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Basel Committee on Banking Supervision

Consultation document: *International framework for liquidity risk measurement, standards and monitoring*

Euroclear response

The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the Euroclear group includes the International Central Securities Depositary (ICSD) Euroclear Bank, based in Brussels, as well as the national Central Securities Depositaries (CSDs) Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & Ireland.

We are pleased to be given the opportunity to provide our view on the consultation issued by the Basel Committee on Banking Supervision, *International framework for liquidity risk measurement, standards and monitoring.* The views expressed in the responses to this consultation are similar to those communicated to the European Commission on *Possible further changes to the Capital Requirements Directive*. We have only included comments for which we believe our views can be helpful to the Committee.

General comments

We support the Committee's work aimed at enhancing liquidity risk management at financial institutions. In that respect, we understand that there is a need to take bold and swift remedial measures, as there is intense pressure on regulatory bodies, and as acceptance of necessary but radical initiatives may weaken when the dust fully settles. However, there is a general concern among industry participants that the cumulative effects of the proposed measures still need to be appropriately assessed; this concerns both the impact on banks' liquidity risk management and business models, as well as the indirect consequences on the markets for liquid assets, funding markets, lending and investment practices and economic growth.

In particular, we understand that the BCBS proposals intend to influence banks in their preference for short-term vs. long-term funding. However, increased demand for longer-term funding can be expected to structurally impact funding markets, as banks will need to manage their liquidity exposures and asset books within longer timeframes than is usually the case today. We believe that banks will face the need to flexibly manage their liquidity and access their collateral at all times, even if such collateral is tied up in longer-term transactions. We would like to note that, in that respect, some market-based solutions, like Euroclear Bank's Triparty repo service, offer the possibility to substitute assets in case of need, while maintaining the same level of funding throughout the chosen period. Not only the borrower, but also the lender, will expect some flexibility. This is why the possibility to reuse the collateral taken in a repo transaction for funding purposes should not be constrained excessively.

From an organisational perspective, we would like to note that the timelines proposed for the finalisation (including calibration) and for the implementation of the proposals seem excessively tight. Concerning implementation, as the proposals will require extensive IT developments, we would favour some flexibility regarding implementation deadlines. Implementation by end-2012 would oblige institutions to

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set aside a substantial budget for that purpose during one single budget-setting period.

We finally wish to draw you attention to the fact that some proposals outlined in the document may have unintended consequences for market infrastructures providing clearing and/or settlement services for clients, and therefore for the smooth processing of transactions in the post-trade environment. This concerns in particular proposals to take undrawn credit facilities, which may be cancelled unconditionally at any time without notice, into account as cash outflows under the Liquidity Coverage Ratio and under the Net Stable Funding Ratio, though a number of other elements may also have a bearing on post-trade infrastructures that need to comply with Basel II.

Liquidity Coverage Ratio

Stock of high quality liquid assets

We believe that, in addition to the liquid assets defined on p.9-10, all central bank eligible assets would also need to qualify for the liquidity coverage ratio. Excluding any central bank eligible asset would not be realistic, as they are used in day-to-day operations by market participants to obtain central bank funds when needed, and by the central bank to conduct monetary policy operations. It is unlikely that central bank eligibility criteria would be rendered stricter in times of crisis.

We would advocate also including foreign assets that are eligible at central banks other than the local central bank, as well as other foreign liquid assets (including mainly sovereign debt in countries receiving a risk-weight higher than 0% under Basel II).

Please note that the terms used for corporate bonds, "central bank eligibility for intraday liquidity needs or overnight liquidity shortages in relevant jurisdictions" seems to exclude assets eligible for (longer-term) monetary operations. This may appear unduly restrictive, the more so as such a restriction does not seem justified.

From a more theoretical perspective, it would be advisable not to be too restrictive concerning the range of eligible assets, with a view to ensuring the continued availability of the relevant asset classes in the future. An example is government debt. A decade ago, officials started to worry about how monetary policy could be conducted in a world in which the levels of government debt outstanding were declining structurally. Although this scenario has now left the realm of possible medium-term outcomes, this point still needs to be kept in mind. A too restrictive list bears the additional risk of artificially inflating demand for certain asset types, potentially affecting private investment and thereby economic recovery if government debt were to be excessively favoured.

Finally, we believe that the requirement stating that "Banks are expected to meet their liquidity needs in each currency and maintain high quality liquid assets consistent with the distribution of their liquidity needs by currency" (p.9) is too restrictive. Indeed, maintaining liquid assets in all currencies in which institutions are active, including minor currencies, would impose an unnecessarily high burden on banks, as liquidity or collateral would be trapped in numerous markets. If applied too literally, the requirement would create an undesirable incentive for banks to restrict their operations to local (and a few complementary or major) markets. In addition, this would unduly create foreign exchange risk, especially if it is sized to cover exceptional liquidity demands. It may particularly affect institutions offering settlement services in many currencies and markets, like Euroclear Bank. The positions that such institutions have at their cash correspondents in local markets is

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driven by client behaviour; it is therefore highly unpredictable, and rather volatile. While end-of-day positions tend to be positive, debit positions can and do occur, and are generally resolved by the next business day. Agreements with cash correspondents ensure the continued provision of short-term liquidity to cover such needs.

Net cash outflows

We would like to draw your attention to the fact that defining one single set of run-off factors for many different types of institutions may be challenging. Client behaviour may vary depending on the type of shock, but also on the type of institution concerned. For some institutions, the consequences of idiosyncratic and market-wide shocks may be diametrically opposed. During the recent market turmoil, highly-rated or single-purpose institutions saw negative run-off factors, as other market participants chose to leave their cash balances with such institutions. This was the case of Euroclear Bank, which, in the autumn of 2008, did not experience any liquidity shortages, but rather needed to manage exceptionally high inflows of liquidity.

The comments below relate to a few specific proposals contained in the Committee's document.

With regard to unsecured wholesale funding provided to non-financial corporate customers, sovereigns, central banks and public sector entities with operational relationships, we believe that the accounts concerned should be comparable to the transactional accounts mentioned for retail activities. The list of services provided on such accounts could include clearing, settlement and custody services, such that they would cover "accounts used by clients for clearing, settlement and custody services". We would also like to draw your attention to the fact that such transactional accounts are also offered to credit institutions or to other financial institutions; we believe that they would deserve a lower run-off factor than that proposed for credit institutions (100%).

We believe that off-balance sheet items that are unconditionally cancellable should not be taken into account in a LCR, and in particular unconditionally cancellable credit lines. There are several reasons for which such an inclusion would not provide a meaningful contribution to the LCR:

- Such elements are unlikely to lead to a material increase in net cash flows over the relevant timeframe, as the institution is entitled to revoke them unilaterally, unconditionally, and immediately. For example, reputational considerations would not prevent Euroclear Bank from reducing or eliminating outstanding credit lines if they were believed to increase the risk to the ICSD beyond its risk appetite.
- Such credit lines are unlikely to be used simultaneously. Including all these lines in the LCR assumes simultaneous usage of the lines.

In addition, including unconditionally revocable credit lines is likely to substantially affect institutions providing payment, clearing and settlement services for clients. Intraday credit provided by such institutions contributes to the well-functioning of financial markets. Including it in a regulatory ratio bears the risk of hampering the smooth settlement of financial market transactions, thereby increasing risks in the market.

As explained in Euroclear's Pillar 3 report (p.34, to be found on www.euroclear.com), Euroclear Bank extends short-term credit to its participants to facilitate the

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settlement of securities transactions. When the buyer does not have sufficient cash on its account to settle a transaction, temporary credit is extended, allowing settlement to take place efficiently. Such credit extensions occur when participants do not hold their cash reserves in Euroclear Bank and/or there are structural time lags in the flow of funds as a result of time-zone differences and differences in operating hours of the various intermediaries involved in payments.

Generally, the duration of exposures is less than 24 hours (ie intraday). The duration varies with the sources of exposure and funding. Participants for which cash flows are mainly driven by purchase and sales within the Euroclear system in a back-to-back mode, may need credit only for a few milliseconds, to allow the chain of transactions to settle. Exposure that needs to be funded by either cross-border deliveries or credits on Participant accounts from external intermediaries tends to last longer, up to several hours. Only in unforeseen circumstances (primarily as the result of settlement failures or delayed credits), part of the exposure can become an end-of-day overdraft retained in the books of Euroclear Bank until the next day.

This credit is unilaterally, unconditionally and immediately cancellable, and Euroclear Bank would not hesitate to decrease or cancel such lines when the financial health of a client would deteriorate. Therefore, we believe that such credit lines should not be considered as leading to cash outflows.

Finally, we wish to highlight that (intraday) credit provided by Euroclear Bank is collateralised in the vast majority of cases (on average, more than 98% of the value of such credit is collateralised), with some uncollateralised credit facilities offered to central banks that cannot enter into secured transactions for various legal reasons. Collateralisation of these exposures allows Euroclear Bank to control adequately the credit and liquidity risks that it runs when clients make use of their facilities. In particular, with regard to liquidity risk, Euroclear Bank has developed some specific solutions to allow it to bridge the time gap between a participant default and cash inflows from collateral sale, making use of the pledged participant collateral. However, the current proposal does not take into account collateral, which does not lead to increased amounts of liquid asset nor to decreased net outflows.

We also believe that the potential asymmetrical treatment of unilaterally cancellable credit lines, with the inclusion of outflows and the exclusion of inflows, is not consistent. As explained above, this would unnecessarily penalise firms that specialise in the provision of services to institutions, for example in the field of clearing and settlement.

Net Stable Funding Ratio

As explained above, we believe that unconditionally revocable credit lines should not be included in the NSFR. In the case of institutions offering such lines to facilitiate clients' settlement and custody activities, they do not lead to liquidity demands at the proposed maturities.

It seems to us that the treatment of repos and reverse repos may need to be clearified under the NSFR. As repos shoud not be considered as stable funding, we would have expected in application of the symmetry principle that reverse repos with a maturity shorter than one year would not need to be considered either. However, to be granted a 0% RSF factor is subject to conditions (annex 2).

Monitoring tools

We would like to flag that, if reporting is required to be done on a daily, or even weekly basis, institutions will not be able to use their accounting models for that purpose, as definitive figures are not available within such a short timeframe (due, among others, to back valuations of receipts). Not relying on accounting models

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would make consolidation of data amongs different group entities, located in different countries, meaningless, as the basis for reporting would not be harmonised.

We believe that the liquidity standards should apply at an individual institution basis for those groups in which one single credit institution coexists with other entities that do not run material liquidity risks. This would be the case of Euroclear. While it is meaningful to apply the liquidity requirements set out in the Commission's proposal to Euroclear Bank, requesting additional measurement and monitoring of liquidity risk at consolidated level (Euroclear SA/NV or even Euroclear Plc) would be overly burdensome and would not bring any benefits in terms of liquidity risk management. In addition to Euroclear Bank, the Euroclear group mainly consists of Central Securities Depositories (CSDs) that are not credit institutions. These CSDs do not face any material credit or liquidity exposures, as they only carry out the securities leg of securities transactions and do not grant any credit to their clients. They are also subject to specific local regulatory liquidity requirements in the countries in which they operate, so as to ensure that they can continue operating under all circumstances.

Presentation and drafting

Please find hereunder some suggestions regarding the presentation and drafting of the chapters of the BCBS' paper, with a view to improving clarity and consistency:

- §29: We believe that "flight to quality" is a behavioural element, not a market characteristic.
- §56: A run-off of 100% is only realistic for short-dated bonds, notes and debt securities, whereby the institution needs to roll-over such debt to fund its activities. Long-term debt cannot be drawn upon in case of idiosyncratic stress.

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