

**Basel Committee for Banking Supervision
Consultative Document 165: International framework for liquidity risk
measurement, standards and monitoring
Response by the Royal Bank of Scotland Group**

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This Appendix is intended to be read in conjunction with the covering letter for our responses to the Basel Committee's December 2009 capital and liquidity consultation papers.

Our response to the liquidity proposals is split in two sections. The first section gives an overview and the second section sets out detailed comments.

Section 1: Overview

1. We welcome any attempt to improve the way in which liquidity is measured across different regulatory jurisdictions.
2. We recognise the value of institutions and regulators looking at a short term measure to cover short term liquidity risk and of a structural measure to cover structural funding risk.
3. We also agree the need for the provision of timely liquidity data. Indeed, we would encourage the Committee to make reporting requirements for liquidity risk measurement as harmonised as possible, whether or not common metrics are introduced. Common reporting will assist colleges of supervisors in looking at the liquidity risk in global banks by creating 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.
4. 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.
5. We are concerned at the level of prescription in the proposals both in terms of the percentages and in terms of the split of the liquidity risks themselves. This is important because:

- 5.1. The percentages will dictate the size of the liquidity multiplier and hence the level of credit available in the economy.
- 5.2. If banks are to return to historic levels of liquidity then this will require an increase in the overall level of stable deposits and therefore a change in the savings ratio, particularly in the West. This will require a cultural change which will need to be communicated and which will take time.
- 5.3. By publishing prescribed run-offs the Committee could take away the incentive for institutions to set their own liquidity risk appetite. The way in which the industry will value and price different types of business (e.g. deposits, loan facilities) will also follow the regulatory approach.
- 5.4. The prescribed split of the risks does not fully reflect the full granularity of the risks e.g. the split of deposits into just 7 categories within the deposit base does not allow for the differing behaviours across the mix of product, customer type, geographic location etc. Again by prescribing the split, there is a danger that industry uses the regulatory split to assess liquidity value of the different types of deposit and not develop its own views. Pricing would follow.
- 5.5. We therefore suggest a transition period and that the results of the QIS be carefully considered perhaps resulting in a recalibration – at least in the short term – of the risk factors.
6. Taken together with the treatment of debt securities, the liquidity buffer is too narrow. This has a number of consequences:
 - 6.1. Firms will not be able to diversify their liquidity risk against a market wide stress event. There is a scenario where all banks are trying to sell or repo the same type of assets at the same time.
 - 6.2. Where securities of a particular government become ineligible e.g. due to a downgrade, there will be significant market disruption as banks seek to rebalance their portfolios.
 - 6.3. Assets not in the buffer become less marketable making it harder to fund certain markets (e.g. the mortgage market).
 - 6.4. We are also concerned at the level of the factors and, in particular, for undrawn commitments to corporate clients, both financial and non-financial.
7. The Committee might consider a combination of:
 - 7.1. A transition period so as not to stifle the fragile recovery seen recently.
 - 7.2. Allowing two tiers of liquid assets. In this approach banks will be required a certain proportion of the highest quality of assets in their ring fenced buffer (say 50%) but would be allowed to also hold, subject to haircut, the second tier of assets when calculating the LCR.
 - 7.3. Having two horizon periods. In this scenario (as suggested by CEBS) a relatively short period of (e.g. one week) net outflows must be covered by the highest quality of assets. However, a second period of net outflows (e.g. 1 month) must also be covered but a wider range of assets is allowed recognising that whilst a crisis exists the markets are coming to terms with its magnitude.
 - 7.4. Allowing value to the “second tier” assets in the denominator. In this approach a narrow definition of the liquidity buffer remains for the numerator. However, a firm would be allowed to bring forward the haircut value of

unencumbered less liquid securities in the mismatch ladder in accordance with the time taken to sell/repo them at a value consistent with the stressed environment.

8. The scenario for the NSFR appears to include an idiosyncratic stress for the numerator but have elements of market stress in the denominator: The term of the funding required to support marketable assets (a reflection of haircuts) seems to be high if the scenario is purely an idiosyncratic stress. The term funding should more closely reflect market haircuts in repo transactions with, perhaps a small forced sale add on.
9. We also question other assumptions in the NSFR as they appear to ignore management action that would be taken during the 1 year horizon. Such action would be dependent upon what any one institution saw as its core and non core businesses. For this reason we propose the NSFR be more risk based. If such a ratio is required, keep it simple but have it supported by a “pillar 2” type approach.
10. The paper states that the core buffer must be ring fenced from any trading activity and we agree with this. However, it is not clear that the buffer also needs to be term funded. Indeed the treatment of core liquidity buffer assets in the NSFR suggests that the buffer can be funded with less stable funds. We would contend that it is the investment of term funds in liquid assets which creates the ability to reduce the balance sheet in a stress scenario. As less stable deposits are withdrawn, liquid assets can be sold (or repo'd) to raise replacement funding. The term funding remains in place to fund the less liquid assets, effectively replacing the deposits which have been withdrawn.
11. We welcome the Committee's recognition that the monitoring, management and control of liquidity requires institutions and regulators to look at a number of metrics, to review the trends within those metrics and to review the inter-relationship of the differing metrics. Regulators also have the advantage of being able to look across similar institutions to compare one institution against another and where apparent anomalies exist require the firm to comply or explain. In addition to the metrics outlined in the paper we believe a number of other metrics are also useful and have listed some of these in Section 2.
12. In conclusion, we still believe that the measurement of liquidity is only one part of the management of the risk. As the Committee has stated before, there are a number of other principles which are at least equally important. Not the least of these is the firm's decision on liquidity risk appetite taken at the highest level of the organisation. How much insurance is the firm prepared to pay for? That decision should then be debated with the regulator(s) taking account of the importance of the firm in the relevant jurisdiction(s).

Section 2: Detailed Comments

Liquidity Coverage Ratio (LCR)

13. Whilst we agree that banks should be clear about the size of their liquidity buffer, we do have an issue about establishing a minimum level across the industry,

particularly if this is to be published. The point about having a buffer of assets which are marketable is that they can be used when necessary. By establishing a minimum level of holdings that have to be met at all times, there is a presumption that the portfolio can never be used, even in a crisis.

13.1. Publishing a ratio which is below the minimum immediately suggests to the market that the firm has a liquidity problem. There are clearly circumstances when it is quite valid for a bank to use those assets without counterparties being concerned that their deposits are at risk. Getting the right level of transparency in public disclosure documents is crucial.

13.1.1. As an example, consider a rumour circulating in the market about a bank which has discovered a “rogue trader”. There will be a period when the bank needs to marshal all its liquidity resources whilst it investigates the rumour, confirms or otherwise its truth, quantifies the level of loss and communicates to the market what it means for the firm. During that period the buffer may well be used.

13.1.2. A variation on that might be that the rumour has identified the wrong bank. RBS is only too aware that it is only one key stake different from UBS – no doubt UBS are equally aware!

13.2. Furthermore normal flows of cash through the firm due to seasonal and other factors may well see fluctuations in the LCR. 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.

13.3. We also question the value of publishing a single number at a point in time. Liquidity needs to be managed daily.

13.4. For these reasons we believe that the LCR, in particular, should only be shared with the Regulator and not made public to the wider community.

14. If there is a need for publication, we would therefore suggest either:

14.1. Significant delay in that publication; or

14.2. The denominator should be based on normal conditions with banks being required to hold buffers in excess of that norm based on the results of their stress tests. We contend that the level of buffer above the norm represents the firm’s liquidity risk appetite. It is therefore appropriate that the firm’s executive management examine and agree the level of liquidity stress they expect to be able to tolerate rather than that being set by regulators. Having said that, regulators should have the right to challenge that appetite and require a firm to re-examine the risk level if the regulator believes it to be out of line with the peer group and/or out of line with the regulator’s view of prudent practice. We recognise that the regulators place emphasis on setting a high hurdle for systemically important firms. What we would argue against is publication of a ratio based on a single, regulator imposed scenario.

15. Having said that we do recognise that the bank’s management must have day-to-day oversight of the ratio and governance procedures in place which clearly set out the circumstances in which the buffer can be used and, when used, what the

process is to return the buffer to the agreed level. Further, it is right that supervisors can challenge the level of the buffer at any one time and that supervisors satisfy themselves that the appropriate governance to control the buffer is in place.

16. We agree with the Committee that the buffer should be separated from other assets. However, in order to ensure that the buffer can be used in times of need we believe it needs to be funded with stable funding since it is the investment of stable funding in liquid assets which actually creates the liquidity. The proposed method of calculating the NSFR requires term funding for the liquidity buffer but in an indirect manner i.e. by duplicating risk factors for the on and off balance sheet items that generate the need for the buffer.

Numerator

17. In defining the assets eligible for including in the buffer we agree that there is a link between the severity of the stress scenario to be covered, the horizon of the stress event. We broadly agree with the Committee on the characteristics of a liquid asset although – and we are not suggesting they necessarily qualify – equities trading on major exchanges would count under many of the criteria.
18. We recognise that a firm must also be seen to be trading the asset for it to be liquid as far as the firm is concerned. This will reduce the risk that sudden sale or repo of a new asset class by the firm will start rumours in the market that the firm has a liquidity problem. Such rumours will, of course, only exacerbate the problem.
19. Turning to the definition of what would count for the narrow definition, we welcome the recognition that government guaranteed paper and non central government public sector entities can be included (subject to conditions) and also that the Committee recognises the value of paper issued by lower credit rated governments to support liquidity risk in the local currency of that government.
20. We believe the liquidity buffer, for the horizon being considered, is too narrow. We agree the purpose of a liquidity buffer of high quality assets is that these can be used, no matter how severe the stress, to create short-term liquidity by the outright sale or repo of the assets with minimum forced sale risk. We have a number of ideas which would address both our concerns and achieve the objective:
 - 20.1. Allow two tiers of liquid asset. In this approach banks will be required a certain proportion of the highest quality of assets in their ring fenced buffer (say 50%) but would be allowed to also hold, subject to haircut, the second tier of assets when calculating the LCR.
 - 20.2. Have two horizon periods. In this scenario (as suggested by CEBS) a relatively short period of (e.g. one week) of net outflows must be covered by the highest quality of assets. However, a second period of net outflows (e.g. 1 month) must also be covered but a wider range of assets is allowed, recognising that whilst a crisis exists the markets are coming to terms with its magnitude.
 - 20.3. Allow value to the “second tier” assets in the denominator. In this approach a narrow definition of the liquidity buffer remains for the numerator. However, a firm can also ring fence lower quality assets in their buffer on an

unencumbered basis and is allowed to bring forward their value in the mismatch ladder in accordance with a) the time taken to be able to sell them and b) at a value consistent with the stressed environment.

21. Note that the current proposals also require the assets, of whatever quality, to be held in the ring fenced buffer itself in order to count in the numerator. There needs to be a mechanism to allow liquidity value to at least the core liquid assets not held in the buffer itself which are unencumbered. For example, if a firm's traders happen to hold high quality government paper "in the box"¹ on a particular day. As written this would count against the firm from an LCR point of view as the liquid assets are not ring fenced. We accept this but would suggest this holding should be allowed to reduce the denominator.
22. Whatever the maximum stress horizon banks should, of course, look at their daily cumulative cash flows over a number of periods to ensure there are no "cliff" effects.
23. In looking at the broader definition of the buffer we would argue that any haircuts applied should reflect observed price volatility, particularly during the recent crisis. We would be interested to know the basis on which the proposed haircuts have been calculated.
24. As stated above, a firm must first demonstrate that it regularly trades (by sale and/or repo) the asset. During the crisis such assets continued to trade but with wider spreads. In assessing haircuts therefore, the Committee should consider:
 - 24.1. The period over which the asset might be sold. On one hand the longer the period to sell the less forced sale risk; on the other, however, the greater the risk that the underlying market price moves against the seller.
 - 24.2. The periodicity that the firm marks the asset to market. It cannot be assumed all firms will necessarily mark to market daily.
25. We recognise that the problem of allowing bank paper to count in the buffer is that it could create "illusory" liquidity in the system where two or more banks issue to one another. However, taken together with other developments in the market we are concerned that there will be a significant reduction in the appetite for bank paper which will do nothing to restore the interbank market to pre-crisis levels and will reduce the appetite for term bank paper. The loss of market appetite for bank paper will also reduce banks' ability to lengthen their funding maturity profiles.
26. Furthermore, in an idiosyncratic stress event, is it better for a bank (bank A) to have a fixed term deposit with another bank (bank B) or a marketable bank instrument such as a CD or CP issued by that bank (bank B)? In the former case, were bank A to require funding due to some liquidity problem it would need to break the deposit signalling it had a problem. However, in the latter case it could sell bank B's CD/CP without alerting the market to its need for funds.

Denominator

27. We are concerned at the lack of granularity in the items in the denominator but, at the same time, we also have reservations about the prescriptive nature of the run offs and risk factors.

¹ i.e. held long and unencumbered.

28. Liquidity risk in deposits reflects the liquidity risk spectrum associated with different classes of depositor, which is often met by offering different types of product. There is a danger of the BCSB setting regulation which segments the liquidity risk spectrum in a dysfunctional way.
29. Pricing will follow regulatory segmentation, and the flexibility to design products with a risk/reward profile which fully reflects the liquidity risk will be reduced. As stated we recommend firms be free to set out the basis on which they split the liquidity spectrum rather than have it dictated by the regulators. It follows that firms be required to justify to regulators their behavioural overlays (run offs) on each split to their respective regulators.
30. We do accept that regulators have the right to challenge firms' treatments particularly if their treatments appear to be out of line with similar products in other firms. Indeed, regulators might use a "standardised" set of overlays to compare with the firms approach.
31. There is a danger that the existence of mandatory run-offs will dissuade firms from examining their own liquidity risk appetite, i.e. the level of liquidity insurance they are prepared to pay for across the matrix of customer/product/geography/legal entity etc given the nature of and node within the matrix. Some examples may help: within the non-financial corporates category there are corporates who have professional treasuries and corporates who have few employees and who behave more like small business customers. Similarly within the financial institutions category, cash and securities settlement business are relatively stable, and there are, again, a wide range of financial institutions (e.g. smaller wealth managers and financial intermediaries). Some clients of financial firms instruct those firms how to place their funds rather than allowing the financial manager to place them. Finally, transmission accounts are often very sticky as moving them requires considerable administrative burden.

Retail Deposits

32. We welcome the clear definition of retail deposits as being those belonging to individuals and that balance size has not been used in the definition. We also agree that having insurance cover for such deposits will not necessarily lead to deposits being stable. Where we disagree, are the prescriptive minimum outflow levels being suggested. We appreciate that the Committee is looking to provide a simple way of calculating this metric but they themselves recognise that their 7.5% and 15% are only the starting points for agreement on behavioural overlays. We suggest supervisors and firms should be left to agree how best to break up the spectrum of stability across different types of retail deposits.
33. Furthermore the Committee should not set the minimum for each class of deposit but leave that to be agreed between regulator and firm dependent upon the way in which the liquidity spectrum is broken down.
34. We have already seen the price of retail deposits rise (due to the supply and demand of such deposits at current levels of savings ratios, particularly in the West) as banks chase these regulatory attractive deposits. The stability of such deposits may be threatened as the price rises and customers become aware of the value of their funds. This will cause them to shop around making their deposits, paradoxically, less sticky. If banks are to return to liquidity levels seen in say, the 1970s, then it is important for the community at large to recognise that a cultural change is required.

Small Business Customer Deposits

35. We are disappointed that the Committee have included an aggregate limit on what counts as a small business deposit. Quite often customers will use different products for different purposes and may not therefore move all funds at the same time; particularly they may not move transmission accounts.
36. We would also make the same arguments about splitting the deposits (between stable and less stable) as we did for Retail.

Unsecured wholesale funding provided by non-financial corporate customers, sovereigns, central banks and public sector entities with operational relationships

37. We note the recognition that operational (transmission) accounts should be treated differently from other types of account for these types of customer. The fact that the Committee has identified this type of product separately demonstrates the complexity of dividing up the liquidity spectrum. We do not believe that the behavioural overlay at 25% is a representative “average” of all the non-financial customers. More professional counterparties are likely to run down their balances quickly as they will have options to use alternative accounts for their transmission business. On the other hand, the less professional counterparties, such as smaller corporates and even mid-sized corporates will be more reluctant to move such business elsewhere as they are less likely to be multi-banked. It is also worth remembering that many customers run their transmission accounts at minimum levels using cash management systems and that therefore they will have related non transmission accounts which some customers, at least, will also be reluctant to move.
38. We recognise that the Committee are looking to provide some guidance on the segmentation of the liquidity spectrum whilst balancing the degree of prescription. However, once again, we see that any regulatory prescription will drive banks to review the liquidity value they ascribe to these types of balance and also to their pricing.

Unsecured wholesale funding provided by non-financial corporate customers

39. Again we believe by grouping together all this class of deposits the committee are 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, FIs like Insurance Cos, Hedge funds or Asset Managers. Furthermore our experience is that depositors from different countries also behave differently. Relationships established over long periods also played their part.
40. We would also caution against lumping all “financial institutions” in the same class. Like corporates they do not all behave in the same way. We do, however, accept that banks, of whatever size, might be grouped together.
41. It might make sense to make a distinction between customers with professional treasuries – where 100% outflow might be assumed and those without, where a lower outflow would be appropriate.

42. We recognise the Committee has the dilemma of being, on the one hand too granular and, on the other not granular enough.

Unsecured wholesale funding provided by other legal entity customers

43. We agree that there will be a class of funding sources that will not renew in the event of the stress scenario. We believe the class of funding outlined in the paper is broadly correct although, as we say above, we believe it is those customers with professional treasury operations that are the most likely to move the deposits at the earliest time. Having said that, even for counterparties with professional treasuries, we did see some stickiness as a result of longstanding relationships. However, we are not convinced that banks will necessarily be locked out for a whole month and suggest a shorter period of at least a week as proposed by CEBS.

Secured funding run-off

44. In considering secured transactions we would strongly recommend that the rules are developed to recognise the flow of cash separate from the flow of the underlying security.
45. We believe maturity of the repo of high quality assets should be treated as an outflow of cash but an inflow of the security. The cash outflow can then be treated as an unsecured outflow whilst the return of the collateral can be reviewed dependent upon the nature of that collateral. (Similarly the maturity of a reverse would show the outflow of a security and an inflow of cash.) Separating the cash positions in and out and the collateral positions in and out, the firms and the regulators will be given a more comprehensive view of the firm's changing liquidity risk patterns. Note that a long position in a security would need to be split between the cash returned at maturity in the cash ladder and the surrender of the bond – in the security ladder.

Additional requirements

46. Increased liquidity needs related to downgrade triggers embedded in short term financing transactions, derivatives and other contracts. We agree that 100% of the additional collateral should be measured although we would argue that this should be measured against a 2 notch (rather than, as suggested a 3 notch) downgrade (of the long term debt) for the purposes of the published measure. We do, however, recognise that banks must be able to identify downgrade levels (of whatever magnitude) where any significant additional liquidity is required and that this should be shared with the bank's regulator (and, of course, through its risk management governance)
47. Increased liquidity needs related to market valuation changes on derivative transactions. It is not clear why there should be national discretion on this potential outflow when other overlays have been prescribed by the Committee. We would also suggest that this is considered on a net basis.
48. Increased liquidity needs related to the potential for valuation changes on posted collateral securing derivative transactions. We would appreciate the Committee advising on how the 20% figure was calculated and again suggest a netted approach.

49. Increased liquidity needs related to the potential for valuation changes on posted collateral securing derivative transactions. Again a netted approach is suggested.
50. Loss of funding on term asset-backed securities, covered bonds and other structured financing instruments. No comment.

Draws on committed credit and liquidity facilities

51. As the scenario includes a market event it is important to allow for the fact that many customers seek to repay their borrowing rather than draw down on unused lines. This reflects their concern about employment prospects etc.
52. We accept that a firm should consider the possibility that at least some of their undrawn committed facilities will be drawn down in normal circumstances and that the pattern of drawdown may change in differing stress scenarios. As the possibility to raise funds in the markets dries up in the stress scenario then a bank will need to be able to liquidate a proportion of its liquidity buffer if it is to meet those commitments.
53. We believe the Committee needs to be precise about what they define to be a liquidity facility versus a credit facility. (Indeed we would strongly recommend the Committee to provide a glossary of terms used to avoid ambiguity throughout the paper.)
54. We accept that facilities to certain vehicles which get called or need to be collateralised in the downgrade scenario must be included at 100%. However, is it the Committee's intention that any revolving credit facility and/or multi-option facility be included at 100% - or are these defined as credit facilities?
55. We accept liquidity facilities of a revolving nature (e.g. credit card receivables, overdrafts etc) may not be repaid during the course of a scenario of the type envisaged. We do not agree, however, that there will necessarily be an additional draw on such facilities let alone of the magnitude envisaged. Our experience for use of such facilities by non financial corporate customers has been that drawings were well short of the proposed 100% level. Non financial organisations use such facilities as working capital and the stress scenario does not lead to increased drawdown of such facilities to any great extent.
56. On the other hand, for credit facilities which are linked to specific projects and purchases, we might expect a higher level of drawdown as they represent drawings for specific purposes. In normal (let alone stress scenarios) we would expect at least some of these to draw in full over defined periods. For example, where the facilities are related to pipeline risk we would expect a higher level of drawdown e.g. mortgage pipelines tend to be drawn over a 2-4 month period and hence a 33% draw over the 1month horizon might be prudent. We would therefore like to have a clear definition of a liquidity facility vs. a credit facility and understand the basis on which the percentages suggested by the committee have been calculated.
57. Turning to facilities granted to finance companies we would make a distinction between those relating to banks (or bank SPVs) and those relating to other financial businesses. We agree that those relating to banks should carry a 100% draw where their terms require collateralisation of the liquidity line on downgrade of the sponsoring bank. The scenario is clear that there is stress in the market and all banks are likely to fully draw their lines. Of course, the corollary to this is

that writing of such lines is likely to be unattractive to banks – particularly given the asymmetric treatment of the facilities. For other financial firms we would make a similar argument as we have for facilities to corporate clients.

Other cash outflows

58. We note that other cash outflows include interest and planned derivative payables. We suggest allowance is made for materiality here particularly as many are offset by cash inflows. Furthermore interest paid (and received) may involve no actual cash being paid away (or received) but rather an adjustment to the account or deal balance. For derivative payments it is often the case that these would be picked up as collateral adjustments and there is a need to avoid double counting.

Cash Inflows

Retail

59. We believe there is a need to make adjustment to contractual flows particularly in respect of products offering revolving credit. For example overdrafts in the UK are contractually repayable on demand but, of course, in practice are not demanded. Credit card receivables have contractual minimum repayments but some customers pay more than this. Perhaps the answer is to allow some national discretion?

Wholesale inflows

60. We agree that 100% of these should allowed in the LCR.

Reverse Repos and secured lending

61. We do not understand why an unsecured loan to a bank, which is due to mature in the 1 month period, will count as an inflow whilst a loan to a bank secured with government debt cannot be treated as an inflow. We believe this is because the treatment of secured flows (repos and reverses) needs to consider the cash flows separate from the securities flows as described above under secured outflows.

Additional Comments

62. As indicated under the numerator, we believe that assets which can be traded and are unencumbered should be allowed to be given an inflow value in advance of their final maturity. In other words assets which are marketable should be treated as being able to generate an inflow via their sale or repo in the short term. The value will be subject to a haircut on their MTM value recognising forced sale risk. It is important to recognise that such assets are not being included in the ring fenced liquidity buffer.
63. It is probable that a firm will have assets in its trading book which are eligible for inclusion in the liquidity buffer but are not part of the ring fenced portfolio. Where these are unencumbered it is sensible to recognise their ability to generate a cash inflow quickly but, at the same time not include them in the liquidity portfolio (and hence the numerator). Instead they represent a reduction in the net outflow of the denominator.

- 63.1. Similarly other classes of assets, if not in the liquidity buffer by definition, can generate a cash inflow. Government guaranteed paper not weighted 0% in Basel 2, for example “Freddie and Fannie” paper, might be an example of relatively high quality paper included in this way.
- 63.2. Less liquid assets which nonetheless can be sold or repo’d could also be given some liquidity value by including an inflow – with a haircut – in the short term.

Net Stable Funding Ratio (NSFR)

- 64. The stated objectives of the measure include encouraging more medium and term funding and to encourage institutions to move away from short-term funding.
 - 64.1. We agree that a measure of this sort will be useful as part of the suite of metrics for measuring liquidity risk in a bank.
 - 64.2. We agree that some banks did become overly reliant on short-term funding, particularly from the wholesale money markets and have seen first hand the consequences of such a policy.
 - 64.3. However, we caution against going too far given that banks remain in the business of maturity transformation. In setting its liquidity risk appetite an institution is balancing between prudence on the one hand and the level of maturity transformation on the other.
 - 64.4. We anticipate that the QIS will reveal just how draconian the proposed ASFs and RSFs are. It is quite possible that the required levels of stable funding do not exist. If so then either substantial reduction in lending will take place and/or a significant increase in the savings ratio, along with a willingness to extend deposit maturity on precautionary cash balances, will be required. A shift in the savings ratio and preferences will require a cultural shift, particularly in certain western countries.
- 65. The scenario for the NSFR appears to be only an idiosyncratic stress. If this is the intention then the proportion of term funding for marketable assets (not eligible for inclusion in the core) would appear to be high. The funding levels (and hence the implied haircuts) appear to assume a market stress event as well. We would recommend using levels of term funding which more closely reflect the haircuts used in current trading.
- 66. The NSFR horizon is one year. The proposed assumptions ignore management action. Such action would impact, for example, the amount of new/replacement business that a firm would undertake. The type of business impacted would, in turn, depend upon what the firm regards as its core and non core business. What is core for one bank may not be core for another. A mortgage bank might concentrate on mortgage lending at the expense of personal or corporate loans, for example; a private bank upon retaining deposits rather than undertaking lending, a corporate focussed bank on corporate lending rather than retail lending etc. For this reason we suggest the measure will have to have an element of internal modelling.
- 67. If there is to be a ratio it should therefore contain minimal behavioural assumptions. For example:
 - 67.1. Capital plus term funding with residual maturity over one year plus non professionally sourced funding divided by assets not marketable within one

year plus liquidity buffer. (By professionally sourced funding we mean placed by companies with a professional treasury. The funds themselves would come into the receiving bank's money market desk and be priced at the firms LIBID or equivalent.)

67.2. Or, if it is accepted that the problem was one of over reliance on short-term (<1year) wholesale funding, it might be possible to simplify the metric by using a formula of the form: Unsecured wholesale funding less than one year divided by total deposits plus debt securities in issue plus capital. Clearly this type of ratio should be used anyway in the concentration of funding metrics outlined in Section III.2.

67.3. The ratio suggested by the New Zealand authorities.

67.4. Other possible ratios include: Retail deposits/retail loans, Small business deposits/small business loans etc.

Turning to the ratio as proposed we would make the following points:

Numerator

68. On category 1 (ASF 100%): we would make clear in the main text that the maturity is residual maturity (it is spelt out in the annex)

69. On category 2 (ASF 85%), we note that:

69.1. This is just double the 7.5% used for such deposits in the LCR. We would therefore welcome an explanation of the basis for the weighting which implies 7.5% of such deposits might run off in the >1m to 1 year period after 7.5% ran off in the 1 month period.

69.2. On category 3 (ASF factor 70%) we would again make the point that introducing stress test percentages for this relatively sticky funding gives the ratio a misleading degree of accuracy.

69.3. We suggest it would be simpler to recognise all retail and small business deposits are stable and not introduce stress test assumptions at all for this structural ratio?

69.4. To get round the problem of the element deemed less sticky in the LCR we propose that the liquidity buffer itself be term funded.

70. On category 4 (ASF 50%) we believe this category to be too wide:

70.1. It includes a wide range of non financial corporate deposits (which range from the very largest with highly professional counterparties to the very smallest with very simple banking relationships).

70.2. It also includes a number of product types from transmission products through various savings products (time and sight) through to money market deals.

70.3. Our suggestion is to at least break this down into two categories splitting between customers with professional treasury operations from the rest. The former could be deemed to be particularly fast to react with and ASF down to 0%. The latter would have a much lower factor more akin to the approach adopted for retail and small business.

71. Similarly we believe treating all financial institutions the same is also over simplification of the large range of counterparties in this category.
72. We note that secured funding less than one year falls into the “other” category and, as such, is given a nil factor and we agree with that approach for this ratio. However, it is not clear from the RSF table the treatment of the corresponding reverse repo transactions. Firms will not always “exactly” match the repo with a reverse but would often take a mismatch position.
73. The Committee might also consider setting out the treatment of a reverse repo covering a short position. We would suggest that again no term funding is required here.
74. We note that para 84 states that term central bank funding should be excluded from this measure and we accept that reliance on central bank funding is to be discouraged. However, with the market as it is, we believe it would be unrealistic for institutions to replace such funding in the near term by funding from the market. We therefore suggest some form of grandfathering or a transition period.
75. It is not clear how MTM balances and balances pending settlement on both sides of the balance sheet are to be treated.
 - 75.1. If the liabilities are given a zero weight and the assets a 100% weight, as appears to be the case, then we believe this will distort the ratio.
 - 75.2. It might be better to include only the net the position on the appropriate side of the balance sheet with net liabilities being treated as providing no stable funding (ASF 0%) and net assets as needing stable funding (RST 100%). We believe such an approach would better reflect the objectives of the ratio. The same applies to the relative treatment of, for example, payables and receivables.

Denominator

76. The objective of the NSFR is to influence the level of maturity transformation that an institution undertakes. We agree that such a metric is a useful tool. We would suggest that the denominator therefore needs to consist of those on balance sheet assets which require term funding. We believe the core liquidity buffer should be funded by term money. It is, in fact, the investment of stable funding in liquid assets which creates the liquidity reserve. However, the paper suggests that assets of a form to qualify for the core liquidity buffer only need 5% stable funding. This seems odd. It implies that 95% of the funding of such assets could be at say 1 m and 1 day. That implies the institution could run out funding for its liquidity buffer after 1 month. The assets in the buffer need stable funding.
77. We would ask if the treatment of undrawn commitments to customers (other than retail and non financial corporates credit facilities) is correct in the NSFR versus the LCR (10% vs. 100%). It implies that liquid assets covering the potential draw down be 15% >12m funding, 85% be funded at 1-12m.
78. The amount of term funding for debt securities appears to be more in line with a market stress event rather than an idiosyncratic stress.

79. We are concerned at the treatment of MTM and balances awaiting settlement. These currently appear to fall in the “other assets” category and, as such, would need term funding. Given many of these positions are hedged or offsetting, we would argue that it is only the net position which needs to be covered with stable funding and not the gross.
80. We are not clear why 50% of loans less than one year to non-financial clients require 50% stable funding. We assume this may be based on the assumption that some loans represent working capital and are of a non maturity nature, some will roll at maturity and some will be non performing. We would welcome details on how the 50% figure has been calculated.
81. Similarly we would welcome an explanation of how the 85% figure for retail loans has been derived.
82. In all cases the RSF factors take no account of any mitigating action a bank might take were it to experience such a crisis. We do not believe that it would necessarily renew all loans, or continue to hold all the debt securities it has at the start of the scenario. Dependent upon its business model some of the assets will be deemed to be unnecessary to its franchise and could be run down or sold.
83. The scenario, as we understand it is an idiosyncratic one and so markets should be open to sales of securities, albeit subject to some forced sale risk.
84. If the scenario is to include a market wide stress then we can understand the larger haircuts on securities although we may not agree with their size. Having said that, in a market wide stress customers will be looking to reduce their lending and may not wish to roll the loans at maturity. The amount of term funding for <1y loans would then look high.

Comments on use of metrics for measuring liquidity risk

85. We are pleased that the Committee recognise that there are many metrics that should be used to measure, monitor and assess a bank's liquidity risk. The absolute level of one metric can be misleading; what is more important is the trend in a metric and how it moves with respect to all the other metrics.
- 85.1. For example, liquidity coverage type ratio of a bank with a small number of depositors might be expected to be higher than a bank of similar size with a large and well diversified portfolio of depositors.
86. We therefore welcome the Committee's suggestions that regulators look at additional metrics beyond the LCR and NFSR. Different types of institution will concentrate more on one metric than another.
87. We broadly agree that metrics of the type described are an essential monitoring tool although we would have suggestions with regard to detail and whether they are necessarily the most important.
- 87.1. The cash flow measure is, in our opinion, the most important way of measuring the short-term health of an institution. In this measure liquid assets are moved down the ladder in accordance with their marketability and subject to haircuts to reflect forced sale risk etc

- 87.2. The cashflow ladder can also be used to look at the longer term structural exposure of a bank by extending time horizons (and assumptions) beyond the first few months in, say annual increments. This might highlight the extent to which very long term loans, e.g. 20 year mortgages, are being funded by medium term issuance.
88. On the cashflow measure we agree that a contractual report is important but see it only as a starting point. Pure contractual cashflow ladders can be misleading since they will have:
- 88.1. non maturity cashflows – call items – at their contractual position in the ladder i.e. at sight.
 - 88.2. include many undrawn committed facilities at sight.
 - 88.3. include many contingent liabilities at sight.
 - 88.4. take no account of factors such as the institutions' credit downgrade or changes in market conditions leading to changes in the value of assets.
89. We do, however, recognise that they are the basis for other scenarios. In addition regulators should therefore ensure that institutions are looking at how the contractual positions change under normal circumstances. Once normal behaviours are understood institutions should then stress those assumptions in a variety of scenarios. Regulators can then compare different assumptions e.g. about the same type of product across the peer group and across the stress scenarios. Additionally, as the paper observes, regulators can run their own behavioural assumptions using the contractual information as a base.
90. Funding concentration measures are extremely important and we agree with the use of such metrics. However, we believe the denominator of the ratio is better linked to "total funding liabilities" rather than balance sheet footings. There are a number of items in the balance sheet which, if included in the denominator might mislead on concentration. For example, the gross size of MTM and settlement balances inflates the balance sheet. Further non banking activity may be included in some institutions balance sheets e.g. insurance activities.
91. We agree that a metric looking at what collateral is freely available as collateral in the market and could be used at standing facilities at central banks. We believe this should also be accompanied by such things as:
- 91.1. Time horizon for sale or repo of said assets.
 - 91.2. Likely haircuts in current and stress markets.
 - 91.3. Collateral available as emergency facilities (not only because central banks are increasingly looking to banks to use such facilities in normal circumstances to remove the stigma and demonstrate that ultimate contingency plans can work) but also to inform Executive management of the size of this ultimate back up. If it is zero then Executive Management should know.
 - 91.4. The concentration of liquid assets e.g. in any one type of asset and/or issue.
92. A number of other metrics could also be recommended and the CEBS liquidity ID card lists many of them. We would bring the following to the attention of the Committee:

- 92.1. Differing cuts of the mismatch report e.g. unsecured wholesale (professional) flows alone, the same plus secured flows. Taking that flow and adding non professional flows, and then adding in retail flows. Finally the impact of undrawn commitments and other off balance sheet items could be added.
- 92.2. The reliance of the commercial bank book on the investment banking book for funding or vice versa.
- 92.3. The relative proportion of the balance sheet used by the commercial bank vs. that used by the investment bank.
- 92.4. Structural currency measures.
- 92.5. Cross border exposures across legal entities and where appropriate between branches in differing jurisdictions.
- 92.6. The level of undrawn commitments against balance sheet size.
- 92.7. The level of additional collateral required to be posted at all of levels of downgrade.
- 92.8. Trends in the level of collateral posted and received over time.

Other Comments

- 93. We also note that para 133 envisages the ratios of both Group and legal entities within a Group. We would caution about how this is done as it would be possible to end up holding liquid asset buffers in both a parent and a subsidiary against the same third party liquidity risk. An example is provided in annex 1.

Annex:

SCENARIO 1: LIQUIDITY BUFFER - NO ASYMETRIC TREATMENT

<p>Assumptions</p> <ul style="list-style-type: none"> Overseas Subsidiary has net surplus less stable retail deposits of £11bn, Intra-group loans have terms of < 1 month holds sufficient buffer determined by “looking through” intra-group flows to third party deposits, i.e. 15% of £11bn retains internal flow of funds thereby reducing external borrowing requirements <div data-bbox="239 660 1157 974"> <p>The diagram shows two entities: Parent and Overseas Subsidiary. The Parent entity has a Buffer of 1.7 and Available assets of 9.3. The Overseas Subsidiary has two values of 11. An arrow labeled 'Intra-group loan (< 1 month)' points from the Overseas Subsidiary to the Parent. A label 'Wealth deposits' points to the 11 in the Overseas Subsidiary.</p> </div>	<p>Buffer requirement Parent treats intra group deposit as if it is a retail deposit. Buffer required for the Parent $= 15\% \times £11bn$ $= £1.7bn$</p> <p>Subsidiary treats intra group loans on same basis i.e. will receive back £1.7bn in crisis as parent holds liquid assets. The inflow nets with the third party withdrawal and the denominator of the subsidiary equals zero. Buffer required = 0</p> <p>Total buffer requirement = £1.7bn</p>
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SCENARIO 2: LIQUIDITY BUFFER - ASYMETRIC TREATMENT

<p>Assumptions</p> <ul style="list-style-type: none"> Same as Scenario 1 (above) except assumes asymmetric treatment for intra-group loans to Parent (Sub treats loan as if evergreen, parent treats deposit as repayable in period and will not roll) <p>Overseas Subsidiary</p> <ul style="list-style-type: none"> is required to hold its own buffer against its third party deposits lends surplus funds to Parent a < 1 month intra-group <p>Parent Company</p> <ul style="list-style-type: none"> has partial benefit of intra-group loans with access to the funds only after Overseas Subsidiary has accounted for its own buffer requirement borrowes the remaining funding from the external market (< 1 month) intra-group deposits and external borrowings generate a buffer requirement <div data-bbox="239 1624 1157 1937"> <p>The diagram shows two entities: Parent and Overseas Subsidiary. The Parent entity has a Buffer of 11, Available assets of 0, and 9.3. The Overseas Subsidiary has a Buffer of 1.7, 11, and 9.3. An arrow labeled 'Intra-group loan (< 1 month)' points from the Overseas Subsidiary to the Parent. A label 'Wealth deposits' points to the 11 in the Overseas Subsidiary. The Parent also has 1.7 External borrowing.</p> </div>	<p>Buffer requirement</p> <p>① Overseas subsidiary is required to hold a buffer $= 15\% \times £11bn$ $= £1.7bn$</p> <p>② Parent is required to hold 100% of intra-group deposits $= 100\% \times £9.3bn$ $= £9.3bn$</p> <p>③ Parent is required to hold 100% of external borrowings $= 100\% \times £1.7bn$ $= £1.7bn$</p> <p>Total buffer requirement = £12.7bn</p>
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