International Banking Federation

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

Dear Madams and Sirs,

Sent by e-mail to baselcommittee@bis.org

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

The IBFed welcomes the proposals for an *International framework for liquidity risk measurement, standards and monitoring* put forward by the Basel Committee for Banking Supervision (Committee). The recent crisis underlines the need for a common approach to liquidity risk standards which, compared to the framework for capital, is relatively underdeveloped. As such we view the Committee's proposal as the first stage in an on-going discussion to develop global liquidity standards.

In terms of the proposed regulatory standards, in principle we support the introduction of a short term ratio that focuses on the adequacy of a financial institution's liquidity buffer in times of stress and a long term ratio that focuses on the structure of its funding. The adoption of such standards will help to promote a more balanced approach to funding in the industry and facilitate the establishment of a globally consistent framework.

While we support the introduction of minimum quantitative standards, we caution the Committee against the introduction of an overly tight and prescriptive one-size-fits-all framework. Moreover, the proposed requirements do not appear to reflect minimum standards but rather a maximum stress test based on an aggregate of recently experienced stress scenarios.

We also welcome the Committee's proposals for common monitoring tools and the inherent recognition for a need of a number of metrics to fully capture a bank's liquidity risk profile. We note our recent letter of 22nd December 2009 to the Chairman of the Committee which provided further recommendations on further harmonising reporting standards and urging the Committee to develop a cross-border liquidity framework via Colleges of Supervisors.[1]

The ability of the proposed framework to facilitate effective liquidity risk management and supervision will depend on the Committee's use of the Quantitative Impact Study (QIS) results to calibrate the ratios and haircuts, as well as final decisions on the composition of the stock of liquid assets. We have serious concerns about the proposed calibration of the ratios and haircuts and the very limited definition of liquid assets. We encourage the Committee to consider very carefully the calibration of the new liquidity measures to avoid pro-cyclical metrics that could impede banks' ability to perform their traditional and important intermediation functions.

CD 165 generated a great deal of discussion amongst IB Fed Members. The key messages are highlighted below:

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[1] http://www.ibfed.org/content/1/c6/01/71/27/IBFed_press_release_re_colleges_of_reg_paper.pdf

Macroeconomic impacts: lending to consumers and business

The potential macroeconomic and market impacts of the proposal raise significant concern, especially when combined with the potential impacts of other initiatives advanced in the Committee, other international fora, by the accounting standards setters, and by national legislatures and regulators. Insufficient attention has been given to the cumulative impact of these initiatives and the unintended consequences that may result there from.

Phase-In

Any new liquidity standards need to be phased in, taking into account the impact of those changes on the market during the various phases of implementation.

Purpose of Regulatory Standards

Regulatory standards generally are designed to be minimum standards reflecting "business-as-usual" market conditions, with higher standards imposed on a case-by-case basis given supervisory concerns and risk profiles. We believe that the proposed specific stress scenario used to measure liquidity risk as a minimum global standard is too extreme. In particular, the NFSR needs to be re-calibrated to reflect "business-as-usual" market conditions typical of a one-year horizon, or possibly even a mild stress test scenario, rather than worst case "tail" event scenarios that are more severe than those experienced in 2007-2008.

More Flexible Approaches

We urge a more flexible comply-or-explain approach to determine whether a bank has adequate funding liquidity in light of its overall liquidity risk management program. This is particularly important for long-term funding liquidity.

Liquid Asset Definition

While we support the concept of holding a liquidity buffer, we are very concerned by the narrow definition of eligible liquid assets and the stress assumptions applying over 30 days. Thus, we urge the Committee to expand the definition to include assets that historically have been liquid even under stressed conditions subject to appropriate haircuts.

Scope of Application

We note that the application of the new framework could be on a consolidated and, potentially, on a legal entity basis. Thus, we would like to invite the Committee to provide more clarity about the scope of application of the reporting. Further, we urge the Committee to apply the framework on a consolidated basis where appropriate to allow banks to reap the benefits of managing liquidity centrally.

Public Disclosure

While we generally support transparency, the Committee's proposal imposes far-reaching public disclosure requirements on the standards and monitoring metrics. Therefore, we believe that prior to actual public disclosure, banks, regulators, and the markets require a better understanding of the new metrics and their impact within and across jurisdictions. In our view the roll-out of common public disclosure requirements should be limited to qualitative information.

We hope all our comments will be of interest to the Committee. Please find our detailed comments relating to our key messages above in the following Appendix.

Yours truly,

Sally J Scutt

Sally Scutt

Managing Director

Appendix – Detailed Comments for Basel Consultative Paper on Liquidity

Macroeconomic impacts: lending to consumers and business

The potential macroeconomic and market impacts of the proposal raise significant concern, especially when combined with the potential impacts of other initiatives advanced in the Committee, other international fora, by the accounting standards setters, and by national legislatures and regulators. Insufficient attention has been given to the cumulative impact of these initiatives and the unintended consequences that may result there from.

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. As such, the new requirements will lock up huge amounts of liquidity in the banking sector.

Overall, we believe that the amount of eligible liquid assets and longer term funding required by banks would materially distort markets. Higher funding costs would be passed on to borrowers resulting in a contraction of long term growth.

Our Members have discussed these proposals with their respective member banks. Many banks indicate that they will have to increase significantly their stocks of liquid assets in order to meet the 100% funding of the Liquidity Coverage Ratio (LCR).[2] The construction of the Net Stable Funding Ratio (NSFR) needs to consider the delicate balance between providing greater financial stability and draining long term liquidity as the pool of investors providing long term liquidity is expected to shrink considerably. The current formulation of the LCR and NSFR would translate into an increased demand for long term funding and no doubt increase funding costs, which again would be passed on to customers as margins are compressed. Cost of funding for banks would increase, further increasing the cost of lending for customers and decreasing their returns on bank deposits not deemed to be stable. This, in turn, likely would lead to bank business being diverted to other sectors of the economy, including the unregulated sector.

The use of similar assumptions under the LCR and the NSFR for determining whether an asset can be monetised over a one-month and one-year timeframe does not reflect the ability of a broader range of assets to be monetised over a longer timeframe. The assumptions also do not reflect that banks will implement contingency plans and revise business decisions and business plans over the longer one-year horizon in response to liquidity stress.

Our concerns about the macro-economic impact of the Committee's proposals are heightened when we consider the potential impact of the Committee's liquidity proposals in conjunction with the new capital requirements agreed by the Committee in 2009 and the capital proposals contained in the Committee Consultation Document 164 *Strengthening the resilience of the banking sector*.

Phase-In

Any new liquidity standards need to be phased in, taking into account the impact of those changes on the market during the various phases of implementation.

To this end we note the Committee's 17 December 2009 statement that a fully developed set of standards should be in place by the end of 2010 with the aim of phasing them in, subject to economic and financial market conditions, for implementation by end-2012. The fact that final calibration of the ratios has not been set makes it difficult to fully evaluate the appropriateness of the current timetable for implementation. However, we suggest that the Committee's liquidity proposals be considered more carefully over a longer timeframe, with implementation ***starting***, rather than finishing at the end of 2012. This would allow for an improved understanding of the likely impact on the global economy, to better understand the trade-off between

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[2] The creation of long term funding by banks will be heavily curtailed by the exclusion of bank CD's and FRN issues from financial institutions from the LCR. Liquidatum Ltd has calculated that the top 60 banks in the world will have to raise €3 trillion in long term funding to reach the 100% coverage mark based on 2008 figures. There are concerns that this will result in significant deleveraging as firms are likely to adapt their business model rather than raise more expensive long term funding. The economic impact will potentially be reduced access to finance for consumers.

risk reduction and economic growth, give markets sufficient time to stabilise and let some form of 'new normality' establish itself before the new liquidity standards are fully implemented, at some point after 2012.

We recommend that any new measures be implemented gradually over several years to allow for sufficient time to develop and implement information technology system enhancements.

Furthermore, the Committee must not underestimate the workload the proposals require. Complying with the new requirements – LCR, NSFR and suite of monitoring tools – is not dissimilar to a Basel II implementation project for which a minimum of 12 months was accepted by most regulators as a reasonable lead time once rules had been agreed at the national level.

Purpose of Regulatory Standards

Regulatory standards generally are designed to be minimum standards reflecting "business-as-usual" market conditions, with higher standards imposed on a case-by-case basis given supervisory concerns and risk profiles. We believe that the proposed specific stress scenario used to measure liquidity risk as a minimum global standard is too extreme. Further, we believe that the various and numerous restrictions and factors used in the LCR and NSFR associated with the stress scenario are, in the aggregate, unnecessarily onerous. In particular, the NFSR needs to be re-calibrated to reflect "business-as-usual" market conditions typical of a one-year horizon, or possibly even a mild stress test scenario, rather than worst case "tail" event scenarios that are more severe than those experienced in 2007-2008.

Furthermore, the Committee is not entirely clear in its objective whether it is treating a financial institution as a going concern or a gone concern. Paragraph 20 states that the LCR "should enable the bank to survive until day 30 of the proposed stress scenario, by which time it is assumed that appropriate actions can be taken by management and/or supervisors, and/or the bank can be resolved in an orderly way." Moreover , no reference is made that the liquidity buffer is expected to be used in times of stress to alleviate funding pressures, leaving the reader with the impression that the LCR is there to ensure funding for the gone concern, implying a requirement for a "buffer on a buffer."

We maintain that liquidity buffers are there to be used in stressed times to ensure that a firm remains a going concern, even if this means they may need to temporarily be run below the levels set by supervisors. We concede that there needs to be an appropriate governance structure and day-to-day oversight for the use of the buffer (and for its level to be considered in the light of other liquidity measures and metrics). If there is a crisis - which may be measured by the firm triggering certain liquidity or other metric hurdles - then the institution's Contingency Funding Plan (CFP) would be activated, and if necessary, its supervisors advised. Such plans would, of course, include the plan for the subsequent rebuilding of the buffer after the regulatory level has been breached, once the institution's crisis has passed.

We agree that supervisors should be able to challenge the level of the buffer at any time and that they should be able to satisfy themselves that the appropriate governance processes to control the buffer are in place.

More Flexible Approaches

We urge a more flexible comply-or-explain approach to determine whether a bank has adequate funding liquidity in light of its overall liquidity risk management program. This is particularly important for long-term funding liquidity.

We believe that each firm should be using assumptions tailored to their particular circumstances and experiences. Consistency could be achieved by using common risk-based principles to arrive at appropriate run-off rates and haircuts for each firm, with regulators reviewing and challenging each firm's assumptions to ensure adherence to these principles. As such, we believe that the liquidity measures should continue to evolve over time so they can more appropriately capture firm-specific liquidity risk.

Although we recognise that the Committee's proposal for a liquidity risk framework is at an earlier stage of development than the Committee's standards for credit, market and operational risk, we remain concerned about the prescription of standardised factors in the supervisory scenarios for both LCR and NSFR ratios. Such an approach stands in contrast to the Basel II requirements which actively encourage firms to use internal

models to improve risk measurement and management and to better understand firm specific risks. We continue to support this approach.

Furthermore, we suggest, that the Committee's run-off assumptions are too conservative. We believe that these assumptions are likely to outweigh any internal assumptions, thus discouraging institutions from assessing and understanding their own risk drivers as there are no incentives in the framework to undertake such an internal assessment. We therefore caution the Committee against being overly prescriptive in setting behavioural overlays that should apply to outflows and inflows given the difficulty in definition of stable vs. non-stable sources of funds. We urge the Committee to remember that there is a multi-dimensional liquidity spectrum across different types of depositor and types of product. So to draw hard lines within that spectrum and apply behavioural overlays to each segment may create dysfunctional risk insensitive behaviour in the evaluation of the liquidity risk and hence, ultimately, pricing of the liquidity spectrum.

In this respect it would be helpful for the Committee to explain how the percentages for the outflows and inflows were derived – they do seem somewhat ad-hoc. In many cases they appear even more severe than experienced during the recent crisis. By publishing prescribed outflows the Committee takes away from an institution the ability to set its own liquidity risk appetite and dictates the way in which the industry will value different types of funding. We are concerned that regulatory arbitrage will result and dysfunctional pricing follow.

Furthermore, we stress 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. 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.

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 liquidity risk to which they are exposed – the understanding being that those internal frameworks would need to be validated by supervisors on the basis of criteria which should be transparent and flexible and which should in any event conform with the Committee's "Principles for Sound Liquidity Risk Management and Supervision". Supervisors could make use of the quantitative standards proposed in CD 165 as a benchmark – meaning the quantitative standards proposed in CD 165 would be imposed as a de minimis standard on those banks that fail to set up an adequate internal quantitative framework, and only on them.

The NSFR should be built up as 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 mild stress test scenario.

As the NSFR metric is to follow a firm specific stress (see paragraph 83) it appears entirely plausible within the framework to include central banks as a possible funding source – albeit only to the extent of their business-as-usual monetary policy.

Furthermore, the assumptions from which the proposed NSFR are derived ignore changes in its business model that a bank 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.

Liquid Asset Definition

While we support the concept of holding a liquidity buffer, we are very concerned by the narrow definition of eligible liquid assets and the stress assumptions applying over 30 days. Demand for eligible liquid assets would increase their price, and conversely, reduce the price and demand for ineligible assets, including those that have retained good market liquidity in most observed stressed environments. The limited scope of eligible liquid assets could also lead to reduced liquidity, particularly during periods of stress, as all banks may look to the same assets to improve their liquidity positions at the same time – the so-called "herd behaviour." In part, our concern relates to outcomes such as the distortion of the government bond market, reduction of inter-bank funding, and increased concentration risk in 'cheapest to deliver' assets of certain government bonds.

The impact of these proposed rules on bank trading, repo, and derivatives activities needs to be analysed thoroughly, as the liquidity proposals could have a material impact on these markets except for those instruments deemed to be liquid assets. Other markets and products may be impacted negatively by higher operating costs imposed by the proposed liquidity requirements – for example, the securitisation markets that are vital to the ability of banks to provide credit to consumers and businesses.

Thus, we urge the Committee to expand the definition to include assets that historically have been liquid even under stressed conditions subject to appropriate haircuts. Given the LCR's time horizon of 30 days, we would argue that over a longer survival period a wider pool of marketable assets would become saleable.

Scope of Application

We note that the application of the new framework could be on a consolidated and, potentially, on a legal entity basis. Thus, we would like to invite the Committee to provide more clarity about the scope of application of the reporting. Further, we urge the Committee to apply the framework on a consolidated basis where appropriate to allow banks to reap the benefits of managing liquidity centrally.

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.

Further, the Committee should consider applying the framework solely on a consolidated basis when:

a) liquidity risks are 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[3]; and
c) the institution is subject to consolidated application of the requirements together with other credit institutions belonging to the same group.

The Committee should confirm that:

- within a single country or single currency-zone, the requirements can be met at a consolidated level only;
- the treatment of intra-group exposures will be symmetric; and
- double counting will be avoided across countries, particularly where third-party deposits are concerned.

The ability to manage liquidity centrally for some banking groups promotes the efficient use of funds in order to reduce the overall funding liquidity risk, minimise cost and earnings risk, decrease consolidated capital, credit and balance sheet usage, and optimise liquidity and exposure to third party funding across the group. In the event of an idiosyncratic crisis involving an individual member of the group, centralised liquidity management ensures it is provided with the necessary support.

Public Disclosure

While we generally support transparency, the Committee's proposal imposes far-reaching public disclosure requirements on the standards and monitoring metrics. Obviously, disclosing detailed quantitative information on liquidity positions publicly is an extremely sensitive issue as any misunderstanding which it might create

[3] We recognise that governments will need time to review arrangements that could facilitate the flow of liquidity within cross-border banking groups while taking into consideration valid prudential concerns about the flow of funds from insured depositories to uninsured or unregulated entities within the banking group.

may have devastating consequences for the institution or sector and even become self-fulfilling, deepening potential weaknesses. Liquidity disclosure is only useful when stakeholders can compare a bank's reported liquidity level against an appropriate or "true" minimum standard. This would be a standard that a bank can choose to exceed to differentiate its liquidity risk management program, while at the same time representing a floor level of minimum prudent liquidity. Moreover, disclosures made on a routine basis under normal conditions provide institutions with less flexibility once the market is under stressed conditions.

Therefore, we believe that prior to actual public disclosure, banks, regulators, and the markets require a better understanding of the new metrics and their impact within and across jurisdictions. In our view the roll-out of common public disclosure requirements should be limited to qualitative information. Also disclosures should be introduced over an extended period to provide the time required for banks to inform their shareholders and other market participants how to use and interpret these new standard metrics and associated results.

If the Committee should decide that there is a need for quantitative disclosure requirements, we urge the Committee not to mandate any current point-in time metrics but rather rolling averages computed over an extended period of time. Additionally we would suggest a significant time lag in the publication of quantitative information in order to give banks flexibility to use the buffer, if needed, without raising undue market concern. Of course, more extensive and closer to real-time information would be made available to regulators.