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

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Dear Sirs,

Response of Euribor ACI Money Market & Liquidity and Derivatives Working Group
On Discussion Paper – CD 165
International framework for liquidity risk measurement, standards and monitoring

Euribor ACI welcomes the opportunity to provide comments on the Basel Committee of Banking Supervision's consultative document 'International framework for liquidity risk measurement, standards and monitoring'. The proposed framework aims to reduce systemic liquidity risk and further enhance consistency in international liquidity risk supervision by introducing new monitoring tools and measures for the ongoing assessment of banks' liquidity risk exposures.

The framework builds on previously published work by the Committee to strengthen the resilience of internationally active banks and to address deficiencies in banks' liquidity risk management and to respond to the G20 recommendation to introduce tools, metrics and benchmarks to promote stronger liquidity buffers at financial institutions.

In contrast to individual banks, the response of both **Euribor ACI Money Market & Liquidity and Derivatives working groups** focuses on key issues and concerns that should have far-reaching effects on markets, pricing, banks' business models, concentration in the banking industry, and the economy as a whole. Moreover, we sometimes do make specific comments and remarks with respect to the Euro area and the ECB as we are an association of market professionals in Europe whose focus is the EURO markets.

Here are our key findings that we categorized as follows:

1. Markets and Economy

- The ability to perform two core functions of the banking sector, maturity transformation and liquidity distribution, would significantly be reduced if current proposals were implemented.

- The increased demand for long-term liabilities would make it more difficult and costly for financial institutions (FI) to issue long-term debt in order to meet the new requirements. Likewise, corporate issuers would find it more expensive and difficult to issue paper and they will thus shift demand for credit back to banks which at the same time would experience pressure on their lending activities to meet regulatory requirements. Both developments might result in higher funding costs not only for financial institutions but also for corporates eventually filtering through to customers.

- The market for such long-term liabilities is somewhat limited in volume to begin with and could be further reduced as financial institutions would effectively be excluded from investing in bank paper as these securities would represent no benefit for their liquidity buffers under these proposals. Therefore, one of the banks' key funding sources would disappear. In contrast, however, Basle's NSFR is set out to force banks to have significant amounts of long-term liquidity to effectively match-fund long-term assets.

- With other, often conflicting and contradicting regulatory approaches currently being discussed (e.g. French regulation reduces average duration from 90 to 60 days on money market funds or US regulation obliges fund managers to be liquid at least 30% of the outstanding in less than 7 days and decreases WAL from 90 to 60 days), global liquidity imbalances between financial institutions required to borrow long-term and asset managers that must invest short-term could be created exposing the entire financial system to much higher risks. Financial institutions could scramble and compete for limited amounts of long-term liquidity while getting flushed with short-term liquidity from asset managers. The ensuing dichotomy between increased requirements for long-term liquidity and excess short-term liquidity could be dangerous for financial institutions and the financial system as the market for liquidity could no longer function properly.

- Increased competition for retail deposits due to the higher demand for long-term liquidity will increase price sensitivity of depositors and erode the stable liquidity characteristics of this funding source. In addition, the simple calculated metric for retail deposit run-offs (7,5 % and 15%) seems to be arbitrary. It would be preferable for each firm to determine its own allocation of the stability spectrum across the different types of depositors. The minimum for each class should to be decided by the firm under the supervision of its regulator, depending on risk experience, a conservative analysis of the bank's sources of funding and market standing.

- The importance of global harmonisation and implementation of new liquidity regulations across the globe cannot be exaggerated. It is absolutely critical for creating a level playing field that any new liquidity rules are to be adopted and implemented at the same time and to the same extension by countries and financial institutions (no geographical exceptions!). Any deviation from both could result in arbitrage between locations and unintentional redirecting liquidity and business towards locations not exposed to these new rules. For the stability of the global financial system, it is crucial to avoid bottlenecks and obstacles to the free flow of liquidity, not only for this proposal but also for other regulatory activities (e.g. CEBS, FSA, FED, etc.)

2. Liquidity Buffer and Securities

- The narrow definition of liquidity buffer-eligible assets increases concentration risk. It discriminates long-term debt issuance of financial institutions in particular and, due to the additional demand for sovereign paper, entails a danger of crowding out non-sovereign debt instruments in general. Eligible assets for liquidity buffers would need to be held in large amounts possibly resulting in less liquidity in those assets due to a limited amount traded in the market.
  In general, central bank-eligible securities should be adopted by any new regulations on liquidity. For banks in the Eurozone in particular, all ECB eligible collateral should be allowed to be taken into account for the Liquidity Coverage Ratio (LCR). Otherwise, a significant re-pricing for securities no longer eligible for liquidity regulations but still ECB-eligible could take place and possibly endanger the repo and fixed income markets and could have severe negative effects on the economy as a whole, too. The mutual recognition of eligible highly liquid assets among central banks allowing banks to pledge assets with central banks in other jurisdictions in order to address (acute) liquidity shortfalls would also go a long way to make the global financial system more robust.

Another aspect with respect to assets is related to the data requirements that seem to be extremely cumbersome or even unrealistic for even liquid papers.

In conclusion, we would strongly recommend that the current definition of highly liquid assets is to be reviewed and expanded to include all central bank-eligible bank-, corporate-, and covered bonds with no additional haircuts beyond those already imposed by the respective central banks. This approach would enable financial institutions to have access to secured liquidity in systemically stressed markets.

> It is unclear how open market operations (OMO) will be treated for the purpose of the NSFR calculation (§84). With respect to borrowings from central banks in general, any new regulations should **NOT** stigmatize them in any environment or case. We welcome the fact, that the BIS committee is recognizing regular market operations as stable funding.

3. More General but still Critical Issues

> Public disclosure of liquidity ratios could result in an outbidding competition, but could also trigger and increase the speed of a liquidity crisis in case of deteriorating ratios. The public disclosure will seriously impair the buffer function of a bank's liquid asset portfolio, because using the buffer will signal weakness to the market (self-fulfilling prophecy).

> With business models substantially differing across the banking industry, the proposed '**one-size-fits-all'-** approach to funding and liquidity risk management does in our view not address institution-, market- and country specific liquidity risks and could expose the entire banking and financial system at greater risk if implemented. It would be more beneficial to the financial system if only minimum requirements/standards were established in a 'core set of regulations/rules' while, at the same time, more room or leeway for banks to account for their individual assessment of their specific liquidity risk supervised by local regulators.

> At the same time, the goal of international harmonization and comparison of institutions could be jeopardized by national discretion and room for interpretation of proposed rules. With the implementation of some rules being at the discretion of national supervisors, the room for regulatory arbitrage and reducing transparency and comparability across institutions in different jurisdictions are certainly possibilities. Therefore, regulators further need to ensure that rules are interpreted and applied consistently among FIs to safeguard comparability of results even within a single jurisdiction.

> For a prudent and effective liquidity management, new liquidity rules are to be applied to consolidated banking groups, i.e. on a group-wide instead of a legal entity level.

> The impact of different accounting standards on the proposed ratios (e.g. with respect to the netting of positions) needs to be considered to ensure comparability between financial institutions.

> In general, the paper's assumptions appear to be extremely conservative that could not really be evidenced even by severe events of the financial crisis. It seems obvious that "stress" has been defined as an accumulation of each and every worst case scenario possible. This does not reflect a realistic and probable risk scenario, in particular the combination thereof.

> Various clarifications of rules are required to avoid ambiguity and room for interpretation (e.g. treatment of intra-group funding lines, assessment of liquidity of assets in times of stress, effective deposit insurance

scheme, early termination of savings deposits, gross vs net assessment of collateral and margin movements, etc.).

> Too rigid quantitative requirements imposed by regulators will reduce incentives for banks to use and develop internal risk models and tools.

> Regulatory targets are in parts conflicting (e.g. leverage ratio vs. liquidity portfolios).

> Increased administrative burden and need to upgrade reporting systems/ processes to obtain excessively granular data required to comply with proposed rules. A balance needs to be struck between increased granularity and effective management control.

> The reporting frequency and the data granularity required might create implementation problems across the banking industry.

> Additional costs to achieve regulatory compliance will increase costs for bank products and will be charged to clients.

> To a large extent, the results delivered into the QIS will have to be based on assumptions and estimates as the requested data granularity is not readily available in the reporting systems. The timeframe for the QIS is too tight to implement necessary system upgrades. QIS results and final ratio specifications derived from it will therefore depend too much on qualitative and possibly varying assumptions made by the participating banks.

4. Weaknesses in methodologies and inconsistencies

Liquidity Coverage Ratio (LCR)

> The 0% RWA criteria for the determination of liquid assets is unreasonable as it would for example exclude US agency debt (Fannie Mae / Freddie Mac) from liquid assets. We would recommend a review leading to a new set of RWA criteria that includes assets beyond 0% risk-weighting.

> The treatment of central bank liquidity reserves needs to be clarified. §34(c) in the CD165 leaves it at the discretion of the local regulator and central bank which of the central bank reserves can be included into liquid assets. This in turn will lead to a lack of comparability and regulatory arbitrage across locations.

> It is not clear whether the proposed 50% limit for corporate and covered bonds in the overall stock of the liquidity buffer should be applied before or after haircut.

> The haircuts on corporate and covered bonds are very harsh and go beyond market experience during the crisis. The requirements for market data (bid-offer-spread and price fluctuations) are very difficult to fulfill.

> The rationale for applying a 20-40% haircut to bonds that have seen no price moves greater than 10% over the course of 10 years seems not appropriate (also: how would bonds without a history of 10 years be treated?).

> Equities, gold and other precious metals are not eligible as liquid assets. This treatment is too restrictive and cannot be justified by the experience made during the crisis. These assets should be recognized as inflows.

> Lack of differentiation of wholesale deposits: The proposed LCR rules specify a 100% run-off factor for deposits of financial institutions, fiduciaries, beneficiaries, conduits, SPVs. This ignores the operational nature and hence the relative stickiness of funds that banks receive in the course of their clearing and settlement business (clearing balances) as well as fiduciary activities and should be reviewed. It punishes transaction banking activities which are vital for any economy, not of a speculative nature, and have not played any destabilizing role in the recent crisis. The proposed treatment will significantly increase the cost of these services, could lead to a further concentration and increase systemic risk in the clearing and settlement industry.

All of the above should have severe implications and repercussions for the interbank market (see details in attachment below). In conclusion, we are of the opinion that any new obstacles limiting or jeopardizing the 'free flow of liquidity' across the world should be avoided or, at least, be subject to a very rigorous and detailed analysis on what their negative effects would be. Neither seems to have been applied here.

> A 100% run-off factor applies to own debt maturing within the 30d horizon unless the investor is known to be retail. It is not possible to determine with certainty whether the final investor in a retail debt instrument is in fact a retail customer (natural person) or not. Again, it needs to be clarified that own debt that is callable by the issuer does not fall in the scope of the LCR.

> The requirements of #33 in combination with the statements that banks shall not rely on central bank funding (#84) and wholesale flows have a zero roll-over assumption seem to indicate that you would need a liquidity buffer in each currency even if Central Bank A would accept collateral denominated in currency B (e.g. Fed accepts EUR collateral). #33 is not very clear as you would only calculate the LCR in one currency but maybe your local regulator wants to know it on single currency level as well. To avoid any ambiguity the proposal should make it very transparent that the LCR is a consolidated ratio taking all currencies into account on a group level.

> Differentiation of liquidity facilities and credit facilities is unclear. How are multi-purpose facilities seen in this context (§66, §76 Draws on committed credit and liquidity facilities, lines of credit)?

> The assumption that 10% of all credit facilities are drawn is not plausible.

> Committed facilities to financial institutions are assumed to be drawn by 100%. Lines of credit that the bank receives, however, do not receive any value. This asymmetric treatment is not plausible, as the flow of funds in the financial system will not add up. For group internal credit lines, this asymmetric treatment is also not plausible.

> For other contingent funding liabilities, articles refer to a broad range of 'other contingent funding liabilities'. The assessment and treatment will be determined by the national supervisor and the bank and is currently unclear (scope includes uncommitted lines, guarantees, LCs and other trade finance instruments, but also potential requests for buybacks of own debt instruments and market making activities).

- It is unclear whether overdrafts and until further notice facilities are to be included as inflows and whether this would include the drawn and undrawn amount of these facilities (e.g. most of the credit lines extended to clients can be revoked at the discretion of the bank and without further notice).

- LCR outflow parameters are crude and overly conservative. It is not transparent to the financial industry how the parameters used in the proposed rules were derived, especially as they cannot be substantiated by the experience made during the crisis.

- According to the proposals (§21), banks are expected to meet the requirements of the LCR on a continuous basis. Therefore, the liquid assets could not be used to generate liquidity in times of stress without breaching the regulatory requirements for the liquidity buffer. It should be clarified under which circumstances banks could liquidate the assets of the liquidity buffer and what consequences would arise from such a breach of the regulatory standard.

- In the LCR (§58), a 100% outflow would apply on secured funding transactions (maturity within 30 days) backed by illiquid and less liquid securities. At the same time, no liquidity value will be assigned to the underlying assets received out of the maturing secured funding transaction. This results in an inconsistent treatment of those assets that are generally eligible for inclusion into the additional assets buffer under section A2 of the LCR as it implies that they have no liquidity value. In contrast, however, they are being recognized as additional buffer asset and granted a liquidity value if funded on an unsecured basis. The rules should be reviewed in this regard to eliminate the apparent inconsistency.

Net Stable Funding Ratio (NSFR)

- With the NSFR looking at the 1-year horizon, we would argue that it would be very unlikely that any financial institution would maintain the same balance sheet (size and/or structure) for one year in either a market or idiosyncratic crisis. In addition, a considerable time gap between LCR (30 days) and NSFR (1 year) would be introduced. Consequently, it might be beneficial to review the time horizon of the NSFR and analyze whether a short time horizon for the NSFR would be more effective.

- Rules are partially ill-conceived. E.g. for NSFR purposes a covered bond issued by a bank will lose its eligibility as available stable funding once the remaining maturity is less than 1 year. At the same time the cover pool will remain to require stable funding, even though the cover pool assets may also mature within one year. To keep the NSFR stable this would imply that the cover pool assets would have to be refinanced twice for one year. A similar issue exists for loans that are refinanced by dedicated funding from agencies such as KfW on a fully matched basis.

- In a number of instances the rules are asymmetric, such that the aggregate impact across the industry captures outflows, but fails to recognize that there will be corresponding inflows across the system. The final calibration of requirements needs to recognize this.

- Equities are not recognized as liquid assets. This treatment is a too restrictive and cannot be justified by the experience made during the crisis. Likewise, gold and other precious metals are not recognized as liquid assets. These assets should be recognized as inflows for the LCR and should not require term funding under the NSFR

- It is unclear how open market operations (OMO) will be treated for the purpose of the NSFR calculation (§84)

- One of the key objectives for prudent liquidity risk management in banking is to develop relationship driven, stable and diversified funding sources, both with retail and wholesale clients (funding diversification). The definition of 'stable' and 'less stable' funding and the respective ASF does not appropriately recognise the value of a well diversified funding base. The ASF factors should give credit to banks where the national regulator has satisfied itself that even in stress scenarios as defined by the Committee, relationship driven and diversified funding sources are mitigating a bank's liquidity risk exposure.

- Capital as defined by the global capital standards of BCBS excludes goodwill and other capital deduction items. To avoid double counting, the same deduction items should also be excluded from the definition of total assets of RSF.

- With respect to the definition of required stable funding (§89), the rationale for the RSF factors applied to securities should be clarified. What is the rationale for a 10% haircut on off-balance sheet commitments?

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Annex

Implications for the Interbank market (from page 6):

Central banks and governments have put in a lot of efforts to revitalize the interbank market by improving liquidity, extending duration, and restoring trust among market participants.The BIS paper seems to be counterproductive to these goals in a number of ways.

⇒ Under certain (severe) scenarios, interbank liquidity could very well be limited but it won't be zero

⇒ Banks would typically start reducing the duration of their lending before cancelling their credit lines and shutting down its trading activities

⇒ With these proposals implemented, banks across the entire spectrum could not get any benefits from wholesale funding liquidity beyond its maturities when determining their LCR

⇒ No differentiation among banks is made even though substantial differences in business model, market access, etc. Exist

⇒ WSF would become very unattractive as a funding source, even more so as the liquidity buffer could not hold any securities from financial institutions

⇒ In addition, the 30day horizon would force banks to lengthen their duration with only limited supply available

⇒ With the importance and attractiveness of the interbank market being significantly reduced by these proposals, banks would need to shift their focus to central bank and long-term funding (from capital markets)

⇒ **HOWEVER:** The Basle paper stresses the fact that central bank funding should not be seen as a reliable funding source. Moreover, financial institutions as a key investor in long-term funding (capital markets issuance) are penalized by not being able to use these securities as part of their liquidity buffer.

Considerations to limit currency exposures within the financial industry could lead to less liquid FX markets further jeopardizing the banks' ability to effectively distribute liquidity to where it is required