Dr. Rudolf Duttweiler, Lecturer at the University of St. Gallen

To the Basel Committee on Banking Supervision
Comments on Consultative Document: **International framework for liquidity risk measurement, standards and monitoring.**

The commentator's background

Although no longer directly affected by the Consultative Document, I am still a professionally interested party in the subject. Liquidity, together with downside risk, is one of the two key subjects I am lecturing in my master course "Bank Treasury Management". Furthermore, the subject is dealt with extensively in my book "Managing Liquidity in Banks - A top down approach", Chichester 2009, finalised in October 2008 and published by Wiley & Sons.

The book addresses liquidity managers in banks. The focal point is the creation of the "Liquidity Balance-Sheet". It combines the degree to which assets and liabilities are liquefiable with the bank management's intention to survive a liquidity crisis, with the franchise staying intact; i.e. financing maturing short-term core business assets with stable funds (≥ one year) and establishing buffers to protect the franchise against outflows not considered in the scenario applied.

The concept is based on experience as Group Treasurer of Commerzbank and in connection with the view, that supervisory requirements did in no way give a bank a chance to survive a serious liquidity stress – let alone, to keep the franchise intact. Its key elements were established and implemented about 10 years ago and helped us to survive, including keeping the franchise intact, when we experienced an institution related severe liquidity stress in autumn 2002.

Comments related to the Consultative Document

Due to the fact that I switched from banking to academia in late 2006 and thus have no hands on detailed information regarding the effects of the subprime crisis, I will limit myself to conceptional issues of the Consultative Document.

a) The basic concept

Conceptional, the document distinguishes between the "Liquidity Coverage Ratio" for the first 30 days and the "Stable Funding Ratio" covering assets and liabilities with a maturity spectrum of at least one year.

We turn to the "***Stable Funding Ratio***" first.

On liabilities,

the criteria required to qualify for this segment are traditional. They consist of inflows with a deterministic fixed maturity of at least one year; and stochastic inflows which have a "stickiness" which allows assuming that they will stay for one year or more, despite shorter legally binding maturities. From experience and own research one can fully agree with the assumptions. The abolitions of two funding means previously accepted by many national supervisors are to be positively mentioned: longer term funds of one year or more but with embedded options which permits lenders to recall the investment before one year; committed funding contracts with third parties to be drawn in case of need. The reliability to get the funds in time of crisis is more then questionable, as reality has proven.

On assets,

requiring stable funding some important changes have been introduced to previously unsatisfactory rules applied by many national supervisors. The inclusion of keeping the lending capacity alive, at least to what is defined by the management as core business or franchise, is a milestone and paramount in surviving in a crisis. Two aspects are at the forefront of the correct considerations: Not being able to uphold what could be called cash-management services with the key clientele easily aggravates the difficult liquidity status the bank is in. It will be taken as a confirmation by the market of severe liquidity problems of the respective institute, leading to further unnecessary withdrawals. Our inclusion of these legally short-term assets into the group stably financed certainly has prevented a run on the bank in 2002. In a wider perspective, if companies are suddenly and unexpectedly cut-off from these means, they my not be able to get the funds immediately from any other bank. A bank related survival technique without including these assets into stably financed items will thus impinge on the real economy without delay in a negative and unnecessary way.

The inclusion of off-balance-sheet items is very much appreciated. As in the case of funds with embedded options (e.g. a rating trigger), the bank has put itself into the position of a writer of options – it is for this reason why I name these types of commitment "optionalities". Depending on the addressee of the promised obligation, the amounts can be substantial by any standard and thus have to be assessed with great care and conservatively. It is especially true for bank related but legally separated entities; acting in the same markets, their funding difficulty may coincide with a similar problem facing the mother company.

We now turn to the ***Liquidity Coverage Ratio*** (first 30 days) and its buffer: As this section is rather complex, I tried to put your recommendations into a comprehensive structure.

Flows within 30 days

Assets

%	
100	Retail / wholesale inflow not prolonged and no credit risk
100	Reverse repo + security lending for illiquid assets.
100	Contractual receivables from derivatives
	Payment Buffer
100	Cash + collateral with Central Bank
100	Marketable securities with intern organ. Governments and Central Banks
60-80	Corp bonds eligible with Central Banks
60-80	Covered bonds eligible with Central Banks.

Liabilities

	%
Retail deposits stable 7.5;less stable	15
Unsecured wholesale funding	
- Small business as retail 7.5 or	15
- Non-financials with cash mgmt	25
- Non-financials with no cash mgmt	75
- Financial institutions	100
Secured wholesale funding	
- All except zero weighted Basel II	100
- Additional collateral by downgrading	100
- Price fall of collateral	20
- Maturing and returnable assets with optionalities, on term ABS, covered bonds, other structured instruments	100
Drawing facilities	
- Retail / non-financial corporations	10
- Back-up lines	100
- Other credit / liquidity facilities	100

If taking all your recommendations, I arrive at the graph above. Assuming my understanding is correct: if expected inflows not subject to expected prolongation minus expected outflows, both assessed in a conservative manner, produce a negative gap, it is to be closed with the buffer. I call it “Payment Buffer” for reasons explained later. Conceptional, it is correct as long as we stay within the first 30 days. The potential net outflow in this period – the likely flow structure of most banks when considering experience – is covered by the buffer. The high quality level of the buffer – practically all instruments are central bank eligible – secures the financing of the gap in a liquidity crisis with assets and liabilities behaving as assumed. Nevertheless, there is an open period of 11 month until the

“Stable Funding Ratio” comes into play. As the considerations are rather complex, I will start with a detour.

The one-year divide:

In the document, measures and measurements for short-term and longer-term resiliencies are defined. But why does the longer end of the first not match with the shorter end of the latter? Although not expressively stated, the “Stable Funding Ratio” seams to be a means to what we call “buying time”. As it coincides with my conceptional approach of “Stable Funds”, the key for my interpretation relates to assets with retail and non-financial clients with a maturity of less then one year. Allocating a large portion of them to the asset group which needs to be funded stable, i.e. minimum one year, it indicates that they shall be protected against stress related outflows. In your as well as in my concept, it gives management one year within which the liquidity problem can be overcome before affecting what I call the “core business” or “franchise”. The ratio plays an important role in the case of longer-term (what we call “chronic”) stress conditions.

The 30 day limitation

The short-term resilience, defined as 30 days, seems to cover stress types which we call “shock”. From character they occur in a sudden and are either technical related or the first step of a “chronic” stress. There is no time or no market conditions for turning assets into cash immediately. Hence the restriction to hold the buffer in central bank eligible assets. As long as the focus is on stress types called “shock”, the limitation to one month makes sense. These stresses are over within 30 days by definition, or they would be of a “chronic” nature.

Although many if not most stresses are covered by the type “shock”, there are some which start like a “shock” but develop into a “chronic” longer-term stress. The personally experienced bank related stress in 2002 is one example, the subprime crisis after the Lehman failure another one. The Consultative Document, however, does not explicitly cover the period between 1 and 12 months. Is it covered implicitly or not at all, and what would be the consequences if the latter applied? Dealing with these questions for me is vital. Already under the unsatisfactory, and for securing a proper liquidity status negligible old regime, too many bankers have been happy to restrict themselves to the supervisory minimum. With a much tighter new regime, they now may feel to be at the absolute safe side. And to be frank, the document would support this understanding and attitude.

The undefined period

If the understanding is correct, in the Liquidity Coverage Ratio inflows and outflows under specific stress scenarios are to be calculated. Negative gaps are to be covered by an appropriate stock (buffer) of defined central bank eligible assets. By definition inherent in the set rule, the buffer needs to be financed longer than 30 days. That is, if my understanding is correct and the calculation of the net outflow is assessed before the buffer is integrated into the equation. Otherwise funding of the buffer will fall due sometime during the 30 day period. Yet, this seems not to be much of a problem. As you state in (21): .. “to be aware of any potential mismatch within the 30-day period and ensure that sufficient liquid assets are available to meet any cashflow gaps throughout the month”. In other words, the buffer is not only to cover the cumulative gap after 30 days but keep an add-on for covering intra-month gaps. It makes much sense and is in line with my definition of what I call the “Payment Buffer”. Yet, for the following months I have difficulty to understand the presented concept.

Also in paragraph (21) you state that “Banks are expected to meet this requirement continuously and hold a stock of unencumbered, high quality assets as a defence against the potential onset of severe liquidity stress”. I assume it means that the requirement is fulfilled each singe month and not only once a year or so. In the following section I need to interpret your intension in order to come to conclusions.

My first question deals with both of the ratios, and the rational behind. The Liquidity Coverage Ratio seems to be an improved version of the already generally applied liquidity concept by national regulators. Adding in the document the Stable Funding Ratio seems to fulfil the purpose to keep the franchise intact for at least one year. That’s my only explanation for allocating short-term assets to retail and non-financial wholesale customers into the group to be stable financed. . And if this is the case, I fully agree with the intension.

For the first month, following your recommendations, the goal is achieved. After that many more months will follow. In normal markets, taking steps to fulfil the requirements will be no problem. Funds will be provided by the markets to achieve the required goals. But at one time in the future, the bank will be faced with a liquidity stress, be it an institutional or a market related one. The quantities provided by the markets will be insufficient to uphold the requirement in the following months. For 30 days the bank should be save, as it has taken in advance the necessary steps to fulfil the conditions asked for. After that time, we are in undefined territory.

Looking at the overall picture of having Stable Funds at least at the level of the corresponding assets, and with fulfilling the Liquidity Coverage Ratio with an asset buffer at least at the level of net outflows, the balance on assets and liabilities is allocated in the period one to 12 months. The structure within, however, is not defined. Yet, we know that a substantial part of the payment buffer is financed within this period. The assets making up the buffer, according to the respective table, require stable funds in the range of 5% to 50% only. Whatever is not stably financed has thus a funding back-up within a maturity range of 1 to 12 months. We now need to focus on the buffer.

The buffer as part of the Liquidity Coverage Ratio in the document has to be allocated in volume as to fulfil two conditions: To cover the cumulative net outflow within the first 30 days and secure on top that any daily negative deviation from that gap is covered as well. As long as daily and cumulative gaps in the following 11 months do not exceed the so defined volume of the buffer, the bank will be on the safe side – at least ceteris paribus. On the other hand, the period is not defined in structure at all. From experience we must consider that banks are more relaxed about larger gaps in the more distant future. And they may even feel supported in their view by the fact that the authorities define buffer related rules for the first month only.

What, however, if gaps in the following 11 months exceed the buffer – either on specific days or, even worse, on a cumulative basis? There is only one inflow segment which one can and must use for covering the gap: Maturing short-term assets belonging to the franchise. It is exactly for this reason that in my concept buffers are financed stable (see graph below).

Liquidity B/S: With Franchise Buffer

Assets	Liabilities
Assets at risk	Short; medium-term funds (non-stable)
Buffers -payments -franchise	Stable funds
Franchise Assets > 1 year	

In fact I am working with two buffers as there are two types of danger. The one related to payments we discussed. And it covers about the characteristic of the buffer in the Consultative document. Yet, the detailed analysis revealed that however conservative you stress assumptions may be, reality may surpass it (we now drop the "ceteris paribus" clause). Even a conservative approach will not be the equivalent of the biblical Flood, or the subprime crisis in modern terminology. At the forefront are mainly stronger drawings on what I call optionalities, for which you put in 10% (e.g. conduits, SPVs etc). The not considered drawings will impinge on the franchise, as only maturing short-term assets to retail and non-financial wholesale customers will be available to cover the unexpected gap (hence my franchise buffer). Securing the franchise is than no longer possible – to what extend depends on the severity of the underestimation. Whether this is an issue for supervisors can only be answered by you. Yet, your inclusion of these types of asset into the group of stably financed items indicates that you wish to protect them. Fact is, however, you won't.
To summarise the findings: The new approach presented in the Consultative Document is a big, necessary and applauded step forward. Yet, if you wish to protect the franchise from being impinged by payment difficulties, rules either are defined also for the period 1 to 12 months or payment buffers are to be financed stable. Furthermore, whether protection of the franchise (from payment difficulties and/or underestimation of drawings) within the concept is only considered or declared paramount in your approach should be clearly stated. Otherwise, addressees may misinterpret you basic attitude and take wrong conclusions.

b) **Auxiliary points**

As mentioned in the introduction, my experience related to the subprime crisis is the one of a professionally interested observer. There are, however, a few points I wish to comment on. Not in the sense of correction but for consideration.

Defining the franchise

Assets to retail clients with a remaining maturity of less then one year and the equivalent to non-financial corporations are set with a minimum of 85% and 50% respectively. If the understanding is correct, the levels can be put higher but not lower. From my point of view, such a requirement does not limit your intervention to liquidity issues but enters the field of policy. With these rules you impinge on the freedom and responsibility of bank management to formulate business policy to the benefit of (state/government) political issues.

Personally I do not judge such an intervention neutral, as it benefits a supranational organisation. In my concept (see table above) I segregate franchise from opportunistic businesses. The latter is allocated to what I call "Assets at risk". They can include assets to both types of clients, if they are not defined as "core". A neutral supervisory assessment should than only judge, whether such an allocation could trigger problems as discussed in "on assets" above. Only interventions on that basis could still be called neutral.

Home and "far away" clients

It seems to me that no appropriate distinction is made when it comes to the depositing behaviour of retail and non-financial corporate customers in respect of their location. In the proposal it is distinguished between "with cash management" and "without cash management" contacts. Icelandic banks (I advised one of them just recently) have made different experiences. But also we experienced rougher behaviour in 2002 when it came to far away customers. In our planning, we assessed them as behaving equal to financial institutions and were correct when reality took place. As a consequence of our assessment, we decided to keep the share from them at non-hurting levels.

Closing

As I mentioned at the beginning, I restricted myself to some conceptual issues which I judged critical. Having been out of direct banking management for more than three years does no longer qualify me to comment on banking details. If anybody wishes to discuss issues further, I can be reached by e-mail: rudolf@duttweiler.eu . For a detailed analysis of my considerations and conclusions on liquidity issues please refer to my publication mentioned above.