Commercial Bank of Kuwait

Comments on BIS consultative documents on liquidity risk measurement and strengthening resilience of the banking sector

At the outset, the Commercial Bank of Kuwait (CoBK) wishes to place on record its appreciation to the Bank of International Settlements in general and the Basel Committee on Banking Supervision (BCBS) in particular for its numerous initiatives that are targeted at strengthening the global financial sector. CoBK believes that meaningful and practical regulations are essential for ensuring the safety and stability of the financial sector. To this end, CoBK is also grateful for the very active role played by its regulator, the Central Bank of Kuwait in not only enforcing the BIS principles and prudential regulations to the extent appropriate for the local economy but also in establishing a disciplined financial system.

CoBK has reviewed the following two consultative documents issued by the BCBS in December 2009 – (1) International framework for liquidity risk measurement, standards and monitoring and (2) Strengthening the resilience of the banking sector.

CoBK appreciates the necessity of expanding the currently one-dimensional nature of regulatory standards which primarily focuses on capital adequacy ratio as the single global standard for measuring a financial institution's strength. The proposed introduction of new standards for liquidity and leverage as well as multi-dimensional measurement of capital adequacy through tier one and common equity related ratios is a laudable effort towards broad-basing the available metrics. The enhancement of supervisory requirements for liquidity and strengthening the current Basel II standards are also significant steps in eliminating possible defects in current approaches.

In general, CoBK notes that ensuring consistent application of the proposed new ratios across the globe could present immense challenges though such issues may not be without precedence. However, unique issues that may arise in implementing liquidity risk measurement include the possible diverse behavioral pattern of depositors across different regions, local regulatory and legal issues, regional experience of liquidity stress etc. which could impact the deposit runoff, ASF and RSF factors. Similarly, the computation of leverage ratio could present its own unique challenges specifically in terms of diverse accounting policies adopted by various countries (as already recognized in the consultative document). Local recognition of such region-specific issues would necessarily mean that the methods adopted for computing the new liquidity and leverage ratios could diverge across various regions thus impairing comparability.

In addition to the very general observation above, CoBK has some specific comments on the two consultative documents which as below. The comments are restricted to only those sections of the consultative documents which could have immediate implication for CoBK.

1. The two ratios (LCR and NSF) which are proposed to be introduced attempt to measure liquidity in stressful situations. While the former measures (in effect) the ratio of liquid assets to short term liabilities (hot money), the latter (in effect) measures the ratio of long-term / strategic assets to long-term / stable liabilities. Hence, it would appear that the components of these two ratios would be mutually exclusive and the components listed in the consultative document definitely seem to be so. Therefore, it would be more meaningful if only one well-defined and foolproof ratio (either LCR or NSF) is introduced since compliance with one would automatically ensure compliance with the other. Based on the fact that the LCR is computed assuming only a 30-day specific stress situation while the NSF is based on a more long-term horizon, it may be preferable to retain the NSF.
2. The document indicates various haircuts, RSF / ASF factors, run-off percentages etc. which require calibration and even then would be subject to regulatory discretion based on regional experiences. However, rather than suggesting standardized factors, it may be more appropriate to introduce a general framework for arriving at such factors based on individual bank experience or circumstance (similar to the IRB approach for credit risk capital calculation). This would provide good incentive for banks to improve their liquidity risk management and build enough data for justifying factors that are used for computation of LCR and NSF. This general framework could take into consideration factors such as, past volatility of various categories of deposits, formulas for translating past experience (including volatility) into haircuts and other factors at the desired confidence level.
3. Time deposits from retail customers (paragraph 43) are treated differently from wholesale customer time deposits (paragraph 46 and 58). Apparently, wholesale time deposits that mature beyond the 30-day horizon are not at risk unlike the retail time deposits which mature after this time period. The rationale behind this is unclear since it is entirely plausible that in a stress situation all term deposits (whether wholesale or retail) would be vulnerable irrespective of their contractual maturities particularly if the withdrawal penalty is not materially greater than the loss of interest.
4. While it is not explicitly stated, it seems that it would also be necessary to adhere to other regulatory ratios apart from the LCR after giving effect to the changes arising out of the scenarios assumed for LCR. For instance, all regulators require banks to maintain minimum reserves in relation to deposits by way of deposits with the respective regulator or other instruments. If central bank reserves are included as part of the numerator for the LCR, it would also be necessary to ensure that under such stress situation, the reserve ratio is also met after excluding the reserves (and the deposits which are assumed to be runoff) that have been considered for the LCR. Similarly some central banks require banks to adhere to a maximum Loans-to-deposit ratio. It may be necessary to rework this and other statutory ratios after excluding the deposits that are considered to be run-off for the LCR.

5. Another minor but necessary point would be that in computing the NSF, the ASF factor for wholesale deposits should take into account the operational relationships with the underlying customers and accordingly higher percentages could be applied for customers with operational relationship compared to those that do not have such relationship. This adjustment may be necessary also to maintain consistency in treatment of such deposits in the LCR and NSF ratios.
6. Strengthening the resilience of the banking sector - Building buffers through capital conservation: The proposed restrictions on dividend payouts in situations where the capital levels fall within pre-specified ranges (defined to be a percentage above the minimum required capital) impose additional minimum capital requirements. The computation of capital under Basel II pre-supposes the existence of adequate risk measurement systems that ought to take into consideration cyclicality of the various input parameters and hence, the capital calculated using such systems should be valid and applicable across different phases of the economic cycle. Imposition of buffers would invalidate this assumption. This would also penalize good banks which have made efforts to attune their risk measurement systems to take into account economic downturn events. Hence, if there are doubts on the appropriateness of the input parameters specifically with regard to whether they adequately capture economic downturns, it is best to address them directly by making suitable adjustments to the input parameters or by establishing higher standards of compliance for such parameters rather than advocating buffers over and above minimum capital requirements.

CoBK may provide further comments and views based on changes made to these consultative documents that may reasonably be expected to occur after the necessary calibration and quantitative impact studies and also based on comments received by the BCBS.