April 16, 2010

AEB RESPONSE TO THE BASEL COMMITTEE CONSULTATION PAPER

International framework for liquidity risk measurement, standards and monitoring

The Spanish Banking Association (AEB) [1]wishes to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to comment on its consultation document *International Framework for liquidity risk measurement, standards and monitoring*. AEB, in its capacity as member of the European Banking Federation (EBF), has played an active role in the drafting of a response to the aforementioned document, and it broadly supports the opinions contained therein. However, given the importance of the issues under consultation, AEB wishes to report to BCBS directly regarding its opinions on this matter, emphasising the issues that affect the spanish banks most and, as a consequence of the above, the markets in which our organisations operate.

The response is divided into two parts: a general comments section, and a further section on specific issues, with the latter following the order of the consultation document itself.

General Comments:

- It is necessary to acknowledge the efforts made by the Basel Committee in developing this consultation document in such a short space of time, and the right direction of most of the proposals which the Committee has put forward, especially those aimed at reducing systemic liquidity risk, as well as advocating the maximum possible harmonisation between jurisdictions and which therefore contribute to levelling the playing field.

- However, one must be aware that the document's proposals will mean a major overhaul in the management of one the key elements of a financial institution, which is liquidity management.

- The impact of these proposals on the real economy must also be borne in mind. It is also worth considering, as we discuss in the body of the text, that the proposed plan may be more discriminatory for the retail banking activity than for other types of banks.

  The main impacts that we have identified are the following:

  - Reduction, or even cancellation, of the financial system's ability to develop its role in transformation of terms, due to the overly restrictive approach in defining ratios, especially the NSFR. The assumptions and calculation of the ratio mean that it is necessary to maintain a positive liquidity gap at 1 year.
  - Decreased availability of resources for lending given the need to acquire liquid assets and increase long term funding to meet LCR and NSFR regulations. This is particularly

[1] The Spanish Banking Association (AEB) is the voice of the Spanish banking sector representing and defending the collective interests of banks operating in Spain (94 member banks: 59 Spanish and 35 credit entities' branches of foreign banks operating in Spain), with total consolidated assets of € 2,110 billion as of December 2010 and 109,996 employees in Spain.

significant in times of crisis, given the need to provide access to credit for economic recovery to take place.

- An increase in the price of loans granted to customers, having to pass on higher costs related to the demands of longer term financing ratios even for short-term transactions.

- "Crowding-out" effect from financial markets for institutions, whose issued securities are not classified liquid assets for the new ratios.

- In general, the consultation paper applies the *one size fits all* criterion and, as the approach is so prescriptive, it does not encourage a better understanding of liquidity risk by the organisation. The same approach would appear to be valid for all organisations. More specifically, the approach does not consider the starting point of the organisation at the beginning of the *stress test*, the strength of the business, balance sheet, rating, etc.

- The amount of eligible liquid assets and longer term funding required by banks would materially distort markets. 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”, increasing systemic risk.

- The stress described in the consultation paper is idiosyncratic and systemic at the same time, it is an extreme situation that accumulates negative scenarios (both for LCR and implicitly for NSFR), and does not consider reaction and change in the business model that the firm will adopt over a one year period.

- In this sense, although Central Banks are not considered as lenders of first resort, their fundamental stabilising role in financial systems cannot be ignored, even more so in stressed scenarios such as those mentioned. Therefore, in our understanding, the principle of considering all eligible assets for discount at the relevant Central Banks concerned as liquid assets must be respected, with their respective haircuts.

- Greater transparency on behalf of the Basel Committee on calibration of the parameters applicable to the two liquidity ratios would be desirable.

- One of the main objectives of the document is to achieve greater consistency in the approach of different regulators when analysing liquidity risks. However, in several paragraphs it is explicitly stated that "national authorities may take decisions establishing greater levels of liquidity." This approach could invalidate the starting point.

  The existence of these differing criteria among supervisors is one of the obstacles to the free flow of liquidity within the global financial system. Additionally, this lack of harmonisation involves a heavy administrative burden for multinational banking groups facing numerous regulations, different types of reports and, finally, competition distortions among institutions depending on their location.

- Regarding non accountability per se of eligible assets at Central Banks as high quality liquid assets, in addition to the statement above on our disagreement with this criterion, we consider that the position of CEBS[2] offers a more reasonable and balanced view of this problem.

- There are certain asymmetries in the definition of outflows (8 pages) and inflows (1 page). Likewise, there are inconsistencies in the treatment of some lines between the two ratios, such as the definition of liquid assets for the LCR and for the NSFR.

- The Press Release accompanying the release of the Paper specifies that the Committee will put in place appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards.

  It is essential that a consultation process be organised on arrangements that the Committee will propose, particularly (i) on the time-frame within which banks will need to apply the new framework as well as (ii) on transitional arrangements. The implementation of the new requirements also needs to be strictly synchronised throughout the world to avoid substantial competitive distortions.

  A transition period spanning some years would be required to allow banks to build up their liquidity buffers and, in particular, transform their short-term funding into long-term funding and, furthermore, make sure that most of the collateral that does not meet the narrow definition has matured and can be substituted by qualifying financial instruments.

- The level of application of the proposal (consolidated and/or individual) is an essential issue that must be clarified as soon as possible. When dealing with this issue, the Committee should be aware of the different models of liquidity risk management used by the banks, being the main differing feature its degree of de/centralization. In fact, and though many large and cross border banks use a centralize model, our Association thinks that the decentralized liquidity model has proven to be superior to a model of branches from a prudential point of view. Arguments about this point are detailed on page 10.

- We note, finally, that the Committee has not delivered a finished product as the Consultation paper reveals that there are still many uncertainties. Clearly, due process needs to be observed. We conclude from this that the Committee will need to organize another consultation round on the amendments that will be made to the Consultative Paper.

[2] Guidelines on Liquidity Buffers and Survival Periods, December 9, 2009, paragraph 64.
"Banks should periodically test whether central banks will effectively provide funding against (assets eligible as collateral) and should apply appropriate haircuts to reflect the amount of funding that central banks might actually provide in stressed scenarios (for the assets in question and for the banks themselves). Furthermore, banks will have to demonstrate adequate diversification in the total composition of the buffer so as to guarantee to supervisors that they are not relying too heavily on access to central bank facilities as their main source of liquidity."

Comments specific to the different blocks:

Regulatory standards. Liquidity coverage ratio

These proposals relate to the constituent elements of stock of high quality liquid assets and net cash outflows over a 30-day time period.

The main comments, according to the order in which they appear in the document, are the following:

- Paragraph 22. We consider that the scenario proposed means an over-stress test due to that, in practical terms, is quite unlikely a 3-noth downgrade scenario in a month framework. We think that a 2-noth downgrade scenario is more reasonable.

- Paragraphs 32 and 33 are too restrictive. In particular, with regard to paragraph 33 (also paragraph 34 d), it seems reasonable that, for example, U.S. public debt in dollars should be classified as high quality liquid assets both in Europe and in the United States.

- Paragraph 34. c) (i). The definition is very restrictive, and only accepts public debt with 0% RWA. This would mean, for example, that in the event of a rating downgrade of these titles, the market would be adversely affected given that they would no longer be eligible as liquid assets for the purposes of the LCR.

- Paragraph 34. c) (iii). It does not seem reasonable that securitisations, the basic instrument that retail banks use to mobilise loans granted to households and companies, and that are furthermore eligible by Central Banks given their high quality, are not classified as high quality liquid assets for the purposes of this liquidity ratio. Moreover, we believe that even those originated and issued by the institution itself should be recognised as such (with the corresponding haircut) because, as in the case of covered bonds, the first guarantee is a portfolio of assets with intrinsic value and, additionally, the maximum amount of an issuance is limited by the loans granted to households and companies.

  This is particularly illogical when it comes to collateral already delivered at Central Banks, that has not yet been drawn down.

  Finally, as explained in the preceding paragraphs, we believe that the most logical action (for the system and the economy) would be to include these securitisations in the numerator of the ratio; if they are finally not included in the numerator, they should be included in the denominator as an inflow (with the corresponding haircut).

  Paragraph 34. c) (iii). Additionally, we understand that the sentence on "the securities are not issued by banks or other financial entities" excludes the possibility to include as liquid asset the bonds issued by banks and fully guaranteed by sovereigns even with 0% risk weight. It is not coherent with the risk quality and liquidity of such kind of bonds.

- Paragraph 34. d) Some loans granted to the public sector are also eligible by Central Banks, in these cases they should have a positive consideration in the ratio, otherwise you would be treating unfairly the loans (retail banking) in comparison to securities and bonds.

- Paragraph 36. An adequate estimation must be made regarding the impact on bank funding and, therefore also on lending (both in volume and cost) to households and companies, of the non-computability as high quality liquid assets of bank debts, as this would be a blow to the senior bank bonds market, and this would, in turn, contradict the objectives pursued by NSFR.

  We therefore support the inclusion of bank bonds under liquid assets, although in this case we believe it would be reasonable to solely account those issued by other organisations and, when applicable, that their position in the numerator of the LCR is restricted to a certain percentage.

  Furthermore, it should be noted that this impact will not be equal in all jurisdictions as it is a well-known fact that there are countries where the dependence on bank financing is much higher than in others, and this means that there is an additional risk of constriction of financing for households and companies.

- Paragraph 37. Criteria on the depth, liquidity and market activity are too restrictive, especially if one takes into account the importance in some jurisdictions of the covered bonds market to finance households. Additionally, these criteria should be sensitive to the uniqueness of the circumstances experienced by markets over the last two years.

  In the same line we have commented above for the securitisations (see comment paragraph 34), we believe that even those covered bonds issued by the institution itself should be recognised as liquid asset.

- We also believe that the LCR numerator should include, with whatever haircut deemed appropriate, listed equities, as these are assets that have showed high liquidity even in the toughest moments of the crisis, if they are finally not included in the numerator, they should be included in the denominator as an inflow.

- Paragraph 41. The concept *"and higher"* could involve an important national discretion, which may lead to a distortion of competition.

- Paragraph 41 b). It does not seem reasonable to consider online deposits less stable than those opened in branches.

- Paragraph 41 b). To the extent that foreign currency deposits are also covered by the Deposit Guarantee Fund, these should also be deemed stable.

- Paragraphs 41 to 44. (*Retail deposit run-off*). The criteria set forth are too restrictive and not very granular regarding the run-off levels of retail deposits. Institutions should be allowed to apply internal models depending on the nature of their customers, and the specific characteristics of each jurisdiction.

  Ultimately, such a rigid approach in the treatment of deposits could lead to dysfunctional behaviour of financial institutions, a lack of incentives in the development of new products given the penalisation from the liquidity point of view.

- Paragraph 43. Accountability of term deposits should not be linked directly to the amount of the penalty, as in a moment of panic this could prove to be ineffective. Term deposits must be accounted with their relevant term, otherwise, we would be encouraging

financing on wholesale markets versus traditional retail financing, when the crisis has demonstrated that this last source of financing is more reliable than the first.

- Paragraph 51. It would be logical to extend the definition of operational client to include the entire client and not only the operational part thereof.

- Paragraphs 57-59. (Secured funding run-off. Amount to add into "Outflows" category, due to lack of roll-over).There is little economic rationale in considering that certain high quality assets, albeit insufficient for a factor 0% classification, would not deserve weighting better than 100%.

- Paragraph 60. We understand that the *3-notch downgrade* criterion does not take the starting point of each of the institutions into account. That is to say, a *3-notch downgrade* is not the same when the rating is AA- as when the rating is AA+.

- Paragraphs 67 and 68. *Other contingent funding liabilities*. It sets out a number of national discretions that might lead to a distortion of competition.

- Paragraph 66 (*outflow*) is asymmetric with paragraph 76 (*inflow*). In the treatment of contingent lines, it is assumed that the financial institutions cannot dispose of contingent liquidity facilities granted to it, but that others will exercise the ones they have versus the institution.

Regulatory standards. Net stable funding ratio

- As a general aspects of this ratio, we must state the following:
  - This ratio is too prescriptive and restricts the initiative of financial institutions in managing their liquidity and risk appetite.
  - The scenario proposed, at one year, is too hard, asymmetrical, and it does not sufficiently take into account the response of the organisation facing the scenario. It is very important to consider the combination of scenario and behaviour regarding this scenario.
  - There is a clear *double counting* effect, which is especially damaging for retail banks. The explanation is as follows:

    The requirement to fund >1 year the main amount of loans maturing <1 year (85% retail loans, 50% non financial corporate clients) implies the following duplicity:

    Let us take the example of a balanced, conservative funding strategy, where all long term retail loans are originally funded long term, matched in maturity. As soon as one of those long term loans, some years later, comes into a residual maturity < 1 year, it would need to be funded again (in 85% of its balance) with a liability maturing over 1 year, even though it already is financed by funds that perfectly match its residual maturity.
  - Appart from the double counting mentioned, from the global liquidity position point of view, this means funding short term assets with long term liabilities, thus creating a positive liquidity gap.
  - The calculations to be applied for the NSFR clearly penalise banks with a significant commercial lending activity, especially retail loans (view former example), and favours investment banks (banks with most assets concentrated in securities).

    In this sense, we enclose an example that could be useful to illustrate arbitrage possibilities of Basel Document. The first table shows the NSFR, according to current Basel's draft, for a bank with retail and corporate business mainly funded by customer deposits where the initial ratio is below 100%. From the second table it can be observed that just by transforming part of the corporate loans into corporate bonds and acquiring ABS to replace part of the loan portfolio NSFR is 100%

ASSETS	AMOUNT	NSFR %	Funding >1year	LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	100		96	RETAIL DEPOSITS	90		72
Maturity > 1year	70	100%	70.0	Insured in transactional based accounts	60	85%	51.0
Maturity < 1year	30	85%	25.5	Other retail	30	70%	21.0
CORPORATE LOANS	25		18	CORPORATE DEPOSITS	10	50%	5
Maturity > 1year	10	100%	10.0				
Maturity < 1year	15	50%	7.5				
PROPERTY AND EQUIPMENT	5	100%	5	SHAREHOLDER'S EQUITY	10	100%	10
OTHER ASSETS	3	100%	3	OTHER LIABILITIES	3	0%	0
				MEDIUM AND LONG TERM ISSUES	25		16
				Residual maturity > 1 year	16	100%	16.0
				Residual maturity < 1 year	9	0%	0.0
SECURITIES PORTFOLIO	8		0.4	SHORT TERM ISSUES	3	0%	0
Government secs. >1year	8	5%	0.4				
TOTAL ASSETS	141		121	TOTAL LIABILITIES	141		103
Commited retail facilities	20	10%	2				
TOTAL FUNDING REQUIRED			*123*	*TOTAL AVAILABLE FUNDING*			*103*

$$NSFR = \frac{103}{123} = 83\%$$

FUNDING DEFICIT > 1 Year = 20 bn

ASSETS	AMOUNT	NSFR %	Funding >1year	LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	100		83	RETAIL DEPOSITS	90		72
Maturity > 1year	70	100%	70.0	Insured in transactional based accounts	60	85%	51.0
Maturity < 1year	15	85%	12.8	Other retail	30	70%	21.0
Securitisation bonds < 1year	15	0%	0.0				
CORPORATE LOANS	25		10	CORPORATE DEPOSITS	10	50%	5
Maturity > 1year	10	100%	10.0				
Corporate bonds < 1year	15	0%	0.0				
PROPERTY AND EQUIPMENT	5	100%	5	SHAREHOLDER'S EQUITY	10	100%	10
OTHER ASSETS	3	100%	3	OTHER LIABILITIES	3	0%	0
				MEDIUM AND LONG TERM ISSUES	25		16
				Residual maturity > 1 year	16	100%	16.0
SECURITIES PORTFOLIO	8		0.4	Residual maturity < 1 year	9	0%	0.0
Government secs. >1year	8	5%	0.4				
				SHORT TERM ISSUES	3	0%	0
TOTAL ASSETS	141		101	TOTAL LIABILITIES	141		103
Commited retail facilities	20	10%	2				
TOTAL FUNDING REQUIRED			*103*	*TOTAL AVAILABLE FUNDING*			*103*

$$NSFR = \frac{103}{103} = 100\%$$

- This also creates room for arbitrage both for products (formalising loans by commercial paper or other securities) and institutions (non-bank institutions intermediating between banks and clients).

- The hypothesis assumed on assets needing stable funding are:

  - Arbitrary: No justification is provided for the percentages it intends to implement
  - It does not take into account neither the institution's business model nor the bank's own liquidity risk assessment.

Against this backdrop, we would like to suggest adopting an approach which allow banks to develop adequate internal quantitative frameworks to measure liquidity risk which fully capture the funding risk to which they are exposed – the understanding being that those internal frameworks would need to be validated by the college of supervisors on the basis of criteria which should be transparent and flexible and which should in any event be in conformity with the Committee's "Principles for Sound Liquidity Risk Management and Supervision". In respect of those firms, supervisors would make use of the quantitative NSFR metrics proposed in the Consultation Paper as a benchmark – meaning that those will apply except if the firm demonstrates to the satisfaction of its supervisor on the basis of behavioural overlays that the run-off factors would need to be refined.

        - It assumes that in liquidity stress scenarios and over a year the institution will not change its expected growth and must maintain the same funding structure

    - The treatment of other assets and liabilities, of collateral, of the market value of derivatives, etc. is not detailed enough and may involve an overly-punitive approach with the current wording, specially, due the asymmetries in the treatment of assets and liabilities.

- Paragraph 86 and 89. To be more specific, the NSFR ratio discriminates *retail* banks both in the numerator where stable deposits will be weighted at 85% - while wholesale financing will carry out this operation at 100% - and in the denominator, where financing with maturity over 1 year for companies and households requires a 100% factor, whereas corporate bonds only require 20%.This circumstance is even more relevant in the retail loans with residual maturity < 1 year where 85% factor is required, whereas no stable financing is required for bonds. In this sense, it is important to assess the impact that these proposals could have on the real economy.

- Paragraph 86. In addition, commercial paper placed across the retail network of branches, where the only significant difference versus deposits is that the former are not covered by the Deposits Guarantee Scheme, should have the same status as deposits, since the stability of both sources of funding is identical.

- The level of application of the proposal (consolidated and/or individual) is an essential issue that must be clarified as soon as possible. When dealing with this issue, the Committee should be aware of the different models of liquidity risk management used by the banks, being the main differing feature its degree of de/centralization. In fact, and though many large and cross border banks use a centralize model, our Association thinks that the decentralized liquidity model has proven to be superior to a model of branches from a prudential point of view. The decentralized model generates natural firewalls in the event of a crisis in both directions: from the parent company to the subsidiary and from the subsidiaries to the parent company. Also, it allows for a fair assessment of the risks involved in financial activity and a proper evaluation of country risk, which limits the possibility of unsustainable growth of credit. Moreover, the adoption of decentralized model contributes to reducing moral hazard in liquidity risk management at subsidiary level. This model would indeed prevent subsidiaries from growing in illiquid long-term assets and financing short-term from the market or the parent company, setting the right incentives for managers to identify, measure and manage liquidity risk at every level of consolidation. The recent crisis has finally demonstrated that, instead of exacerbating shocks, a centralized liquidity model is a determining factor in the spreading of systemic risk.

- Greater clarification would be needed regarding:

    - Possible offsetting of excess liquidity among countries with convertible currencies.

    - How to treat intra-group transactions, as the current approach is conservative and could lead to situations of "double" accounting to achieve compliance with ratios.

- As far as reporting is concerned, we would like to emphasize two circumstances:

    - The issue of frequency in reporting is very relevant and should not be discretionary for each national supervisor.

    - The frequency of information and the granularity arising can involve significant system developments, and significant workloads with a high cost.

- As far as *public disclosure* is concerned, we would like to add two further comments:

    - Although achieving an adequate level of transparency in public information on liquidity is important, the document imposes requirements that may be excessive, such as to communicate to the markets the level of ratios

    - A public breakdown of quantitative and qualitative information on the liquidity of an institution could lead to misunderstandings, if this information is not properly interpreted by the market, and undermine the situation of the institution as a result. A possible solution could be to include notes stating whether compliance with ratios is being achieved, stating the average levels of the financial year.