European
Banking
Federation
Secretary General

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WW/BA

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Brussels, 16 April 2010

Dear Mr Walter,

EBF Positioning on the Basel Committee's Consultation on International Framework for Liquidity Risk Measurement, standards and Monitoring (CD 165)

The EBF has examined with great interest the proposals for an *International framework for liquidity risk measurement, standards and monitoring*. As you may recall, the industry had encouraged the Committee well before the financial crisis to take a fresh look at liquidity requirements and, foremost, to achieve consistency of supervisory regimes globally. The recent crisis has underlined even more the need for a worldwide, common approach to liquidity risk standards.

The Consultative Paper has many flaws. As a matter of fact, we are afraid that, if it would be implemented as proposed, it may have a significant and negative impact on financial stability as well as on the economy – as we illustrate at length in the attached submission. We nevertheless welcome the Paper as a valuable contribution and, more importantly, accept it as a valid starting point to steer further discussions.

We agree with the Committee that the monitoring, management and control of liquidity requires firms and regulators to look at a number of metrics. We note at the same time, however, that the Committee had implicitly conveyed the message in its 2008 document entitled "*Principles for Sound Liquidity Risk Management and Supervision*" that liquidity and funding risk management cannot not boil down to merely applying a range of funding risk metrics. It would be useful if the Committee would confirm more vigorously that this overarching principle still holds.

We welcome the basic methodology which the Paper proposes to measure liquidity risk, i.e. using a Liquidity Coverage metric (LCR) covering the short-term liquidity risk and a Net Stable Funding metric (NSFR) covering funding risk. Our submission makes an attempt to demonstrate, however, that the proposals would benefit from the Committee devoting additional attention to the interplay between both measures.

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Basically, we are supportive of introducing a short-term ratio such as the LCR as a common liquidity risk management metric. However, we strongly believe that such metric can be considered only provided the following caveats are addressed:

(i) the composition of the liquidity buffer should be revised so as to include central bank eligible assets.

(ii) The need to publish the ratios, particularly the LCR, will be self-defeating as the assets in the liquidity buffer will no longer be usable in a crisis without the firm falling below the minimum and thereby announcing to the market that the firm has a liquidity problem. We recommend that the ratios be shared only with the regulators.

We are more critical concerning what is being proposed concerning the NSFR. While we agree this to be a valuable metric, we strongly believe that the proper way forward would be to allow, and encourage, banks to develop adequate internal quantitative frameworks to monitor, manage and control the reliance on stable and term funding. In our view, the proposed quantitative NSFR factors are overly harsh and need to be recalibrated. Once this has been done the metric should be used as a benchmark – meaning that they will apply unless a firm demonstrates, to the satisfaction of its supervisor, that alternative factors are more appropriate

We are critical on the way in which the Committee has designed both measures.

- The run-offs, parameters and other percentages which are being proposed both for LCR and NSFR are far too severe. They need to be reviewed in the light of the QIS and their impact on the amount of credit in the economy as a whole. Their derivation should be explained.
- As the underlying stress test scenarios and horizons are different for LCR and NSFR, liquid asset definitions should be different for both ratios as well. Moreover, the definition of liquid assets would need to be widened within the framework of both the NSFR and the LCR.

Our submission particularly elaborates on the need to recognise the funding pattern of investment funds to custodian banks in an appropriate way.

Our submission, furthermore, highlights the following:

- The need to carefully consider the implementation timetable for the full introduction of the new approach so as to protect the fragile economic recovery in Europe. We expect this timetable to be over a number of years;
- The proposed disclosure requirements are too far reaching;
- The framework should be imposed on all financial intermediaries – and not just on banks;
- The concern we have over possible duplication of liquidity buffers if the ratios are to be met, not only at group level, but also at lower levels within a banking group;

- We encourage the Committee to include in the Paper's final version a statement confirming that it is determined to achieve enhanced convergence of supervisory practices over time.

Finally, we were surprised - and disappointed - to note that the Committee has not proposed developing a common reporting language and a common reporting framework in the area of liquidity risk, notwithstanding the many benefits that such an approach would bring.

Yours faithfully,

Guido RAVOET

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EBF COMMENTS ON THE BASEL COMMITTEE'S CONSULTATIVE DOCUMENT ENTITLED "INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING"

NEED FOR REFORM

1. We welcome the proposals made by the Committee and support many of the orientations that it proposes. The EBF (as well as the IIF) had informed the Basel Committee before the financial crisis of their view that the Supervisory Framework concerning banks' liquidity management had become obsolete. We are therefore pleased that the Committee now has proposed a new framework that will begin to address the reduction in systemic liquidity risk and achieve consistency of supervisory regimes globally across all material jurisdictions.

We believe that the proposals would need to be reviewed in light of the huge impact which they will have not only for the banking industry but for the economy as a whole. These effects should be carefully considered when amending the proposals to positively contribute to safeguarding financial market stability and preserving the overall funding and maturity transformation function of the banking system that is essential to finance the wider economy.

Moreover, the interplay between both liquidity ratios should be also thoroughly assessed in order not to duplicate the burden. We also think that the current draft should be reviewed to eliminate some inconsistencies and overlaps we have identified.

The EBF stands ready to be of assistance by providing constructive input and would like to strongly encourage the Committee to involve it in its future work. We believe it that it would in any event be appropriate for the Committee to organise another consultation process on the amendments that will be made to the Consultative Paper once the outcome of the Impact Assessment Exercise, which the Committee is currently undertaking, becomes available as it is expected to clarify the debate.

IMPACT OF THE PROPOSALS

2. We welcome the statement made in the Paper that the final calibration of the factors of the outflows and inflows as well as the composition of the stock of liquid assets will be

determined with a view to minimising the negative impact on the financial system and broader economy (paragraph 29). However, this will be a huge challenge as the new framework is likely to have far-reaching consequences.

Whilst we fully agree that the industry needs to strengthen its liquidity position, we would like to invite the supervisory community to discuss with the industry the potential macro-economic consequences of the proposals. There will also be an economic impact on markets for particular instruments, customers and market participants, including banks as well as unintended consequences.

The following consequences are worthwhile highlighting in particular:

Macro-economic Impact

- As such, the new requirements will lock up huge amounts of liquidity in the banking sector which will result in unnecessarily high levels of unproductive liquidity.

- The proposals will have a substantial impact on the banks' capacity to lend as the funding used to meet the ratios cannot be used for lending to consumers and business. This effect is particularly relevant for those countries in which the corporate landscape mainly consist of small and medium sized companies (SMEs) which typically do not issue credit-rated financing instruments and/or do not tap capital markets for financing (bank-based economies).

- The effect of the liquidity measures should, moreover, be seen in conjunction (i) with the new capital requirements which have been agreed upon by the Basel Committee in 2009 and those that are being proposed in its Resilience Paper and, furthermore, also (ii) with the need to reduce government deficits in the years to come.

Impact on Financial Stability

- The narrow definition of what is being considered liquid implies that the demand for those assets will increase whilst they will need to be stuck in the balance sheets of banks. As a result, overall liquidity – and, therefore, financial stability - will be reduced.
- The narrow definition will encourage herd behaviour - in normal circumstances and even more so in crisis situations - and result in concentrations in government instruments, which may intensify a liquidity squeeze.
- It is possible that trading assets which are eligible for the liquidity buffer (either in normal course of trading business or in rebalancing liquidity buffers) could be misinterpreted by the market as indicating a bank is experiencing a liquidity crisis.

- In addition there will be increased competition for all types of stable deposits. This will not only increase their price but may lead to the balances becoming less stable as customers become more aware of the value placed on their deposits.
- The narrowness of qualification for the liquidity buffer taken together with the treatment of non qualifying debt securities may result in a situation whereby, under stressed market conditions, the markets may automatically consider any asset that does not meet the criteria as illiquid. This behavioural pattern could, in future events, be the determining factor that shifts a stressed event into a major crisis.
- The Paper assumes that a 0% risk-weight under the Basel II standardised approach is a sufficient indication of the liquid nature of some assets. However, a general statement correlating credit risk to liquidity risk increases systemic risk. Moreover, a credit risk crisis would contribute more to a liquidity crisis if the liquidity buffer is narrowly defined!
- The proposals will increase pro-cyclicality with a risk that the new liquidity framework would magnify economic and/or financial markets fluctuations. One illustration is the spill-over effect which credit driven downgrades will have on the stock of high quality liquid assets: the stock will be inevitably be reduced as a consequence as their liquid quality is derived from credit ratings. Another illustration is the rumour-proning effect of liquidity disclosures.

<u>Impact on some Instruments</u>

- Re-pricing of asset classes may result in some products not being offered any longer, notwithstanding that they are useful to companies and retail clients.
- The new framework will result in a <u>higher demand for those assets which are eligible for the liquidity buffers</u> (particularly sovereign debt).
    - This is likely to distort the demand for instruments issued by the private sector (crowding out effect.
    - The framework may also have as an unintended consequence that the eligible asset classes (particularly sovereign debt) will become less liquid. It may be true that any shortage of sovereign debt is unlikely in the current environment of significant government deficit. However, there are long term concerns should governments recover their debts and thus restrict the availability of sovereign debt.).
    - A concentration issue may arise as the market will lack diversity in favour of a limited number of products.
    - A narrow definition is likely to increase the interdependence (i.e correlation) of highly liquid assets, increasing the likelihood of a possible liquidity shortage.
    - Equities - which is a category that has remained highly liquid throughout the recent crisis - could become less liquid.
- The circumstance that some <u>instruments are not included in the range of qualifying asset classes</u> will significantly remove incentives to hold these assets.

- This is of a particular concern where financial instruments which are issued by financial institutions, are concerned as this will put severe price constraints on banks' funding as well as on the quality of their balance sheets.
- The proposed NSFR will imply a requirement for 100 percent stable funding for financial bonds. As a consequence it will be very expensive for banks to hold bonds issued by other banks and this will increase the funding costs of banks in a considerable way.
- The narrow definition is, in particular, likely to limit interbank lending to assets meeting the criteria - to the detriment of bank debt (such as unbreakable deposits for 3 months with other banks or CDs with another bank). This will reduce the flows in the interbank market (further reducing available credit in the economy) and/or increase interbank market rates that will necessarily need to be passed on to customers.
- It will result in banks which are long of funds being restrained from investing in a diversified way.

- The proposed NSFR will discourage market making for a portion of those assets that do not qualify as being of a high quality (ex: corporate bonds, covered bonds, equities…).

Impact on Market Participants

- The proposals will result in reducing the amount of maturity transformation that banks undertake. Therefore, as there will be less liquidity in the economy, it is possible that other market players will need to step in to substitute banks for this necessary function in the economy, which means that maturity transformation would largely no longer be supervised but take place outside the banking industry and, consequently, outside of the supervisory framework and without access to banking safety nets (liquidity buffer, access to central banks…). As an example, corporates which plan to invest in long-term projects may prefer avoiding the high rates that banks will need to charge them and, as a consequence, may prefer funding themselves on a short-term basis.
- Transactions with other banks would be penalised in comparison to transactions with unregulated entities. This is a paradox and, moreover, likely to increase systemic risk.
- Implementing the proposed requirements will imply a huge burden and will be in particular be troublesome for smaller banks who may leave the market, further reducing available credit.
- Financial institutions which specialise in facilitating the market making in assets which are now proposed to be excluded from qualifying assets (or given no value in the denominator of the LCR) will see their business model disappear. The issuance of securities provided by financial institutions - such as covered bonds - has established a significant market in Europe more so than other locations and would more seriously affect this market.

- By not appropriately recognising the funding pattern of investment funds to custodian banks, the new liquidity ratios might increase the costs for all stakeholders with detrimental consequences for the activity of the custodian banks and for the investment fund industry as a whole.
- The proposals will reduce banks' profitability and, hence, their ability to raise funds in equity markets.

Impact on Banks' Customers
- The proposals will substantially increase the price that banks will charge to their customers, including retail clients to reflect the incremental liquidity costs because of the new regulatory liquidity framework.
- They will decrease the amount of lending offered by banks.
- Household savings will need to increase at the expense of consumption.

We assume that the Impact Assessment which is currently being undertaking will include an analysis of the impact of the proposals on all the factors mentioned above.

MONETARY POLICY DIMENSION

3. The Paper does not openly address the relationship between the new framework that it proposes and monetary policy, although it can be expected that the proposals will fundamentally change the basics underlying monetary policy operations.

By singling out financial institutions' funding sources - money market borrowing, certificate of deposits, commercial paper and debt - banks will be discouraged to lend to each other. This will not only limit the flows of cash between banks to channel excess of liquidity to where it is needed. Limiting interbank lending will also have consequences on the economy as a whole, and, when considered globally, will limit the diversification of bank funding sources which participates in mitigating funding risk.

This will also have a negative impact on the effectiveness of monetary policy operations on the global economy as changes in monetary policy are passed on to the economy through banks. This is reinforced by the NSFR requirements which will basically prevent banks from short-term borrowing as their borrowings - even on a short term - will have to be long-term funded Because both short-term borrowings and interbank markets will decrease significantly, monetary policy operations will become less effective.

It is also worthwhile adding that Libor rates - that are used in trillions of derivatives transactions - will be affected.

European Banking Federation

4. We would like to invite the Committee to undertake work jointly with the central bank community to clarify the future role of central banks during normal times and during crises. Today, there is considerable uncertainty about what the new "normal" role of central banks should be and differing requirements are set by different central banks. If the conditions of access to central bank facilities were more clearly defined, it would be much easier for banking supervisors to decide which assets could be deemed to be of a "high-quality".

5. The proposal that assets which are central bank eligible would not *per se* qualify as high quality liquid assets implies a fundamental change. Yet, the Paper fails to explain the need for such an overhaul.

Our understanding is that this change of policy is intrinsically linked to a broader debate, i.e. the role of central banks in resolving financial crises. We fully agree that central banks should not be considered as lenders of first resort and that the liquidity buffers should, therefore, be populated by sufficient assets that can be liquefied directly into the markets. We fully support the view which the paper implicitly takes that banks should be restrained from relying on emergency facilities to obtain liquidity and strongly agree with the observation made by the Committee of European Banking Supervisors that *"(B)anks should periodically test whether central banks will effectively provide funding against (assets eligible as collateral) and should apply appropriate haircuts to reflect the amount of funding that central banks might actually provide in stressed scenarios (for the assets in question and for the banks themselves). Furthermore, banks will have to demonstrate adequate diversification in the total composition of the buffer so as to guarantee to supervisors that they are not relying too heavily on access to central bank facilities as their main source of liquidity*."[1]

However, such a debate should be conducted in an open and transparent way. One of the main issues to be addressed within the framework of such a discussion is if prudential measures in the area of risk liquidity management would indeed be an appropriate instrument to achieve central banks' objectives.

More importantly, the Consultation Paper apparently relies on an implicit assumption that banks should manage liquidity risk on the basis of a market wide stress scenario under which central banks will not provide any liquidity under any circumstance. Such an assumption is highly questionable as the test concerning the highly liquid quality of assets is a base scenario which assumes that the bank will be hit by both an idiosyncratic crisis and a market-wide shock at the same time. We strongly believe that it would be unreasonable to imply that central banks cannot be accepted as part of the solution if a market-wide stress event would occur. In such a situation, central banks cannot possibly refuse to intervene by providing "normal" (as opposed to "emergency")

[1] Guidelines on Liquidity Buffers and Survival Periods, 9 December 2009, paragraph 64.

liquidity facilities as influencing liquidity within markets is a basic role of central banks and an essential tool within their monetary policy framework.

NEED FOR APPROPRIATE TRANSITIONAL ARRANGEMENTS

6. The Press Release accompanying the Paper's publication specifies that the Committee will put in place appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards.

It is essential that a consultation process be organised on arrangements that the Committee will propose, particularly (i) on the time-frame within which banks will need to apply the new framework as well as (ii) on transitional arrangements. The implementation of the new requirements also needs to be strictly synchronised throughout the world to avoid substantial competitive distortions.

Even if the proposed framework is substantially amended to meet the various concerns expressed by stakeholders, a transition period spanning some years would be required to allow banks to build up their liquidity buffers and, in particular, their long-term funding to the meet the NSFR requirement and, furthermore, make sure that most of the collateral that does not meet the narrow definition has matured and can be substituted by qualifying financial instruments. Part of the solution for the transition might be to phase in the new requirements and, more particularly, apply low percentages initially and increase those gradually over time.

The duration of the transition period will need to be determined on the basis of a number of factors, amongst which the following will be mostly relevant:

- return to stable economic growth;
- change of the savings ratio;
- the exit strategies that central banks will decide upon.

DISCLOSURE REQUIREMENTS

7. The Paper imposes far-reaching reporting and disclosure requirements.

a) Reporting Requirements

We agree that it is indeed essential for entities to calculate any metric that they use in a timely fashion and to share the outcomes with internal management and their supervisor.

b) Frequency of Reporting

The proposed reporting frequency is a cause of concern. The regulators should recognise the trade off between speed of availability and accounting level accuracy. A "80/20" rules applies to data proved from raw systems. That does not rule out a regular reconciliation process to ensure the raw data is complete. It would be undertaken post event and less frequently.

c) Public Disclosures

Getting the right level of transparency in public disclosure documents is crucial as more public disclosures may prove self-fulfilling, in negative ways.

- Obviously, disclosing detailed quantitative information on liquidity positions to the public at large is an extremely sensitive issue as any misunderstanding which it might create may have devastating consequences on the institution and even become self-fulfilling and deepen potential weaknesses. Publishing a ratio which is below the minimum immediately suggests to the market that the firm has a liquidity problem. Moreover, disclosures made on a routine basis under normal conditions provide institutions with less flexibility once the market is under stressed conditions.

- Furthermore normal flows of cash through the firm due to seasonal and other factors may well see fluctuations in the Liquidity Coverage Ratio (LCR) and in the Net Stable Funding Ratio (NSFR). Publication of the LCR at specific dates could well show a decrease between one date and another (whilst still showing levels above the minimum) which merely reflect those normal movements but could create unnecessary concern among the uninformed.

- Finally, it should not be overlooked that the market may expect from banks that they conform to the disclosure requirements before the new Liquidity Framework will become applicable, i.e. at a moment in time (i) at which banks have not had sufficient time to adapt and (ii) at which the economy recovery process is still fragile.

Against this backdrop, we would strongly like to suggest that the liquidity position of a bank needs to be reported solely to the (colleges of) supervisors, and not to the wider community.

PROPOSED METHODOLOGY

Preliminary Observation

The methodology which is being proposed in the Consultation Paper has many merits but also many flaws.

Our observations are not meant to comment on each and every suggestion that the Consultation Paper makes but aim instead at providing constructive input by identifying - and commenting on - the main foundations and building blocks of the proposed framework and exploring alternative solutions, where appropriate.

General Comments

8. The Basel Committee published in September 2008 a document entitled "*Principles for Sound Liquidity Risk Management and Supervision*" which recognised - implicitly but clearly - that funding risk management does not boil down to merely applying a range of funding risk metrics as a superficial reading of the Consultation Paper may suggest. Our understanding of the 2008 document is that the Committee believed a robust funding risk management framework primarily to require it to be "*integrated into the bank-wide risk management process*" (see paragraph 8). More particularly, the Committee' document – as we understood it - highlighted that the main foundation for a robust funding risk management framework should consist in embedding funding risk into the bank's culture and needs to include in particular the following major building blocks:

- Governance;
- Information Technology;
- Internal Fund Transfer Pricing System;
- Funding Risk Measurement;
- Funding Risk Actual Management from both business-as-usual and stress test perspectives.

All this confirms that funding risk measurement is merely part of a more global picture and should not be looked at in isolation from the other main foundations of a bank's funding risk management framework.

Furthermore, funding risk management cannot be looked at in isolation from the context within which it operates and which includes, amongst others:

- the businesses in which the bank is involved (i.e. the bank's business model);
- its customer base;
- competition;
- capital markets;
- legal and regulatory requirements;
- the role of rating agencies;
- the economy as a whole with its ever ongoing globalisation process.

9. <u>We welcome the basic methodology which the Paper proposes</u> to <u>measure</u> liquidity risk, i.e. (i) using a Liquidity Coverage metric (LCR) covering the short-term liquidity risk and (ii) using a Net Stable Funding metric (NSFR) covering funding risk.

However, we would urge the Committee to devote more attention to the <u>interplay between both measures</u> as it seems essential to us to consider the LCR and NSFR requirements together.

- The <u>NSFR</u> should build up a first layer of robustness in liquidity risk management. It should be designed to support sound liquidity risk management over a medium term horizon in a business-as-usual mode or possibly even a mildly stress test scenario.

  It seems essential to us that, within the framework of such a scenario, central banks be included as a possible funding source – albeit only to the extent of their business-as-usual monetary policy. This means that non-marketable loans should be term-funded, even though they may be central bank eligible and, therefore, that central bank eligibility would not be a decisive criterion to qualify an asset as being highly liquid within the framework of the NSFR. Therefore, as such, the NSFR cancels out moral hazard, if any, to overly rely on short-term funding and, more particularly, on central banks in a business-as-usual-mode.

  Furthermore, the 1 year long bank-specific stress test assumptions from which the proposed NSFR is derived ignores changes in its business model that the firm will undoubtedly adopt over such an extended crisis period. The NSFR should embed bank specific assumptions on its adaptation of its business model over a one year long idiosyncratic stress test scenario, including scale-down assumptions on the non-core businesses of the bank

  Adopting a one year horizon for the NSFR is reasonable.

- The <u>LCR</u> should complement the NSFR to make sure that each bank is in a position to survive an acute short term idiosyncratic and market-wide stress test scenario. This is a second layer of robustness.

  Within the LCR framework, central bank eligibility should be a relevant criterion as assets which are not marketable but central bank eligible can help mitigating a market wide acute stress test.

  A one month horizon for LCR seems reasonable to us.

Rationale of the proposed run-offs, parameters and other percentages

10. It would be useful if the Committee could clarify how the various run-offs, parameters and other percentages which are being proposed have been derived as they are not supported by any fact-finding exercise, behavioural assumptions or any other evidence disclosed in the Paper.

We do, of course, acknowledge that the level of potential liquidity risk in the market was seriously underestimated in the past. However, to try and make sure that will not happen again, it is vital that the economic impact is well understood. If the overlays are to be used as an industry standard, then it is vital that they reflect that experience and perceived potential liquidity risks if the ratio is to achieve the objective for which it is designed.

This is important because:

- it would improve the understanding of banks' management. Even within the proposed framework which is utterly prescriptive, banks' management need to be aware of the key drivers of liquidity as well as of the way in which different types of funding need to be measured;
- the percentages will describe the amount of the liquidity multiplier and hence the level of credit available in the economy. If the percentage is set too low i.e. a high multiplier, asset bubbles will emerge. If set too high, however, the economy will be restrained below its optimum growth rates, which could lead to stagnation or worse;
- by setting prescriptive run-offs, the Committee will be dictating the way in which the industry will value different types of deposit. For example we are concerned that regulatory arbitrage will result and dysfunctional pricing follow.

11. The run-off/rollover assumptions which are being proposed both for LCR and NSFR are far too severe in many cases relative to experience during the crisis. This can be illustrated by the assumption which the Consultation Paper proposes within the framework of the NSFR that a bank would not adapt its business model (e.g. by scaling down its activities) over a 1 year long idiosyncratic crisis - which does not make sense. Furthermore, the implied haircuts for debt securities appear large if the scenario is a pure idiosyncratic stress event.

Within the alternative framework that we are proposing (see above, under number 9), firms would be required to justify to their supervisor how they have broken up the categories that they believe to be relevant to their situation as well as the behavioural overlays (run offs) which they assume. Those categories and the way in which they would be broken down would be different for LCR and NSFR as the two scenarios on which they are based are different. We do accept that supervisors should remain entitled to challenge the treatment opted for by firms, particularly if it would be out of line with how others are treating similar products.

12. As the underlying stress test scenarios and horizons are different for LCR and NSFR, liquid asset definitions should be different for both ratios as well. Moreover, the definition of liquid assets would need to be widened within the framework of both the NSFR and the LCR.

- We suggest that liquid assets that qualify for the LCR liquidity buffer (numerator) be limited to most marketable, liquid securities and central bank eligible assets. It may be envisaged recognising a portion of the marketable, liquid securities that would be recognised in the liquidity buffer.

  The next highest liquid assets should be recognized their liquidity in the LCR denominator (cash inflows).

- Within the framework of the NSFR, a liquidity value needs to be allocated to assets that can be liquidated in a market: the non-liquid portions of those assets would require longer than 1 year term funding.

Design of the Liquidity Coverage Ratio

13. We are prepared to accept a short-term ratio such as the LCR as a common liquidity risk management metric subject to four caveats which we believe to be crucial:
(i) Overlay factors should be revised;
(ii) the composition of the liquidity buffer should be revised so as to include central bank eligible assets (see our comment below, under nr 14);
(iii) there should be no requirement to publish quantitative information on liquidity positions to the public at large (see our comment above, under nr 7).
(iv) the design of the Liquidity Coverage Ratio (LCR) as an absolute minimum level across the industry should be revised. The point about having a buffer of assets which are marketable is that those types of assets can be used whenever necessary. By establishing a minimum level of holdings that have to be met at all times (and be disclosed), there is a presumption that the assets in the minimum buffer can never be used and, hence, that the assets are in fact no longer usable for what they are destined to from an LCR standpoint

Composition of the LCR Buffer

14. As observed above, we believe that within the framework of the LCR a portion of the Liquidity buffer should be allowed to consist of central bank eligible assets (which may not necessarily be marketable).

Furthermore, we suggest considering adopting a two-Tier approach under which 50 %, say, of the requirements would need to be met with assets that are highly liquid whereas the remaining could be composed of assets which are less liquid (subject to an appropriate haircut).

15. No mention is being made of some assets which are obviously highly liquid (such as equities, gold and other precious metals, commodities, mortgage-backed securities, instruments issued by the US Federal National Mortgage Association and Federal Home Loan Mortgage Corporation and credit claims), without any explanation being provided.

We suggest including such assets either in the liquidity buffer or in the LCR as inflows, with haircuts which are determined on the basis of their characteristics. Note that the haircut would need to be different depending on whether the calculation is done for LCR and NSFR purposes.

Covered Bonds and Investment Funds

16. The treatment of covered bonds and investment funds needs to be reviewed.

a) Covered Bonds

- We agree that covered bonds which are not issued by the bank itself need to be included in the liquidity buffer. However, we strongly believe that the Committee should recognise the different risk inherent in the different bonds by means of imposing appropriate haircuts (e.g. on the basis of their rating, the maturity of the bonds or the strength of the applicable legal framework). The proposed haircuts of 20 or 40 percent constitute a very harsh and simplistic treatment of covered bonds which (i) do not reflect the high quality of the bonds, (ii) will significantly reduce the incentive to hold these bonds and (iii) create a too narrow definition of the liquidity buffer. The proposed treatment may have a severe negative impact on the financing of private real estate as well as of SMEs and commercial property in general. Covered bonds are being used as an important funding source for such types of assets in many countries. Cutting off such type of funding will, therefore, increase the costs of financing and have a negative impact on the housing market, which may spill-over to the wider economy.

- According to the proposals, covered bonds which have been issued by the bank itself would not be included in the stock of highly liquid assets.

  We do not consider it to be logical to exclude a covered bond from the stock when it issued by the bank itself but not when it is being held by another bank. The asset pool backing up covered bonds reflects the general state of the market concerned

(e.g. the housing market, if the underlying assets are mortgages). As the risk exposure of the covered bond is not on the issuer but on the underlying pool, the requirement that the bond not be issued by the bank itself does not seem relevant.

We strongly believe that the Committee should recognise the different risk inherent in the different bonds by means of imposing appropriate haircuts (e.g. on the basis their rating and the maturity of the bonds).

b) Investment Funds[2]

Investment funds provide usually funding to their custodian bank via their cash account and deposits.

The run-off factor of 100% that is supposed to be applied to this funding (see Paragraph 55) appears excessive because:

- The Basel Committee proposal fails to demonstrate the articulation between the underlying assumptions (a combined idiosyncratic and market-wide shock) and their outcome (the 100% run-off factor).

- The strong operational relationship existing between the investment funds and their custodian banks is not taken into account.

  The Consultation Paper (see Paragraph 51) recognises the benefits of the operational relationship between a bank and its non-financial corporate customers by allocating a 25% run-off factor to the specific amount of deposits utilised for these operational functions. In a similar manner, investment funds maintain with their custodian banks a very robust operational relationship. Custodian banks indeed offer to investment funds a wide range of services in the framework of a global custody contract: Cash management, Management of the currency risk, Management of securities transactions, etc. This link proves to be, as a minimum, as robust as the operational link with a non-financial corporate customer.

- It is not consistent with the lessons learned from the crisis that are corroborated by quantitative observations:

  (i) Regulation contributes to the stability of the investment funds' funding patterns

  Investment funds are generally highly regulated and are compelled to invest in high quality and liquid assets. For example, in the EU context, the majority of investment

[2] A detailed analysis prepared by the Luxembourg Banking Association (ABBL) is attached (Annex I)

funds take the form of Undertakings for Collective Investment in Transferable Securities (UCITS). These characteristics contribute to the liquidity of the UCITS and facilitate, in times of stress, the reimbursements to the shareholders who redeem their shares without drying up the buffer of cash held by the UCITS.

(ii) <u>The asset managers' investment strategy in times of stress increased the level of cash held by investment funds</u>

In a market crisis, asset managers adopt a more defensive investment strategy and tend to increase the proportion of cash in the investment funds' portfolios: more cash in the portfolios indeed reduces the exposure to the market risk. This leads to liquidity inflows at the custodian banks.

(iii) <u>The funding base of the custodian banks is well diversified</u>

Market practice shows that custodian banks benefit from a well-diversified customer base. The custodian banks' funding risk is hence split among a large number of investment funds and sponsors. It is therefore highly improbable that all the investment funds (and their sponsors) decide simultaneously to terminate their contractual relationship with the custodian banks.

Should they however decide to do so, it would take a long time to terminate the custody contract, well above the 30 days period prescribed by the LCR.

(iv) <u>Observed run-off factors</u>

We have observed the monthly variations of the (up to one month) funding received by a representative sample of custodian banks from December 2006 to December 2009, providing therefore a reliable evidence of the run-offs factors over the period.

The monthly variations are comprised in a range varying from +20% to -12%, the latter being hence the worst run-off factor observed.

<u>Conclusion</u>

In order to fairly reflect the operational, legal and economic reality of the Custodian banks' activity, we call for a maximum 25% run-off factor to be applied to the part of the (up to one month) funding related to the operational relationship between the investment funds at their custodian banks. This part of operational-linked funding is material as it is represents, based on our observations, 70% to 95% of the total (up to one month) funding provided by the investment funds to their custodian banks.

The <u>residual funding</u> is not linked to the operational relationship and results from investment decisions taken by the investment funds' asset managers: we agree that it

is, by nature, less stable. However, we would like to invite the Basel Committee to reflect on the negative consequences which the application of an overly conservative 100% run-off factor to such funding would have for the whole financial industry. Indeed, as this residual funding is likely to be transferred from the banking sector to less regulated sectors, this will increase the risk for the final investors (i.e. the investment funds).

Government Debt

17. We welcome the recognition that government guaranteed paper and non central government public sector entities can be included (subject to conditions) in the short-term buffer and also that the Consultation Paper recognises within this framework the value of paper issued by lower credit rated governments to support liquidity risk in the local currency of that government.

However, the value of such paper should also be recognised within the framework of the NSFR by attaching a far lower than 100% coefficient to it.

Moreover, claims on (or guaranteed by) sovereigns and the like which have a 20% risk-weight should be included in the liquidity buffer (with an appropriate haircut) and should be assigned a far lower than 100 % coefficient in the NSFR. Note also that, should a downgrading cause a government bond (or similar) to go from a 0% to a 20% risk weight, the proposed revision would limit the potentially devastating sell-off of the bond, that the regulation would otherwise artificially trigger.

Treatment of deposits

18. Liquidity risk in deposits reflects the liquidity risk spectrum associated with different classes of depositors which are often met by offering different types of product.

We caution against being overly prescriptive in setting behavioural overlays that should apply to outflows and inflows given the difficulty in definition of e.g. stable vs. non stable sources of funds.

- There is a danger of the Committee setting regulation which then segments the liquidity risk spectrum in a dysfunctional way. The more regulators prescribe the breaks in the spectrum the more the value of the deposits will be perceived to follow the regulators segmentation. Pricing will follow the segmentation and flexibility to design products with a risk/reward which fully reflects the liquidity risk will be reduced.

- The proposed run-off rates ignore, moreover, that a comprehensive view needs to be taken on the relationship with customers as experience has demonstrated that withdrawals of liquidity lines may be accompanied by increases in deposits.

19. By classifying all deposits in categories, the Committee is in danger of falling between not being detailed enough (to allow a granular approach to this type of product and customer set) and being too granular to allow banks (and regulators) to have flexibility. For example, deposits from the following counterparties all have their own characteristics: Central banks; Sovereigns; Public Sector; Corporates; Financial institutions such as insurance companies, Hedge funds or Asset Managers. Furthermore our experience is that depositors from different countries also behave differently. Etc.

In distinguishing between (i) counterparty-types, (ii) the nature of the relationship, (iii) product types and (iv) legal and tax related issues, the proposed matrix is in any event utterly complex.

All of this suggests that a more advanced approach which takes into account the bank's own assumptions may be more appropriate

Should a highly standardized assumption set be retained, it would need to be more granular (notably to breakdown financial institutions into finer categories) and the extent of the relationship should be considered for all type of counterparts (i.e. including financial institutions).

Net Stable Funding Ratio

20. We strongly believe that the monitoring, management and control of the NSFR basically still needs to rely on the bank's own liquidity risk assessment.

Against this backdrop, we would like to suggest adopting an approach which would encourage banks to develop adequate internal quantitative frameworks to measure liquidity risk which fully capture the funding risk to which they are exposed – the understanding being that those internal frameworks would need to be validated by the college of supervisors on the basis of criteria which should be transparent and flexible and which should in any event be in conformity with the Committee's "*Principles for Sound Liquidity Risk Management and Supervision*". In respect of those firms, supervisors would make use of the quantitative NSFR metrics proposed in the Consultation Paper as a benchmark – meaning that those will apply except if the firm demonstrates to the satisfaction of its supervisor on the basis of behavioural overlays that the run-off factors would need to be refined.

Furthermore, the quantitative standards proposed in the Consultation Paper should be imposed as a *de minimis* NSFR standard on those banks which fail to set up an adequate internal quantitative framework, and only on them.

21. We believe that, in general, it would be more appropriate to apply the NSFR on a static balance sheet. Concerning call deposits and revolving credit facilities, however, some behavioural assumptions need to be made.

The treatment of all other assets and all other liabilities is asymmetric. For example balances awaiting settlement which are due to be paid by the firm require 100% term funding but balances awaiting settlement which are due to the firm do not count as term funding. Since in many cases these will be two sides of the same trade this seems odd. Similar anomalies apply to MTM balances for derivatives and prepayments and receivables.

The measure is an idiosyncratic stress: the proposed haircuts for tradable securities therefore appear to be draconian given that the market will be operating normally. We would suggest that haircuts be more aligned to those used in the repo market currently.

We believe that the measure should be accompanied by a need for banks to undertake a pillar 2 type assessment of how the ratio changes over time. Such analysis will require banks to identify their key sensitivities, their core business franchise, their non core activities and the mitigating actions available to them over the one year horizon. Since different banks will have differing core activities the results will be different. For example whilst a mortgage bank might well seek to roll 85% of its retail lending it would not be seeking, necessarily to roll 50% of its corporate borrowing.

Investment funds as an Available Stable Funding category

22. The operational-linked (up to one month) funding provided by investment funds to custodian banks proves to be stable in the framework of the Liquidity Coverage Ratio, as we have demonstrated in section 17.

The rationale can be transposed to the NSFR framework and we think that the operational-linked funding fulfils the conditions of Available Stable Funding.

Due to the operational link, investment funds maintain with their custodian banks a stable relationship that is of a corporate nature. This stability over a one-year horizon and in times of stress is confirmed by the yearly variations of the funding.

These characteristics should be recognised by the NSFR. Therefore, we propose to allocate, similarly to non-financial corporate customers, a conservative 50% Available

Stable Funding Factor to the part of the (up to one month) funding related to the operational relationship between the investment funds at their custodian banks.

SCOPE OF APPLICATION

23. To foster financial stability and avoid creating competitive distortions, the framework should be imposed on all financial intermediaries – and, therefore, not just on banks – and implemented on a global level within the same timeframe.

LEVEL OF APPLICATION

24. We would like to invite the Committee to provide more clarity about the scope of application of the consolidated reporting and, in particular, on the distinction between group consolidated reporting and the possibility of subset of the group reporting at consolidated level. More clarification would in particular be welcomed on (i) the possibility to off-set liquidity excesses across convertible currency jurisdictions and (ii) how intra-group transactions need to be treated. We are concerned that double counting of the same third party liquidity risk could occur if there is an asymmetry of treatment of intra group exposures. This is a point the European Commission has noted in CRD 4.

25. The application of the new framework – i.e. on a consolidated and, potentially, on a legal entity basis as well – is a cause of concern.

We recognise that governments will need time to agree on arrangements which foster an optimal flow of liquidity within cross-border banking groups and which would, in particular, lift restrictions to intra-group exposures which are an obstacle to organising liquidity transfers within a banking group in conformity with banks' best practices.

However, the requirements should be applied at the level at which it makes sense – meaning at a group level when there are no cross-border obstacles to the free flow of liquidity.

Moreover, the Committee should examine if it would be possible to waive the application to individual firms whenever it is possible to identify a set of institutions belonging to the same group to which the requirements can be meaningfully applied on a consolidated basis because:

a) liquidity risks can be managed centrally in the group;

b) there are legally binding mutual commitments for liquidity support between the relevant institutions and assets are freely transferable between legal entities even when under stress; and
c) the institution is subject to consolidated application of the requirements together with other credit institutions belonging to the same group.

26. The Committee should anyway explicitly confirm the following:
- within a single country or single currency-zone, the requirements can be met at a consolidated level only;
- the treatment of intra-group exposures need to be symmetric;
- double counting needs to be avoided across countries, particularly where third-party deposits are concerned.

NEED FOR ENHANCED CONVERGENCE OF SUPERVISORY PRACTICES

Establishing a Common Reporting Framework should be a top Priority

27. The EBF welcomes the proposals made by the Committee to the extent that the new framework will foster consistency of supervisory regimes across all material jurisdictions globally.

However, the proposals are also disappointing to the extent that the Basel Committee has not proposed developing a common reporting language and a common reporting framework in the area of liquidity risk, irrespective of introducing common metrics.

Introducing common templates would serve the interest of the banking supervisory community as common templates are likely to facilitate a "common language of liquidity" as well as enabling supervisors to identify potential sources of liquidity vulnerabilities. It would also serve the interests of the many banks that are operating in multiple jurisdictions and that are currently faced with a variety of liquidity reporting practices by reducing systems costs in reporting liquidity risk being run by such entities. This will assist colleges of supervisors in looking at the liquidity risk in global banks and create a common language, reducing the risk of misinterpretation of information by Boards, commentators and regulators. It will also have the added advantage of reducing systems costs in reporting liquidity risk being run by such entities.

We strongly insist that the final version of the Committee's Paper would provide an outlook of the work that the Basel Committee intends to undertake in this area.

The proposed new Framework fails to achieve a sufficient Degree of Convergence

28. The proposals fail to convey the message that the supervisory community is determined to make progress towards achieving further harmonisation. On the contrary even, as the Paper explicitly states that "*national authorities are free to adopt arrangements that set higher levels of liquidity*" (see Paragraph 5).

It may be understandable that, due to any lack of experience which the supervisory community has gained with the proposed new framework, the Basel Committee has included a safeguard clause in its proposals authorising supervisors to use additional metrics "*to take account of jurisdiction-specific conditions*" (Paragraph 15). We welcome, moreover the discipline which is being introduced in this respect by the requirement that "*the (jurisdiction-specific) parameters should be transparent and clearly outlined in the regulations of each jurisdictions*" (ibidem). However, this cannot be sufficient.

The existence of diverging supervisory practices maintains an obstacle to the free flow of liquidity within the global financial system. It also adds an administrative burden which cross-border banks face when managing liquidity risk. Finally, it fails to address competitive distortions between institutions.

Against this background, the industry would like to encourage the Committee to include in the Paper's final version a statement confirming that the Committee is determined to harmonise supervisory practices over time. Moreover, it is crucial that the Paper would also include additional measures aiming at bringing more discipline to supervisory practices:

- The final version of the Paper should include a <u>comprehensive glossary</u> which provides clarity on the terminology used throughout the Paper. This is essential.
- Supervisors should not only be obliged to provide <u>transparency on the more stringent and/or differing parameters and other requirements</u> that they impose but also to explain the reasons that would justify such a deviate approach ("comply-or-explain").
- <u>The Basel Committee should undertake to publish a Report at the latest three years after the new framework has been implemented</u>. Such a Report would, firstly, need to provide an exhaustive overview – jurisdiction by jurisdiction - of the way in which national supervisors have made use of their freedom to deviate from the global standard as well as the reasons which they have invoked to justify their deviant practices. Furthermore, the Report should come up with proposals aiming at fostering convergent practices.

Pending the outcome of these efforts to harmonise rules and practices, regulators, by way of supervisory colleges, should improve coordination in this field, matching the needs of the firms which they supervise to regulatory practice. Against this backdrop, we particularly welcome the initiative taken by the CEBS Task Force on Liquidity Risk

Management to develop a "Liquidity Identity Card" which is meant to help supervisory colleges to develop a common language and consistent processes in this area. This will improve mutual communication amongst the members of supervisory colleges and contribute to a more efficient treatment of cross-border firms. The final version of the Basel Committee's Consultation Paper should draw inspiration from this initiative and expand its use on a global level.

ANNEX: Impact of the Basel Committee Proposals on the Custodian Banks' Activity and on Investment Funds

1. Background

The Basel Committee on Banking Supervision published in December 2009 a consultative document proposing a new framework for liquidity risk measurement, standards and monitoring.

By not appropriately recognising the funding pattern of investment funds to custodian banks, the new liquidity ratios might increase the costs for all stakeholders with detrimental consequences for the activity of the custodian banks and for the investment fund industry as a whole.

Against this background, we like to propose adjusting the qualifying parameters for the metrics of "Liquidity Risk Coverage" and "Net stable funding ratio" in order to fairly reflect the operational, legal and economic characteristics of both the custodian banks' activity and the investment funds.

2. Liquidity Coverage Ratio: run-off factor of 100% applied to investment funds for the calculation of the cash outflows

2.1 Introduction

Investment funds provide usually funding to their custodian bank via their cash account and deposits.

The run-off factor of 100% that is supposed to be applied to this funding (see § 55) appears excessive because:

1. The Basel Committee proposal fails to demonstrate the articulation between the underlying assumptions (a combined idiosyncratic and market-wide shock) and their outcome (the 100% run-off factor)

2. The strong operational relationship existing between the investment funds and their custodian banks is not taken into account

3. It is not consistent with the lessons learned from the crisis that are corroborated by quantitative observations

2.2 Assumptions underlying the 100% run-off factor

The idiosyncratic shock resulting from a three-notch downgrade is questionable if considered as an absolute value without any reference to the current rating of the institution. The impact of the downgrade on a custodian bank's reputation will be different if its current rating is AAA or BBB: this shock should therefore be appreciated in a more relative and granular manner.

We believe that the contagion from specific risk (three-notch downgrade) to market-wide shock should be subject to a more detailed impact analysis. Clearly, all institutions do not bear the same level of systemic risk and it is unlikely that idiosyncratic, default-type event at the scale of an institution systematically materialize into market shocks. We would thus advocate to analyse beforehand what is the extent to which the institution would contribute to systemic risk, for instance by means of analyzing the network of immediate dependences (in terms of funding risk, counterparty risk…) to this institution.

We agree that collateral quality of the assets should be taken into consideration as well, provided haircuts are adjusted to reflect increasing volatility and higher liquidity risk. We recognise that assets will definitely not be tradable at optimal level, but depending on their nature, some potential for recovery might be computed, even in very illiquid situations. This is particularly true for the assets comprised in the eligibility portfolio.

Concerning a market wide-shock, applying a 100% run-off factor would mean that all shareholders of an investment fund would redeem their shares simultaneously, leaving the investment fund short of liquidity. Such an assumption is not realistic and is not observed during the crisis.

2.3 Operational Relationship between the Investment Fund and its Custodian Bank

In § 51 the Basel Committee recognises the benefits of the operational relationship between a bank and its non-financial corporate customers by allocating a 25% run-off factor to the specific amount of deposits utilised for these operational functions. § 52 enumerates examples of cash management services that are part, amongst other types of services, of the operational relationship.

In a similar manner, investment funds maintain with their custodian banks a very robust operational relationship. Custodian banks indeed offer to investment funds a wide range of services in the framework of a global custody contract, mainly:

- Cash management
- Management of the currency risk
- Management of securities transactions: control of settlement and delivery of the securities
- Security lending or borrowing

- Management of security income (dividends on equity or interest coupons on bonds), including tax aspects
- Providing real time market information (on security prices for example)
- Providing real time access to transactions and positions
- Reporting
- Selection and control procedures for sub-custodians
- Granting of credit lines to the investment fund
- Pre-financing the transactions entered into by the investment fund

The relationship between investment funds and their custodian bank is a true partnership, which cannot be terminated within a short timeframe because:

- A custodian bank is legally mandatory and the investment funds need to have another global custody contract in place before cancelling an existing contract.

- A global custody contract is a long and complex document with many key clauses that require lengthy negotiations (such as pledge clauses, netting clauses, settlement conditions, etc.). Usually external lawyers are involved to participate to the negotiations.

- The migration of assets from the current custodian bank to a new one requires at least six months and represents a significant cost for the investment fund as well as unnecessary operational risk.

- The "pledge clauses" of the global custody contract enable the custodian bank to pre-finance transactions and ease the proper settlement of the transactions.

- The assets of the investment fund (including cash) cannot be deposited by the asset manager to any third party without prior approval of its custodian bank. The custodian bank is responsible towards the investment fund's investors that those assets are well safeguarded and not at risk (according to the legal obligation of the custodian bank towards investors and banking regulators).

- According to the investment fund's prospectus, the asset manager is legally obliged to maintain minimum levels of cash, which is monitored by the custodian bank.

The operational link between an investment fund and its custodian bank proves thus to be, as a minimum, as robust as the operational link with a non-financial corporate customer.

Such an operational link is a strong incentive for investment funds to maintain a stable relationship with their custodian bank. This is particularly true in times of stress because the operational experience gained by both parties facilitates a prompt reaction to adverse events and the proper and timely execution of the investment funds' transactions.

2.4 Experience of the past crisis

Regulation contributes to the stability of the investment funds' funding patterns

Investment funds are generally highly regulated and are compelled to invest in high quality and liquid assets.

For example, in the EU context, the majority of investment funds take the form of Undertakings for Collective Investment in Transferable Securities (UCITS). UCITS are highly regulated and liquid investment funds, which meet the criteria laid down by EU Directives in this area. UCITS are subject to a mandatory diversification whereby no position held in portfolio can exceed 10% of the total assets.

These characteristics contribute to the liquidity of the UCITS and facilitate, in times of stress, the reimbursements to the shareholders who redeem their shares without drying up the buffer of cash held by the UCITS. During the crisis, we observed an extreme situation where some money market UCITS faced significant shareholders' redemptions. This was due to an arbitrage made by the funds' shareholders in favour of banking deposits benefiting from an extended public guarantee granted by some EU governments. In a first stage, the amount of cash held at the custodian banks decreased temporarily but it was promptly reconstituted after the sale of the corresponding proportion of assets.

The rationale could be extended to other regulated investment funds that are similar to UCITS with regard to their investment restrictions and redemption rules, for example to nationally regulated investment funds offered only to institutional investors.

The asset managers' investment strategy in times of stress increased the level of cash held by investment funds

The asset managers are committed towards investors to manage adequately the liquidity risk of the investment fund (the figures we could see during the crisis demonstrated that asset managers increased the levels of cash to anticipate important redemptions).

In a market crisis, asset managers adopt a more defensive investment strategy and tend to increase the proportion of cash in the investment funds' portfolios: more cash in the portfolios indeed reduces the exposure to market risk. This leads to liquidity inflows at the custodian banks.

The funding base of the custodian banks is well diversified

Market practice shows that custodian banks benefit from a well-diversified customer base, mainly composed of two categories of investment funds

- The investment funds sponsored by a banking group, for which the banking group is sponsor, depositary bank and asset manager

- The other investment funds, sponsored by third-party financial institutions

The custodian banks' funding risk is hence split among a large number of investment funds and sponsors. It is therefore highly improbable that all the investment funds (and their sponsors) decide simultaneously to terminate their contractual relationship with the custodian banks. Should they however decide so, it would take a long time to terminate the custody contract, well above the 30 days period prescribed by the LCR.

Moreover, the volatility of the funding received from the groups' investment funds proves to be low due to the groups' decision to maintain the majority of the liquidity within the group. This is especially true in times of crisis where it becomes crucial for the group to maintain fast and safe access to liquidity.

2.5 Observed run-off factors

Methodology

We consider of primarily importance to deepen our analysis by observing the stability of the one-month funding deposited at the custodian banks.

For that purpose, we have aggregated the monthly balances of the (up to one-month) funding received by a sample of 8 significant custodian banks active on the Luxembourg marketplace. The observation period covers December 31st, 2006 to December 31st, 2009, i.e. 3 years. The category of investment funds observed consists mainly of UCITS.
The funding monthly balances are expressed on a 100 basis, i.e. the starting figure 100 represents the aggregated balance at December 31st, 2006.

Evolution of the monthly balances of the funding received by custodian banks

Graph 1 attached shows the evolution of the monthly balances, which start increasing in May 2007 when the first signs of the crisis materialized: first articles and discussions on potential problems linked to subprime started to emerge in the newspapers and the market. We can see a clear and rapid trend beginning Q1 2008 with steep cash inflows that were accelerated by the Bear Stearns problems and the subsequent takeover in May 2008 of the latter.

The balances then increased rapidly and reached a peak of 209 at the heart of the crisis in September-October 2008. Balances decreased afterwards. It is worth highlighting that the balance at December 31st, 2009, is stabilized at a high level (161) compared to the starting point of 100 (+ 61%). The observation proofs that the asset managers increase the cash positions of the investment funds in times of stress.

Monthly variations of the funding received by custodian banks

Graph 2 attached indicates the monthly variations of the funding, providing therefore a reliable evidence of the run-off factors over the period.

The monthly variations are comprised in a range varying from + 20% to – 12% and the average monthly variation is +1,6%.

The first worst negative variation observed during the crisis (- 6% in July 2008) comes from the significant redemptions on money market UCITS, which we explain in § 2.4.
After Lehman collapse (September 2008), investors redeem their shares resulting in cash outflows at custodian banks, leading to the negative peaks of -9% (November 2008) and of -12% (January 2009).

From March 2009, stock markets turn positive again. Asset managers then buy stocks to be in the uptrend. Cash holdings at custodian banks obviously go down as cash cushion of investment funds decrease.

When stock markets are positive, cash at custodian banks decrease because asset managers fully invest. When stock markets turn negative, the cash at custodian banks increase because of asset managers anticipating redemptions. This mechanism is countercyclical and works in favour of custodian banks' liquidity position. Custodian banks usually monitor stock markets closely as an indicator on future cash inflows or outflows.

We can conclude that the observations corroborate the qualitative arguments discussed previously explaining why the funding received from investment funds is significantly more stable than advocated by the Basel Committee proposal.

2.6 Conclusion

In order to fairly reflect the operational, legal and economic reality of the Custodian banks activity, we call for a maximum 25% run-off factor to be applied to the part of the (up to one month) funding related to the operational relationship between the investment funds at their custodian banks. This part of operational-linked funding is material as it represents, based on our observations, 70% to 95% of the total (up to one month) funding provided by the investment funds to their custodian banks.

The residual funding is not linked to the operational relationship and results from investment decisions taken by the investment funds' asset managers: we agree that it is, by nature, less stable. However, as a matter of reflection, we draw the Basel Committee's attention on the negative consequences, for the whole financial industry, of applying to such funding an overly conservative 100% run-off factor. Indeed, this residual funding is likely to be transferred from the banking sector to less regulated sectors, hence increasing the risk for the final investors (i.e. the investment funds).

3. Net Stable Funding Ratio: investment funds as an available stable funding category

The operational-linked (up to one month) funding provided by investment funds to custodian banks proves to be stable in the framework of the Liquidity Coverage Ratio, as we have demonstrated in section 2.

The rationale can be transposed to the NSFR framework and we think that the operational-linked funding fulfils the conditions of Available Stable Funding defined in § 82 as: *" that portion of stable funding non-maturity deposits and/or term deposits with maturities of less than one year that would be expected to stay with the institution for an extended period in an idiosyncratic stress event."*

Due to the operational link described in section 2.3, investment funds maintain with their custodian banks a stable relationship that is of a corporate nature. This stability over a one-year horizon and in times of stress is confirmed by the yearly variations of the funding, which we derive from graph 1 attached, i.e.:

- + 41%: December 2007 vs. December 2006
- + 48%: December 2008 vs. December 2007
- - 23%: December 2009 vs. December 2008

These characteristics should be recognised by the NSFR. Therefore, we propose to allocate, similarly to non-financial corporate customers, a conservative 50% Available Stable Funding Factor to the part of the (up to one month) funding related to the operational relationship between the investment funds at their custodian banks.

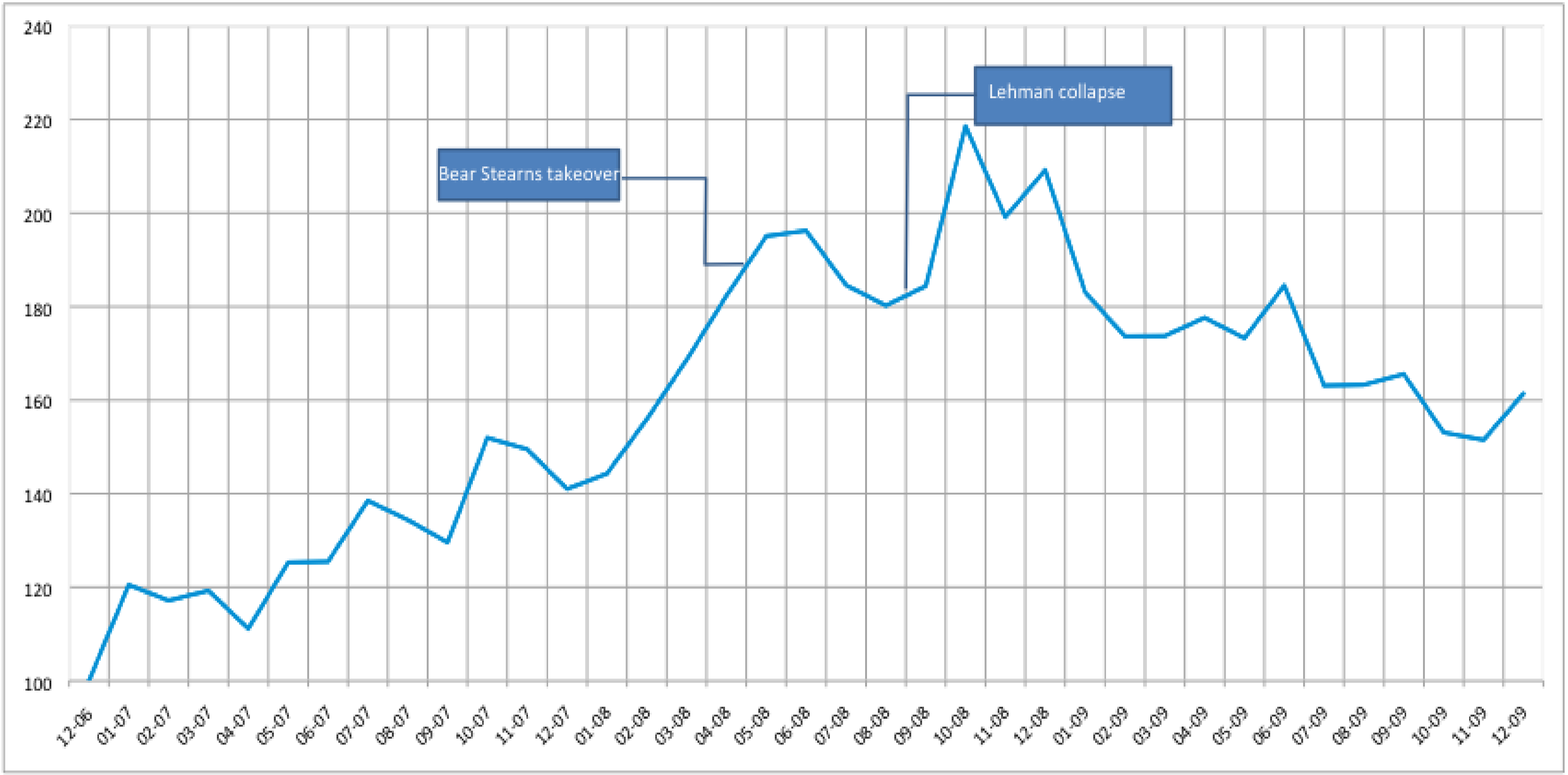
4. Net Stable Funding Ratio: investment funds as additional asset categories

We welcome that money market mutual funds are included in the category "All short-term unsecured instruments and transactions with outstanding maturities of less than one year", being assigned a Required Stable Funding Factor of 0%.

In order to be consistent, the investment funds investing in the other asset categories should also be recognised. For example, investment funds investing in sovereign debt rated AA or higher and assigned a 0% risk-weight under the Basel II standardised approach should be added to the list of the Asset Categories with the corresponding Required Stable Funding factor, i.e. 5%.

In the current proposal investment funds (other than money market mutual funds) are indeed unduly discriminated because they belong by default to the category “All other assets”, which is granted a Required Stable Funding Factor of 100%.

Graph 1: Evolution of monthly balances of the funding received by custodian banks



Graph 2: Monthly variations of the funding received by custodian banks