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Basel Committee on Banking Supervision  
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Dear Committee Members,

We would like to commend the Committee on Banking Supervision for proposing very comprehensive measures for liquidity risk measurement in Consultative Document "International Framework for Liquidity Risk Measurement, Standards and Monitoring". We applaud the comprehensive scope of the document and we are very pleased to see the extent to which it promotes what we think is industry best practice.

We respectfully submit the following comments and suggestions in response to your December 2009 draft and request for comment.

#### **A. Overall comments**

1. The committee proposes a liquidity coverage ratio and a net stable funding ratio as key risk indicators (KRI) for covering the short-term and the structural liquidity profile. Both KRIs are reminiscent of the cash capital approach moved forward by certain rating agencies. In this approach on-balance sheet and off-balance sheet items on the asset and the liability side are matched applying certain static and generic haircuts (run-off factors) on the book or notional value. While this approach is very intuitive and easy to communicate, it contains rather aggregated information. This can obscure valuable information and lead to wrong decisions. We recommend that the committee encourage banks to supplement the proposed liquidity coverage and net stable funding ratios with an additional cash-flow-based analysis.
2. The proposal assumes a stress scenario and compares, in form of a ratio, a bank's potential future cash shortages stemming from its balance sheet structure with the assumed inflows that can be generated by hypothetical liquification of its stock of highly liquid assets. The underlying basic condition is that a bank will stay liquid as long as its ability to counterbalance potential cash shortages exceeds its cash needs.

The proposal requires this condition to be valid for a 30-day (or 1 year) period, unfortunately without further explicit specifications. In practice the basic condition needs to be satisfied each day. Given the severity of the assumed liquidity stress scenario, one might assume that the net cash flows are negative for every single day and thus the cash deficit would peak at the end of the regarded period.

In point of fact, however it cannot be ruled out that the worst case is already reached within the period. A bank with material cash inflows in day 29 of a stress event could, in theory, pass the 30 day test yet still not have enough cash to remain in business for some shorter time period.

Another concern arises from the 30 day and 1 year time horizons. The stock of highly liquid assets changes also in time due to outstanding unsettled transactions. Hence it would be much more appropriate to determine and compare the net cash flows and Counterbalancing Capacity at every single day of the envisaged period.

3. The proposal assumes only one scenario, which is equivalent to forecasting one possible state of the future. But we cannot know the future, and therefore have to deal with various possible realisations of it: scenarios. Only a wide range of hypothetical scenarios can productively reveal material vulnerabilities. The proposition should consider multiple scenarios. The forecasting of the net cash flows and the generation of the Counterbalancing Capacity should be nevertheless done in the same scenario.
4. A bank will never discontinue its business franchise and will, therefore, continue to make new loans – unless it is dying. The proposal does not include the renewal of assets but assumes that deposits can be (at least partially) rolled over. This is not consistent and should be fixed.
5. The proposal does not differentiate between the stock of highly liquid assets (HLA) itself and the process that assumedly converts them into cash. It should be clarified how the bank's counterbalancing capacity is derived from the HLA. Selling an asset creates longer term liquidity compared to repoing it, but possibly results irreversible losses which again could spur an idiosyncratic crisis. Therefore banks prefer to liquefy the HLA solely per repo. As unfortunately no one knows in advance if a crisis will be only temporary, banks fully relying on liquification by repo can easily miss the point in time when it is still possible to sell. Therefore the proposal should demand that banks additionally model the saleability of their HLA in order to generate long term liquidity.
6. During the recent crisis interbank lending imploded and sale and repo activities in almost each asset class became rapidly impossible until secured central bank borrowing was the only open liquification channel. Because central banks, which needed to broaden the range of accepted collateral in face of the final meltdown, understandably want to come back to normality, the committee wants to encourage banks to use other liquification channels.

It is, however questionable, if the reduction of the HLA to only very few asset types is in fact the solution of this vicious dynamics, or possibly its enforcement: A non-HLA asset will be regarded as illiquid (respectively as liquidity consuming) and therefore its trading activities will deteriorate. In a future crisis all non-HLA assets will rapidly be barred from liquification. Conversely HLA-eligible assets will become very expensive as they are sought by banks which have to comply with the new requirements. As a consequence banks have to bear the cost of holding HLA assets, reduce their 'illiquid' business (with all its negative macroeconomic impacts) or run massive debt issuance programs. In any case their profitability will be negatively influenced.

7. If the currently binary approach of two liquifiability classes ('liquid' and 'not liquid') would be widened to a whole spectrum of classes with differentiated saleability and / or repoability capacity, each security could be mapped into one liquifiability class; depending on its rating and its other characteristics as outlined in the proposition.
8. The concept of unencumberedness needs to be enhanced. The cash flows e.g. of a repo starting and ending within in the observation period are captured, but how is the security treated in the Counterbalancing Capacity?

A solution could be to calculate the 'position' of each HLA security per single day and furthermore distinguish between ownership and possession. Purchasing or selling transactions change the bank's ownership of the security, whereas repo or borrowing and lending transactions only temporarily change the possession of the security.

## B. Details

1. The Cooke-ratio as only criteria for HLA eligibility is inappropriate as long as central banks definitions are close to rating criteria: a Greek Government Bond e.g. would be part of the HLA but potentially not ECB eligible any longer due to recent downgrades.
2. The chosen market related characteristics exactly reflect this dilemma: as soon as markets close (Lehman scenario) banks must solely rely on central banks and therefore need a stock of central bank eligible assets which means that all non-HLA qualifying assets become 'second class' assets constituting severe problems for bank's long term debt issuing activities

3. Covered bonds issued under a specific law (Cooke 10%) should be differentiated from those without law (Cooke 20%); this could be reflected by the application of different haircuts
4. Covered bonds issued by the bank itself should qualify for the stock of HLA as they are not the same credit risk (bank vs. collateral pool) and even accepted by central banks; potential buy-backs of own issues and their negative effect on liquidity could be offset
5. Bid-ask spread criteria might be difficult to verify and only available for assets having an active market making
6. Price decline criteria should be seen in relation to the general market development, only underperforming should be handicapped
7. The classification of assets is not granular enough, particularly if liquification through sale or market repo has to be taken into account
8. The proposed haircuts seem to be very prohibitive
9. When calculating the cumulative net cash flows, 'false' positive cash flows resulting from short selling of securities must not be considered (or should be offset)
10. Financials should be incorporated in the HLA as well

### C. Specific comments

1. Paragraph 22 (also mentioned in §11 and §83): Our understanding is that the roll-off factors presented in the document refer to a shock that incorporates all scenarios proposed in §22 simultaneously. While admitting that the current crisis has shown many of them, we still believe that some of them might have different causes (e.g., run-off of retail deposits) and need different actions. It is mandatory therefore for banks, in our view, to analyze all 'all for the bank relevant' scenarios individually. We recommend allowing banks here more flexibility – also as the current scenario list is naturally biased towards the events of the last crisis – and adding a note emphasizing this point.

The first scenario descriptor on your list is a three-notch downgrade in the institution's public credit rating.

- Are you referring to the short or long-term rating?
  - Are you referring to ratings for each legal entity in a group or just the rating for the parent entity?
  - Most importantly, we believe that changes in long-term ratings are trailing indicators. Either in place of the rating scenario descriptor or as an addition, we suggest banks use "a notable, quantified deterioration in the credit quality of the institution's loans."
2. Paragraph 70: We suggest that you add one more topic to your list:  
"Funding for a minimal quantity of new loans, not under legally binding commitments, made for the purpose of maintaining public confidence."
  3. Paragraph 81: We support very much the proposal of the committee on stable funding. We would like to hint at the point that in some business models a "one-year time horizon" might not be sufficient to assess a structural liquidity risk through extreme structural funding mismatches. We recommend that the committee encourage banks to analyze their structural liquidity risk on longer time scales. This can be done by using funding ratios as key risk indicator showing cashflow-based the available funding to the required funding above various time horizons.
  4. Paragraphs 92 through 94: While we recognize the merit of the 30-day ratio proposed in Section II, we believe that a single time horizon obscures too much valuable information. For that reason, we suggest that the committee propose one more monitoring metric. Specifically, behaviorally expected cash flow mismatches in the same time buckets specified in Paragraph 96 for contractual mismatches. In order to facilitate comparisons between banks, you may wish to specifically that the behaviorally expected cash

flows used for these mismatch calculations employ the exact same assumptions set forth in Section II for the 30-day ratio.

5. Paragraphs 96 and 97: We suggest that the contractual cash flow references in paragraphs 96 and 97 be supplemented by inserting an explicit reference to the definition of stable, non-maturity deposits in Paragraph 82, item 4. If you do not permit banks to treat a segment of their non-maturity deposits as “long-term” you will lose the ability to compare banks with significant non-maturity deposits to all other banks.
6. Paragraphs 104 through 107: We strongly urge the committee to delete any concentration measure based on individual counter-parties and, instead, employ a concentration measure based on counter-party type. Under the current proposal, a bank with a concentration of deposits obtained from a pension fund can mathematically reduce that concentration by obtaining the same quantity of deposits from 10 pension funds rather than one. For all practical purposes, however, the bank in this example has not reduced its concentration risk since all fiduciaries can be expected to withdraw funds at the same time.
7. Paragraphs 108 and 109: It is unclear to us how granular instrument/product-types are defined (e.g., are plain vanilla and structured senior bonds different instruments?) and on what rational the 1% threshold relative to total liabilities is derived – also having in mind that the definitions on total liabilities vary by accounting regarding (e.g., difference in US GAAP and IFRS regarding netting of replacement costs).

Respectfully submitted,

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