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Basel Committee on Banking Supervision
Via email baselcommittee@bis.org

Date April 16, 2010
Reference BR1122

Subject: NVB Reaction to BCBS 165 – International framework for liquidity risk measurement, standards and monitoring

Dear Sir / Madam,

On behalf of the Dutch Banking Association[1] (NVB), I would like to thank you for giving us the opportunity to provide you with our feedback on consultation paper 165, '*International framework for liquidity risk measurement, standards and monitoring'.*

The proposals put forward by the Basel Committee on liquidity risk management represent a very important step in the introduction of a global framework for measuring and managing liquidity risk. The international alignment of the diverse approaches that are currently used will contribute to the enhancement of the level playing field in this area. We hope that these developments will make it possible for cross-border banking groups to integrate their liquidity risk management without being faced with trapped pools of liquidity. The development of a global reporting language would also benefit this ultimate goal, which will allow cross-border financial institutions to manage their liquidity risk on a more centralised level and in a more effective manner.

In addition to these positive points, the proposed changes will require banks to hold larger liquidity buffers, and will have a profound impact on the real economy. The current proposals, particularly the Net Stable Funding Ratio, would limit the amount of lending that can be made available to the real economy. We are particularly concerned about the phasing in of the proposals, the calibration of the measures, the criteria for asset eligibility and the stress-like setup of the Net Stable Funding Ratio.

The quantitative impact study that is currently being undertaken is very important for ensuring the final calibration is correct. The objective of changing the liquidity risk management framework should be to add resilience to the financial system, whilst making sure that the pace of change is at a manageable level (i.e. that not too much is done in a too short timeframe). This will, in effect, ensure that there are no major shifts in funding and asset prices, which would hinder the provision of credit and the economic recovery.

The expected larger buffers that will be required will also increase institutions' leverage ratios. In addition to this interaction with '*Strengthening the resilience of the banking sector*' we also note the

1 The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

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relationship between capital and liquidity buffers. Both create additional resilience and reinforce one another. The changes made to both areas should therefore be seen in an integrated way. We also see an opportunity to achieve further international alignment of the reporting requirements. In the attached document, we will provide our comments in more detail.

Our feedback to consultation paper 164 '*Strengthening the resilience of the banking sector*' will be sent to you in a separate letter, with reference BR1120.

Should you have any questions relating to our feedback, please feel free to contact us at your convenience.

Kind regards,

Wim Mijs
Managing Director

Onno Steins
Advisor Risk Management

Enclosure: NVB Reaction to *'International framework for liquidity risk measurement, standards and monitoring'*

NVB reaction to
‘International framework for liquidity risk measurement, standards and monitoring’

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1 Management Summary

We appreciate the proactive approach that was adopted by the Basel Committee on Banking supervision in the wake of the crisis. A lot of proposals have been put forward to make the banking sector more resilient, for instance:

- BCBS 147: Principles for sound stress testing practices and supervision.
- BCBS 148: Revisions to the Basel II market risk framework.
- BCBS 149: Guidelines for computing capital for incremental risk in the trading book.
- BCBS 150: Proposed enhancements to the Basel II framework.

And, in Europe, the CRD revisions:

- CRD2, containing changes to the requirements for own funds, large exposures, supervisory arrangements, crisis management, securitisations and OTC derivatives.
- CRD3, containing changes that relate to remuneration, market risk, (re-) securitisations, the extension of the Basel I floor as well as the alignment of the trading and banking book.

We endorse the objective of the Committee and we are pleased that shortcomings in the requirements for liquidity risk management that surfaced during the crisis are now being addressed. Against this background we will provide you with our feedback as well as concrete suggestions on how the proposals could, in our view, be improved.

We would also like to direct your attention to the reaction from the European Banking Federation, which has our full support.

1.1 Developments in the banking industry

Although this document is a reaction to the proposals made by the Basel Committee, there is a broader movement that is seeking additional regulation of financial institutions. In the end, it will be the cumulative effect of all the rules and regulations that will dictate how banks will be able to shape their role in the economy. For instance, there are currently discussions around remuneration, financial responsibility tax, setting limits on banks that are too big or too complex to fail and discussions around deposit guarantee schemes. It is clear that banking as we knew it over the last decades will undergo significant changes. After the sector has reinvented itself in the wake of the crisis, banks should still be able to fulfil their purpose in society; supporting sustainable economic development by acting as an intermediary on the financial markets, providing credit and payment services to clients as well as contributing to the important challenges that lie ahead for society, such as the transition away from a carbon economy, combating global economic imbalances, etc.

1.2 Interactions between the proposals

As was mentioned before, there are several interactions between the proposals that can have amplifying and dampening effects on one another. Therefore, the proposals cannot be seen in isolation. As we understand from the speech that was given by Mr. Wellink at the Dutch Embassy in London on February 19th, 2010 the Basel Committee is aware of these interactions. The quantitative impact study will be used to calibrate the measures in an even and balanced way. When this feedback document was written, the results of the QIS were not available, as the deadline for submission of the data by individual banks had not yet passed. Therefore, we will only point out the main areas where we feel interaction will occur.

In particular, we see interactions between the liquidity risk and the following proposals in consultation paper 164:

Leverage ratio
The suggested setup of the leverage ratio is risk-insensitive; therefore the leverage ratio will be impacted by the requirement to hold additional unencumbered, marketable and highly liquid assets. These added – typically safe – assets will increase the leverage ratio, keeping all other items constant, whilst simultaneously increasing the resilience of the banking sector; a clear conceptual mismatch. Although we do not support the introduction of the leverage ratio, we propose the exclusion of highly liquid assets from the leverage ratio, as there is no connection between the leverage ratio and additional safety of the financial system.

There are two additional related issues:

- Cash-rich, highly liquid institutions are punished by the leverage ratio. This is contrary to the incentive one would expect from a regulatory standard setter.
- There may be an impact on the real economy if banks have to change their business model in order to comply with the leverage ratio (potential impact on pricing of loans, negative impact on macro-economic growth, etc.).

Own funds
As both the definition of the tier structure on the liabilities side of the balance sheet and the requirements for liquidity risk on the asset side are going to be changed, the interaction of these two elements should be taken on board when setting up the final calibration of the proposals.

Counterparty credit risk
The Basel Committee requires banks to manage their liquidity risk via the capital markets. Under normal conditions, this means that banks will be trading with parties on the financial markets to either acquire or sell cash, depending on their liquidity position. These deals generate counterparty credit risk. As Basel also proposes additional capital requirements for this type of risk, the management of liquidity will become more expensive as a result.

Margining as a result of the incentive to settle via CCPs.
In addition to the dependency on the repo markets, an incentive is created to clear via central counterparties. Notwithstanding the lower solvency requirements, central counterparties require the posting of margins. This will increase the amount of liquidity that is tied up in the system as a result of banks managing their credit risk. The increased use of central counterparties can create a systemic risk as well. Given the added importance that central counterparties will have in the financial system and the associated systemic risk, it is extremely important that these central counterparties are well-capitalised and are subject to top-notch supervision. We are also unsure how central counterparties will be able to capture exotic deals.

With regard to the margin requirements that result from the use of CCPs we assume that the assets that are pledged to satisfy the margin requirements are regarded to be encumbered until the settlement has taken place.

1.3 Key Concerns

Impact on the real economy

The proposals relating to liquidity risk management, and in particular the Net Stable Funding Ratio (NSFR), will impact the financial markets and individual banks. If the proposals are phased in without any changes, asset prices will be distorted; eligible instruments will see an increase in price and demand, while assets that are no longer eligible for the liquidity buffer will see less demand and a lower price. As a result of the expected scarcity of stable funding, these markets will be distorted. For instance, an increase of the available retail savings is not to be expected in developed economies. This will put upward pressure on these types of funding, which must be compensated on the asset side of the balance sheet, either by reducing the provision of credit or by increasing pricing.

Net Stable Funding Ratio

We agree that there should be a short and a long-term liquidity buffer. However, having examined the NSFR, this measure appears to be engineered to reflect a stress scenario. The run-off percentages that are suggested are too high and lack empirical evidence. We feel that this scenario is too descriptive when looking at the long horizon and that it will require banks to hold concentrations in certain safe asset classes. This will have a significant impact on financial markets, the transformation function of banks and – as a result – the real economy.

Transition requirements

Given the fundamental nature of the proposals, banks will need time to adjust the makeup of their balance sheet. The timeframe for the phasing in of the new requirements needs to be very carefully considered. It should be long enough to guarantee a gradual transition that does not cause too many distortions, but it should not be too long, which would reward slow adopters.

1.4 Key Suggestions

Based on our analysis of this consultation paper, we have made a number of key suggestions for improvement, which have been consolidated in this paragraph. Our most important suggestions are:

- **Market liquidity vs. Central Bank Eligibility.**
  Although we agree that the central bank should not be the lender of first resort, the current definition of highly liquid assets is too restrictive. Selecting which assets are appropriate to hold in the liquidity buffer should not be based on an imposed list. The experience of the banks' treasurers should also be taken into account. A broadening of the eligibility criteria for the buffer will also decrease the systemic risk of banks holding comparable paper in their buffer.
- **Net stable funding Ratio: allow more room for an institution-specific approach.**
  The Net Stable Funding Ratio is very prescriptive and represents a name-specific stress scenario of one year. Given the specific characteristics of banks and the tools that management has at its disposal, there should be more room to allow for these institution-specific elements to be taken on board during this long horizon.
- **Organise a second consultation**.
  Referring to the concerns highlighted in paragraph 1.3 around the assessment of the total impact and setting the right parameters, we suggest setting up a second consultation after the proposals have been made more concrete and the results of the QIS have been fed back to the participating banks. We are aware of the ambitious timelines that the Basel Committee is facing. Therefore, this second consultation should not result in a delay of the finalisation of the proposals; it should be used to make sure the calibration is done thoroughly, ensuring the proposals are well-balanced.

- **Leverage Ratio**.
  As the suggested changes to the liquidity risk management framework will affect the leverage ratio (which we do not support) we would like to draw your attention to an alternative model that we have put forward. This approach to introducing a leverage ratio, which we call the delta approach, requires that an institution calculate its leverage ratio followed by a periodic evaluation of changes to the leverage ratio. The observed changes are subsequently discussed with the regulator as part of the supervisory review and evaluation process (SREP). For more information, please see section 4.3 of our reaction to '*Strengthening the resilience of the banking sector*', Reference: BR1120.

2 International framework for liquidity risk measurement, standards and monitoring

The proposals made in the paper '*International framework for liquidity risk measurement, standards and monitoring*' are an important step; these represent the introduction of the first global standard for liquidity risk management. We are pleased with this very important move forward. However, against this background, we have a number of concerns about the detailed proposals, which we would like to share.

2.1 Main Concerns

Based on our analysis, we would like to highlight several points that concern us the most:

Market liquidity and central bank eligibility of assets
In the paper, a distinction is made between market liquidity and central bank eligibility. We understand from the tone of the consultation paper that in the opinion of the Basel Committee on Banking Supervision, central banks should not be seen as a primary provider of liquidity. We agree with this point of view, but would like to emphasise that there is a strong correlation between the liquidity of assets and the overall market conditions. Assets that are highly liquid under normal conditions can become illiquid during periods of stress. Therefore, the central bank will always have an important role to play in terms of providing liquidity to banks during periods of name-specific or general economic stress. In such cases, central bank eligibility appears to be a more predictable measure for liquidity risk management and eligibility for liquidity buffers than market liquidity. In this respect we would like to quote from the October 6, 2009 blog of Willem Buiter[2]: '*The degree of liquidity of a financial instrument depends on confidence and trust..* .' If this trust is damaged for whatever reason, the central bank will be the only party that can be relied upon to liquefy assets.

Net Stable Funding Ratio is a stress scenario
We agree that the short-term liquidity risk position, as well as the longer term and more structural funding position, could be relevant. However, having examined the Net Stable Funding Ratio (NSFR), it appears this measure is engineered to reflect a one-year stress scenario.
We feel that this scenario is too descriptive when looking at the long horizon and that it will require banks to hold concentrations in certain safe asset classes. The suggested run-off percentages – for instance – lack empirical evidence backing up the calibration and are significantly higher than one would expect. In addition, the ratio does not take into account the specific characteristics of the institution and the tools management has at its disposal to deal with such an extreme one-year stress scenario. In practice, for instance, banks would limit their origination levels in non-core activities.

Net Stable Funding Ratio excessively limits the transformation function
The long horizon covered by the NSFR decreases a bank's ability to perform maturity transformation. This transformation function represents an essential role that banks play in the economy. Overly limiting the transformation function will have an impact on the real economy.

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[2] *http://blogs.ft.com/maverecon/2009/10/after-subverting-bank-insolvency-our-leaders-are-now-about-to-make-a-mess-of-liquidity/*

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Here are some examples concretely illustrating the implications:

In order to have an NSF above 100%, a € 100,000 10-year mortgage loan to a retail client should be funded by either:

- € 117,647 in stable retail funding, implying a loan-to-deposit ratio of 0.85, or
- € 142,857 in less stable retail funding, implying a loan-to-deposit ratio of 0.70, or
- Wholesale funding with a remaining maturity >1 year.

A € 10 million 3-month loan to a corporate customer or even a non-financial government-guaranteed loan requires:

- € 5.9 million in stable retail funding, or
- € 7.1 million in less stable retail funding, or
- € 5 million in wholesale funding with a remaining maturity >1 year.

Holding securities rated BBB or lower, non-sovereign or non-corporate (e.g. financials), structured credit (e.g. RMBS) requires (even if these securities are central bank eligible):

- 118% in stable retail funding, or
- 143% in less stable retail funding, or
- 100% in wholesale funding with a remaining maturity >1 year.

As different business models have different requirements for liquidity risk management, we advocate incorporating a degree of flexibility in the regulations that takes this into account. This could mean, for instance, distinguishing between a mortgage bank and an investment bank as well as incorporating national differences such as retail run-off percentages. This guidance should allow for the implementation of the NSFR based on verified assessments of the liquidity risk that are - to a certain extent - based on the business models of banks and the associated characteristics.

Suggested ratios

At various points in the paper, parameters are suggested. However, there does not seem to be a clear reasoning behind their calibration nor is any insight given into the way they were derived. Clarification from the Committee would be very much appreciated.

The run-off factors for both the LCR and the NSFR appear to have been set arbitrarily and do not take into account the specific characteristics and behaviour of the client, or the client relationship. As an example, a 100% run-off factor is suggested for assets that relate to custody and settlement services that are offered to pension funds. This run-off factor is not realistic for the 30 day horizon. During the crisis these assets proved to be far more stable. We propose to treat liquid assets that have been placed in relation to custody activities as 'unsecured wholesale funding provided by non-financial corporate customers with an operational relationship'. This would allow for a more realistic run-off factor of 25%. This is especially important given the unique position of Dutch pension funds.

Government guaranteed bonds are not eligible as a liquid asset under the current proposal, as these instruments are issued by a financial institution. This treatment does not match with what has been observed in practice, where these instruments are regarded as highly liquid. We propose to treat government guaranteed bonds as highly liquid.

Distortion of asset prices

As a final point we would like to stress the importance of the phasing in of the new requirements. In particular, the introduction of the Net Stable Funding Ratio will cause a shift in the demand for high-quality liquid assets. If the new requirements are introduced too quickly, price distortions are likely to occur. In addition, a crowding-out effect is possible if there is an overly narrow definition of the

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eligible assets. Should this occur, it will most likely be to the detriment of private issuers of securities (i.e. corporate paper). It goes without saying that this would have an impact on the real economy.

Distortion of funding markets
Alongside the distortion of asset prices, there is also a chance that funding market prices will be distorted. For instance, in developed economies, the amount of available savings is fairly limited. If banks have an added incentive to increase their market share in the funding market, this will increase the demand and therefore the price. The same reasoning applies to wholesale funding.

Counterparty credit risk
The Basel Committee requires banks to manage their liquidity risk via the capital markets. Under normal conditions, this means that banks will be trading with parties on the financial markets to either acquire or sell cash depending on the liquidity position. These deals generate counterparty credit risk. As Basel also proposes additional capital requirements for this type of risk, the management of liquidity will become more expensive as a result.

2.2 Detailed Remarks

Having addressed our major points of concern, we would like to share a number of more detailed remarks on some of the proposals that are put forward in the paper.

Page 9, Paragraph 35 states: *'In addition, the Committee will gather data on the following instruments to analyse the impact of this standard on the financial sector. If included in the stock of liquid assets, these instruments would receive substantial haircuts, would comprise not more than 50% of the overall stock, and the portfolio would have to be diversified. The haircut would be applied to the current market value of the respective asset.'* The requirements put forward in the consultation paper will effectively tighten the regulations compared to the current situation. Looking at the requirements, we believe that assets such as cash and government bonds will form a dominant portion of the liquidity buffer in the future. Setting overly narrow eligibility criteria would effectively increase the systemic risk, as banks would be holding very similar instruments. In order to reduce this risk we suggest including covered bonds, RMBS instruments – issued by the bank itself or others – or senior unsecured bonds issued by government-sponsored entities or agencies, based on objective criteria that properly model the characteristics and liquidity value of the instrument. By this we mean that the instruments should be liquid and of high quality. Not allowing these instruments in the liquidity buffer would hinder the transformation function of banks.

As a result of the requirements put forward in paragraph 35 (quoted above), the leverage ratio – which is introduced in '*Strengthening the resilience of the banking sector*' – will incur a 'minimum utilisation' as a result of the liquidity requirements. Not allowing any form of deduction of the safest assets from the leverage ratio is a major contributing factor to its utilisation. We urge the Basel Committee to pay close attention to this and other interactions that occur among the proposals put forward in both documents.

On page 10, the consultation paper states that an institution should be able to demonstrate that corporate bonds are: '*Traded in large, deep and active markets characterised by a low level of concentration.*' The requirements set forth in this sentence are so general that they are very open to interpretation. We therefore request that the Basel Committee add additional principles that can act as further guidance. Moreover, we have some doubts regarding the full exclusion of corporate bonds issued by banks, investment or insurance firms. We appreciate that this requirement was created in response to the crisis and aims to reduce dependencies among financial institutions. However, it is important that the liquidity flow among banks continue, as this promotes the efficiency of financial markets.

On Page 11, it is stated that: *'The depositors have other established relationships with the same bank which make deposit withdrawal highly unlikely.'*
This requirement is hard to implement, as it requires setting up a clear definition of an established relationship. We question whether this criterion will be significant in practice.

Page 12: '*43. Fixed or time deposits, regardless of maturity, that have a withdrawal penalty not materially greater than the loss of interest, should be treated no differently from other types of deposits and be subject to the same run-off factor as other deposits in the same bucket.'* Again, this requirement is very difficult to implement in practice. We request that the Basel Committee provide additional guidance on this requirement.

With regard to '*unsecured wholesale funding provided by small business customers*' mentioned on page 13, we feel the one million Euro threshold is quite low and the associated run-off percentage too high. We request that the Basel Committee review these two quantitative parameters and would like to point to the approach that is currently applied by the Dutch Central Bank in this respect. This approach is based on whether or not the customer is active via its own treasury function on the professional money market. As an indication, professional counterparties (non-small business customers) should be able to enter into a transaction with a minimum of 20 million Euros. With regard to the definition of small business customers, we would welcome an alignment with the current definitions in use.

As regards: '*(iv) Lines of credit: 76. No lines of credit, liquidity facilities or other contingent funding facilities that the bank holds at other institutions for its own purposes are assumed to be able to be drawn. Such facilities receive 0% meaning that this scenario does not consider inflows from committed credit facilities. This is to reflect the possibility that other banks may not be in a position to honour credit lines, or may decide to incur the legal and reputational risk involved in not honouring the commitment, in order to conserve their own liquidity or reduce their exposure to that bank.'* We consider these requirements very prudent. On the one hand banks should assume that liquidity facilities to non-financial corporate customers are fully drawn (in the LCR), whereas if the same type of facility is held by the bank, it should assume that these facilities cannot be drawn. This asymmetrical approach puts an additional strain on smaller banks in particular, as these institutions are typically faced with higher costs in the capital markets, while they do make use of facilities provided by other banks. We understand that this requirement was created in response to the crisis and aims to reduce dependencies among financial institutions. However, it is important that the liquidity flow among banks continue to exist, as this promotes the efficiency of financial markets. The importance of non-bank financiers in the market may increase as a result of the proposals, removing these liquidity flows from the banking supervision oversight.

As the interbank facilities are fully included in the LCR, we suggest including at least a portion of these assets in the liquidity buffer as it seems harsh to fully exclude them. Moreover, due to diversification effects, these types of facilities will not be required by all institutions at the same time, should they be required at all.

The result of the proposals as they are currently suggested would be the creation of a large amount of dead capital in the system, as banks would not be allowed to incorporate any lines of credit from other banks.

The run-off per percentages indicated on page 22 are steep. We feel that holding additional assets to satisfy the requirements of the NSF may impact the capital markets. As the demand for stable funding around the one-year horizon will increase, this will raise the price of - and demand for -

these instruments. The one-year time horizon for the NSFR appears to be chosen arbitrarily. The NSFR may therefore create an incentive for banks to limit their transformation function.

Looking at the ASF Factors, we appreciate that the Basel Committee has allowed banks to demonstrate the stickiness of internet-based accounts. In a lot of cases clients have an internet savings account with the institution where they also have their checking account, i.e. an established relationship. These types of accounts may demonstrate different run-off rates as compared to customers who do not have a broader relationship with the institution. Therefore, the simple fact that an account is internet-based does not have a predictive value of the stickiness of the savings. As a result of technological developments it can be expected that a majority of bank accounts will be accessible via Internet in the near future. To get around this issue, we suggest that banks demonstrate the liquidity characteristics of these accounts.

The article also mentions – for instance on page 11, when discussing retail deposit run-offs – that savings covered by a deposit guarantee scheme (DGS) are more stable than savings that are not covered. We doubt if there is empirical evidence that backs up this assumption.

On page 23, the proposed RSF factors for loans that have a residual maturity of less than one year are too high. Loans with low or no risk of extending beyond the contractual maturity should be awarded with a RSF factor of zero, as is applicable to money market instruments, securities and loans to financials with a maturity of less than one year. For example, loans to sovereigns or non-central government PSEs with a fixed maturity within one year that have no extension risk should not require funding longer than one year.

Page 31 mentions reporting requirements in paragraph 132: '*The metrics should be calculated and reported at least monthly, with the operational capacity to increase the frequency to weekly or even daily in stressed situations to the discretion of the supervisor. The time lag in reporting should be as short as feasible and ideally should not surpass two weeks.'* Looking at the different liquidity characteristics of products, we note that certain activities, such as retail lending, are much more stable than, for example, financial markets activities. We therefore suggest that the type of activity and the required level of aggregation be taken into account in case a higher reporting frequency is required.

The requested reporting capability may put a large burden on banks' IT departments. We are especially concerned about the required short time lag. Linking the calculation requirements to portfolio characteristics would ease some of the pressure on the IT systems.