for determining operational balance levels, run-off and ASF factors accounting for the aforementioned institution and portfolio specifications. We believe the Committee should distinguish between funding sourced through discreet interbank funding activities and the relationship driven depository funding derived through the provision of transaction services.

3. Contingent Liabilities in Transaction Banking[1]

BAFT-IFSA believes that contingent liabilities in transaction banking should be treated as low risk in terms of the recommendations in the consultative document. As such, there should be a standard treatment globally in terms of off-balance sheet instruments, including contingent liabilities in transaction banking. The majority of transaction banking off-balance sheet exposure stems from guarantees and letters of credit (LC) in connection with the trade-related business line. Compared with regular undrawn committed credit lines, those business types bear a much lower risk for several reasons.

First, guarantees issued by a bank in connection with trade-related transactions usually facilitate commercial transactions by providing the beneficiary with coverage during a bid process, related to advance payments as well as payment, delivery, performance and warranty obligations. Drawing of such a guarantee is widely dependent on the performance of the applicant related to the underlying commercial contract, so that in case of a credit event related to the applicant, actual drawings under guarantees are still dependent on the commercial performance of the counterparty which, to a large extent, is not directly correlated with the financial standing of the counterparty. That is, default of the obligor does not necessarily induce drawing of the guarantee by the beneficiary as the underlying trade contract will likely be fulfilled as agreed (*e.g.*, warranty guarantee). Moreover, in most cases, guarantees do not allow for drawing by the beneficiary in case of insolvency of the applicant but are triggered by the non-performance of the underlying contract.

Second, when a bank issues an LC on the instruction of an importer, actual payment under such LC, and subsequently actual reimbursement through the applicant (in case of LC issuance), depends on submission of LC-compliant trade documents to the bank. In most cases LCs are

[1] For more information on the capital treatment for trade related off-balance sheet activities see the BAFT-IFSA comment letter on the Basel Committee Consultative Document entitled *Strengthening the resilience of the banking sector.*

short-term in nature, which adds to their low risk profile. A credit event for a bank occurs when – in case of an Import LC – the importer is not meeting its reimbursement obligation towards the bank when at the same time LC-compliant documents are presented to the bank. When a bank confirms an LC, the bank adds a confirmation to the payment obligation of the issuing bank for the benefit of the exporter and assumes a bank-related payment risk depending on actual performance of the contractual parties on the underlying transaction on which the LC is based. Such risk is mitigated through the fact that in most cases, related bank risks are of higher quality compared to the risk profile of the underlying importer / applicant, and in stress scenarios experience has proven that emerging countries (for which most LCs are confirmed) continue to honor payment obligations related to "trade" on a preferred basis.

Additionally, it is important to note that the low risk treatment of trade-related assets and contingent liabilities in transaction banking has a vital economic benefit. The issuance of trade-related assets and contingent liabilities are pivotal in supporting international commerce and contributing to the growth of the world economy. In the economic crisis, world trade fell by more than 12% in 2009, in part due to some global banks reducing the flow of credit to alleviate losses.[2] While some banks in fact raised their lines of available trade credit during the crisis, the fall in overall demand for trade in goods and services mitigated that rise and largely caused the fall in trade volume. During the G20 meeting in London 2009, it was recognized widely by world leaders that trade finance is the lifeblood of $14 trillion in annual global commerce and one of the fundamental engines of growth and development, especially in the emerging markets. Restricting the flow of credit to this area, by increasing the risk weight of contingent liabilities, means essential goods cannot be traded, posing a threat to importers in emerging countries, with smaller banks and small- and medium-sized enterprises being disproportionately affected.

The consultative document recommends that the Required Stable Funding (RSF) for the types of trade-related off-balance sheet activities mentioned above should be left to the determination of individual national supervisors. If individual supervisors establish the RSF, banks operating globally will be in the difficult position of meeting these requirements within each individual jurisdiction in which they operate and these varying rates would establish an imbalance and uncompetitive situation between banks operating in differing jurisdictions. BAFT-IFSA believes that a single RSF should be established for these activities on a global basis to avoid the imbalances that would be created by an individual jurisdictional approach.

Conclusion:

BAFT-IFSA is broadly supportive of the framework for a quantitative liquidity regime as outlined in the consultative document. However, certain issues in the recommendations give rise to concern for the global transaction banking business and the global economy.

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[2] World Trade Organization; http://www.wto.org/english/news_e/sppl_e/sppl148_e.htm

As such, BAFT-IFSA member banks would like to see greater attention given to issues surrounding transaction banking. Specifically, we believe that transaction accounts of financial institutions should receive similar treatment to those of Wholesale Corporate Customers based on the logic that the underlying transactional drivers from which the deposits are derived are similar. We further suggest that both wholesale and SME corporates receive consistent minimum run-off and maximum ASF factors due to the similarity of balance drivers and influences. A formulaic approach should be used for establishing the respective level of core balances for operational balances for transaction banking for any one portfolio based on an historic simulation over a period of time. BAFT-IFSA believes that the Committee should recalibrate factors based on a consistent treatment of operational balances across non-SME Corporate and Financial Institutional Clients. In addition, we suggest that Wholesale Corporate and SME clients be subject to a consistent minimum run-off and maximum ASF factors, provided the wholesale portfolio does not exceed certain concentration limits. We believe the Committee should distinguish between funding sourced through discreet interbank funding activities and the relationship driven depository funding derived through the provision of transaction services. Additionally, an optional "advanced" approach should be considered for determining the operational balance levels, run-off and ASF factors accounting for institution and portfolio specifications. Lastly, we recommend that a single Required Stable Funding be established for trade related off-balance sheet activities to avoid imbalances created by a national jurisdictional approach.

We very much appreciate the opportunity to comment on the consultative document and look forward to further dialogue with the Committee on these issues going forward.

Very truly yours,

Donna K. Alexander

Donna K. Alexander
Chief Executive Officer

Appendix

Service Type	Activity Description	Reasons for Stability
Cash Services		
Cash Management	Set of services that facilitate the management of cash on behalf of corporate and financial institutional clients. Services can include automated cash concentration capabilities, electronic transaction initiation, account reporting and reconciliation.	Clients are often unable to perfectly match business-related cash inflows and outflows. This mismatch requires clients to maintain cash balances to meet payment requirements as they come due. Clients also maintain a deposit balance to avoid overdraft charges and to take advantage of the earnings credit they receive on these balances. Another influencer of balance stability is the cost and scope of opening accounts, linking clearing systems and automating the services provided. This ensures that clients will maintain a portion of their liquidity with the correspondent bank.
Clearing/Settlement	Local and foreign currency clearing via electronic and paper means.	The inward and outward transaction volumes on these accounts are typically high in terms of numbers and values. With high transaction volumes on these accounts, clients maintain a core balance to maintain a liquidity buffer. There is a high degree of electronic and workflow integration between the client and the bank service provider to ensure straight through processing (STP), fast turn around as well as account reconciliation.
Payments	To assist the payment and collection of funds via various electronic banking systems.	Balances residing in these accounts are not sensitive to pricing factors. These balances are influenced by the client's level of business activity. These balances fluctuate with the client's timing of cash receipts and payments. As above, there is a high degree of electronic and workflow integration between the client and the bank service provider to ensure STP, fast turn around and account reconciliation.

Securities Services		
Corporate Trust	Facilitation of trust and agency services for debt issuers.	Clients who utilize Corporate Trust services must adhere to the trust or agency agreement to determine the uses and movements of their funds. Funding flows outside of the agreement are generally not permitted.
Depository Receipts	An agency facilitation and record keeping service which enables equity securities to trade and settle cross border	Transactions typically settle free of payment in central clearing and settlement systems. Any Cash Balances(deposits) are periodic and relate to corporate action and short term settlement facilitation (see Stock transfer/transfer agency below)
Securities Settlement (Clearing, Custody and Fund Accounting)	The facilitation of settlement and custody of securities.	Settlement of sales transactions can be between 2 to 5 days after trade date so there is invariably a core balance in the settlement accounts. The stability of these monies is enhanced by the integration of technology platforms between the client and service provider. Services include cash related to subscriptions, redemptions, foreign exchange and margin.
Stock Transfer/Transfer Agency	Services include corporate action record keeping, demutualizations, dividend reinvestment, proxy solicitation and employee stock plan administration.	This stable source of balances relates to dividends, unexchanged merger funds and escrow services. Checks relating to dividends often are not cashed providing a pool of deposits until escheated. Also, unexchanged merger funds can remain with the firm for an extended period when shareholders do not execute the required paperwork in a timely manner. Lastly, escrows often relate to transactions which are long in duration. These transactions are governed by the agreement and cannot be moved freely.
Trade Finance		

Trade Finance Services	Provides letters of credit, guarantees and bid bonds, documentary collections, and trade financing which facilitates international trade and commerce.	The balances related to trade finance transactions are dependent on the volumes, values and scope of the underlying international and domestic commercial transactions of the Clients.