POSITION PAPER

WSBI-ESBG Position for the Basel consultation on an "international framework for liquidity risk measurement, standards and monitoring" (BCBS 165)

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The World Savings Banks Institute (WSBI) and the European Savings Banks Group (ESBG) appreciate the call for contributions in the Basel Committee's consultation on an "international framework for liquidity risk measurement, standards and monitoring". They therefore take the opportunity to submit their joint contribution.

1) Summary of WSBI-ESBG's core messages

The Basel proposals set out to increase financial stability by reducing the potential for a future liquidity crisis. This is to be achieved by improving credit institutions' liquidity management, namely by setting unprecedented regulatory standards which shall a) ensure greater robustness of banks to sudden adverse conditions (Liquidity Coverage Ratio, LCR) and b) prevent problematic mismatches between the maturity of funding and assets (Net Stable Funding Ratio, NSF). In addition the Basel Committee proposes metrics for monitoring by supervisors.

WSBI-ESBG generally agrees with the approach taken by the Basel Committee to develop binding rules for liquidity management and with the rationale to increase short-term and long-term resilience to liquidity risk. If properly designed and used, rules to improve liquidity management have the potential to correct many of the weaknesses which contributed to the 2008/09 crisis.

However, WSBI-ESBG also has serious concerns on many important details of the presented proposals. Currently, there are a lot of shortcomings or biases which, if left uncorrected, will lead to severe unintended consequences. The core problems identified by WSBI-ESBG are the following:

On the approach taken:

1. The current proposal takes a one-size-fits-all approach. It is neither adequate for retail banks, nor does it make sense for all national markets.
2. At present the proposal does not sufficiently take into account the different forms in which institutions may be organised. Decentralized organisation forms, a distinct characteristic of the European retail banking market, do not find appropriate consideration in the proposed concept. For instance, depending on the association among decentralised institutions, a special role can be played by a central institution, with which the other institutions are associated in a network in accordance with legal or statutory provisions and which is responsible for the balance of liquidity or handling of payments within the group. In such a setting, and in context of the calculation of the mandatory ratios of the NSF and the LCR, application on a consolidated level only is appropriate.
3. Should there really be regulatory standards? Why does the Basel Committee not take a risk-based approach, as it does for the capital regime? WSBI-ESBG strongly urges to consider establishing only minimum requirements in "Pillar I" and to leave room for banks' individual assessment of their specific liquidity risk under the supervision of local regulators.
4. The monitoring metrics for supervisors need to be more adaptable to different business models.

5. Public disclosure of banks' LCR, NSF and monitoring metrics is ill-advised since any publicly observed unfavorable change of these ratios may trigger liquidity runs and chain reactions on markets.

On the construction of the standards:

6. For both proposed regulatory standards the stress scenarios are excessively severe. The scenarios combine several stress factors in a way which is neither evidence-based nor probable. Here, the assumption that during a systemic crisis central banks would not play their assigned role as lenders of last resort is unrealistic and undermines financial stability.
7. For both proposed standards there are too many blanks or still undefined aspects. Without more and clearer information banks cannot give a conclusive assessment or quantify the effect of the regulation.
8. For both proposed regulatory standards, the stress-related assumed cash outflows/ discounts on availability of funding are exaggerated for important asset and liability categories. This results partly from the excessive severity of the stress test, partly from 'miscalibration' and partly from 'misconstruction' of the asset/liability categories.
9. For the LCR, the set of assets eligible to be counted as coverage is excessively restricted.

On the overall effect of the regulation:

10. The regulation sets out to reduce maturity mismatches within large international financial institutions and results in impeding all maturity transformation. This undermines the stable and sustainable business model of retail banks. Such an outcome will lead to greater financial and economic instability, not to greater stability.
11. The regulation proposal sets volumes of liquidity/funding that have to be held at all times. This will lead to increased competition for eligible liquid assets and funding. At the same time it blocks a great amount of balance sheet capacity at the cost of lending to banks, corporates and households. It may also pressure banks to engage in riskier activities in order to generate necessary returns.
12. Since banks' LCR may not sink below the standard, banks will be forced to earmark additional liquidity for 'real-life' liquidity purposes. This will even intensify the struggle for highly liquid assets and block even more balance sheet capacity, further making long-term commitments to the real economy unattractive – or even unfeasible.
13. The adverse effect on long-term commitments and bank lending is amplified by underestimating the stability of retail deposits as a source of funding. De facto the regulation penalizes retail banking activities. It creates great uncertainties concerning the financing of the real economy.
14. The introduction of the LCR will lead to distortions on asset markets, which are worsened by the excessively restricted set of assets eligible for being counted as coverage. Demand for assets which are treated less favorably by the regulation will decrease, leading to unpredictable declines in prices. On the other hand, prices will increase drastically for those assets made attractive/necessary by the regulation. Asset prices will become a less useful signal on underlying economic fundamentals.
15. WSBI-ESBG decidedly warns against combining liquidity standards of the form presently discussed with a leverage ratio. Especially the high quality liquid assets required by the LCR will already take up significant balance sheet capacity, while at the same time yielding only low returns. Further limiting banks' balance sheet size by tying it directly to capital puts

exaggerated limits to banks' ability to lend and generate necessary returns. ESBG also points out that LCR and leverage ratio are conceptually inconsistent, since a leverage ratio is not risk based, and will therefore not even recognize the low level of risk associated with those assets which banks will be explicitly hold to fulfill a regulatory liquidity standard. Should the leverage ratio (in spite of its serious disadvantages) become reality, it is vital that the assets held in context of the LCR are *not* included among the factors contributing to an institution's leverage.

From these points it is obvious that there is great danger of "overshooting", especially in the retail banking area. For this reason we expect the regulation, as it currently is proposed, to significantly reduce retail banks' ability to lend to the real economy.

In part these problems arise because the Basel Committee's target groups are large international financial institutions. The current proposal does not sufficiently take into account that such regulation will be implemented globally and applied to all types of credit institutions, i.e. well beyond its original scope. Consequently, much more fine-tuning is necessary:

- Either the current one-size-fits-all approach needs to become much more detailed and adaptable to a much wider range of business models.
- Or the approach needs to be changed to allow for adjustment to the individual banks' circumstances and business models.

The present consultation is part of a much wider initiative to overhaul and improve the regulatory framework. Now is the time to take into account stakeholders' comments to the entire reform package. Then the priority is to gain more certainty on the inter-linkages among and the cumulative impact of the different reform proposals. WSBI-ESBG therefore urges the Basel Committee to conduct a comprehensive impact assessment of the entire amended reform package, also covering its macro-economic aspects. Based on the outcome, a second round of consultation needs to be launched.

WSBI-ESBG would also stress that banks and regulators alike need to work in a much more generous time-frame than the one currently envisaged. It is not the pace of reform that counts but the outcome.

2) Remarks on proposed regulatory standards

WSBI-ESBG supports the Basel Committee's objective to a) ensure greater robustness of banks to sudden adverse conditions (Liquidity Coverage Ratio, LCR) and b) prevent problematic mismatches between the maturity of funding and of assets (Net Stable Funding Ratio, NSF). Faced with the concrete proposals, however, WSBI-ESBG sees that a lot of work still needs to be done.

Before addressing detailed problems related to the measures in question, there is one central conceptual issue to be clarified.

The proposed regulatory standards take a one-size-fits-all approach. This is at odds with both bank specific factors and the lessons from the crisis. It also is a significant shortcoming. There is little merit in applying the same assumptions to, for example, pure retail banks and pure investment banks, to institutions relying for funding on retail deposits and to institutions seeking financing only on wholesale financial markets. The serious issues arising from this approach are also becoming evident in WSBI-ESBG's more detailed comments.

For this problem there are two remedies:

- If regulators insist that the liquidity measures have to become regulatory standards, then the standards need to be fine-tuned in order to become applicable to all banks in all countries.
- Alternatively, only minimum standards should be established under "Pillar I", to be complemented by bank-specific liquidity tests (under the control of supervisory authorities), which for instance could include internal models. WSBI-ESBG strongly favours this approach, which is supported by the guidelines developed by the Committee European Banking Supervisors (CEBS).

In any case, introducing a simplistic and hence biased regulation is not the way forward.

It also is problematic that the Basel proposal does not allow sufficiently for national differences, which are difficult to harmonize into prescriptive standards. For instance, the construction of the LCR does not foresee that national governments may have little need to borrow. In the proposal for the NSF, it is neglected that government policy measures may well impact on funding outflows (the observed state guarantees for bank debt or deposits are but one extreme example).

As regards the application within institutions, WSBI-ESBG understands that the new liquidity rules are to apply at the consolidated level only (application on solo level remains the exception). WSBI-ESBG appreciates and welcomes this approach, since it does not unnecessarily restrict the transfer of liquidity within a banking group. Indeed, we would underline that the 2008/09 crisis has demonstrated the importance of banking groups being able to balance overall group liquidity demand among the different group members.

Furthermore it is essential that the Basel Committee will soon give reliable and detailed information on the transition process, including the questions of timing and treatment of banks' existing assets and liabilities. Here WSBI-ESBG points out that a timely discussion with stakeholders is vital to ensure a smooth transition to the new standards. We also stress that institutions need to be given certainty as soon as possible regarding the details of the phasing-in measures and grandfathering arrangements.

a. *Liquidity Coverage Ratio (LCR)*

The LCR is designed to prevent a recurring of the problems arising from the sudden drying up of bank liquidity experienced during the 2008/09 crisis. This is a goal WSBI-ESBG fully supports. However, WSBI-ESBG has important concerns relating to various aspects of the proposal currently on the table, in particular since several assumptions are not based on evidence.

i. *Remarks on stress scenario prescribed*

WSBI-ESBG has doubts on the prescribed stress scenario against which banks are expected to protect themselves by maintaining prudent liquidity profiles. The details of this stress scenario therefore have a great impact on banks' balance sheet decisions. Consequently, a misspecification of the scenario will be highly problematic.

On this basis WSBI-ESBG emphasizes the following points:

- The approach taken is very conservative and the prescribed stress scenario is unrealistically harsh, adding a market wide shock to a deep and sudden idiosyncratic crisis at the bank itself. This combination is very improbable; not even during the 2008/09 financial crisis did such a situation materialize for most banks (while, of course, for those banks which indeed underwent a similar experience, the arising liquidity problems were extremely severe).
- Imposing a three-notch downgrade in the institution's public credit rating within 30 days is very drastic. Assuming that such a downgrade would happen out of the blue and without any regard to the bank's business model, exposures and general soundness does not seem realistic. In addition, the impact of such a downgrade on the bank's funding possibilities strongly depends on its current credit rating. Hence this aspect of the stress scenario is overly simplistic and ignores the importance of a bank's specific characteristics.
- Also, it is not foreseen that banks have access to liquidity support from central banks – a requirement which runs contrary to central banks' function as lenders of last resort. This assumption is improbable in situations where the worst case scenarios accumulate, as they do in the prescribed stress scenario, which after all entails systemic-crisis driven bank runs. This does not imply that central bank liquidity support should be treated as an option to increase the LCR, but it underlines that there is significant overshooting as regards the severity of the currently imposed stress scenario.

Given all these weaknesses, WSBI-ESBG fails to see why there should not be room to introduce more bank and market specific stress scenarios, of course depending on the approval of national supervisors.

ii. Construction of the LCR

The LCR namely "aims to ensure that a bank maintains an adequate level of unencumbered, high quality assets that can be converted into cash to meet its liquidity needs for a 30-day horizon under an acute liquidity stress scenario specified by supervisors". Banks therefore will need to hold a stock of high quality liquid assets which will at least cover net cash outflows over a 30-day period:

$$\text{LCR} = \frac{\text{stock of high quality liquid assets}}{\text{net cash outflows (30-day period)}} \geq 100\%$$

<u>Remarks on the eligible high quality liquid assets (HQLAs)</u>

WSBI-ESBG agrees that, in order to fulfill their purpose, HQLAs should unite certain fundamental and market-related characteristics: low credit and market risk, ease and certainty of valuation, low correlation with risky assets, listed on a developed and recognized exchange market, an active and sizable market, presence of committed market makers, low market concentration, flight to quality (§29). Consequently banks need to cover stressed net outflows of funds by holding a stock of liquid assets that should easily and immediately be converted into cash at little or no loss of value.

Presently included (provided certain conditions are met) and fully recognized are: cash; central bank reserves (to the extent that they can be drawn down in times of stress) and marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities (PSEs), the Bank for International Settlements, the International Monetary

Fund, the European Commission, or multilateral development banks. In addition, the Committee considers whether up to half of the HQLAs can be formed by corporate bonds (unless issued by a bank, investment or insurance firm) and covered bonds (not issued by the bank itself), which, however, receive substantial haircuts and have to fulfill a series of requirements in line with the asset characteristics listed above (§34 – §37). In this context WSBI-ESBG wonders whether haircuts similar to the ones applied by central banks in context of their liquidity facilities would not be more suitable.

While WSBI-ESBG appreciates and shares the reasoning behind holding sufficient highly liquid assets, WSBI-ESBG emphasizes that the range of the concrete assets which the Basel Committee will accept as HQLAs is far too restrictive. In particular the strong focus on cash, central bank reserves and public sector debt (or public sector guaranteed debt) underestimates the liquidity of many forms of private sector issued instruments. It is therefore absolutely vital that high quality and liquid covered bonds and corporate bonds are included among the HQLA eligible assets.

If the current restrictive list is maintained, the ensuing dynamics will have a significant and disruptive impact on banks' business models on the one hand and on asset markets on the other hand:

- Even for certain (potentially) eligible assets, some of the required conditions pose an exaggerated hurdle. For instance, the requirement to demonstrate for corporate bonds and covered bonds that they have a "proven record as reliable source of liquidity" is difficult to meet in general, and would exclude newly issued products – an effect that cannot have been intended. In addition while the requirement of low spreads is reasonable, it is exaggerated to ask for documentation of the bid-ask-yield spread for ten years.
- The current proposal not only affects banks' liquidity management but also their profitability, since it forces banks to hold more eligible sovereign debt (or similar assets), which, given its low risk, also yields low-return. This effect will be amplified since regulation induced increase in demand will lower returns even more.
- The current small range of eligible assets appears incompatible with the diversity in banks' funding sources. Indeed, the fact that bank-issued corporate bonds are excluded from the HQLAs may make them less attractive for other financial institutions and can severely impede banks' funding possibilities, especially since banks are significant holders of financial sector debt (an effect which is augmented also by the treatment of retail banking deposits in the NSF, discussed below). Shrinking the group of investors in bank bonds (thereby also increasing their price) cannot be the goal of the Basel Committee.
- Most likely banks will focus on HQLAs in their own currency. Here the narrow definition of HQLAs can lead to at least three different problems:
    - There will be jurisdictions with very sound public finances and very low levels of public debt, where available HQLAs (where sovereign debt plays an important role), will probably not cover national banks' needs.
    - In other jurisdictions, national sovereign debt may not have a 0% Basel risk weight, equally leading to a shortage of HQLAs available to the national banking sector (as a side-effect, it will make financing of public debt for those countries more difficult and increase the spread between the rates payable on the national debt of different countries; current events lead to the question whether this would be desirable from a macroeconomic point of view).
    - Furthermore, what will happen if countries' risk ratings are down-graded?
- For asset markets there will be a substantial disruption of the risk-and-price-based equilibrium of supply and demand: the regulation will lead to a material surge in demand by banks for

HQLA eligible assets, whereas the demand for other, ineligible assets most likely will diminish. These price changes will be independent of economic fundamentals, and for assets issued in the future these regulation effects will be priced in at issuance. As a result, the value of asset prices as information on the quality and underlying risk of assets will be greatly impeded.

- For the real economy, issuing non HQLA eligible debt may become substantially more expensive, since the regulation increases banks' opportunity cost of holding non-HQLA debt. This can have a significant adverse effect for the financing of industry.
- The restrictiveness of the regulation may even undermine its own objective: If banks all over the world have to hold significant amounts of the HQLA eligible assets, this may actually reduce the liquidity of these assets in reality. Conversely, should a systemic crisis really occur again, in order to cover liquidity outflows all – or at least a very large number of - banks would be selling very similar/or even the same types of assets at the same time. While it is not even clear whether there would be sufficient buyers in such a scenario, it is already obvious that at least asset prices would tumble. In such a situation the specified LCR would be self-defeating.

WSBI-ESBG would also like to point out that the restricted list of HQLAs is a direct consequence of the overshooting of the assumed stress scenario. Decreasing the severity of the stress scenario to levels of stress which are more realistic and which banks should indeed be expected to withstand alone could already solve a lot of the problems listed above.

WSBI-ESBG would particularly recommend as more adequate the assumption of only an idiosyncratic bank specific stress scenario (i.e. without the systemic or market driven assumption). This would have the additional benefit that HQLAs could include high quality and highly liquid corporate bonds, and that the additional haircuts to all eligible corporate bonds and covered bonds would not be necessary. WSBI-ESBG also finds that, in general, central bank eligible assets are highly liquid even in times of market stress.

Furthermore, WSBI-ESBG points out that corporate bonds issued by credit institutions have similar risk properties as corporate bonds issued by non-financial firms. Also, we have observed functioning repo-markets for such papers even during the crisis. Therefore we advocate that such papers should become eligible as HQLAs, receiving the same treatment as corporate bonds. In addition, under certain conditions, for instance if covered by the institution's overall mortgage book, also own corporate bonds should be eligible to serve as banks' HQLAs.

Remarks on the assumption on net cash outflows

The net cash outflows against which banks need to hold sufficient HQLAs is calculated as the cumulative expected cash outflows minus cumulative expected cash inflows arising in the specified stress scenario in the time period under consideration. Cumulative expected cash outflows are calculated by multiplying outstanding balances of various categories or types of liabilities by assumed percentages that are expected to roll-off, and by multiplying specified draw-down amounts to various off-balance sheet commitments. Cumulative expected cash inflows are calculated by multiplying amounts receivable by a percentage that reflects expected inflow under the stress scenario.

In the current proposal, the Basel Committee sets values for these percentages, where WSBI-ESBG has the following concerns.

On cash outflows

As a general comment, WSBI-ESBG would like to stress that the Basel Committee's assumptions on out-flows are overly conservative. Furthermore, should the Committee recognise that, as argued above, the stress scenario is too stringent and improbable, it naturally follows that the out-flow rates have to be adjusted accordingly (this point relates mainly to those ratios which are driven by the systemic crisis characteristics of the stress-assumptions). WSBI-ESBG also would like to point out that, in any case, the run-off rates should not exceed the rates observed during the 2008/09 crisis.

More specifically WSBI-ESBG has the following concerns:

On run-off rates of retail and SME deposits: §41 - §44, §48 -§49:

WSBI-ESBG understands the importance of taking into account a possible 'bank-run like scenario' by depositors. Yet the current proposal is problematic:

- The current 'run-off' ratios (7.5% - 15%) are too high and not realistic in a 30 day horizon for any reasonable stress situation. Furthermore, they penalize the business model of smaller and regionally active institutions, which draw a lot of their funding from retail deposits and invest them into low-risk lending to the real economy.
- The distinction between 'stable' and 'less stable' retail deposits is overly complicated and requires an exaggerated data mining effort by banks, as it builds on too many details of deposit guarantee scheme coverage.
- The cap of eligible SME deposits (currently € 1million) is arbitrary and overly restrictive.

WSBI-ESBG would propose to reconsider the level of the run-off rates and to define as 'stable' all accounts which are covered by a deposit guarantee scheme, since this will strongly influence customers' decision to leave their money at the bank. For SME also larger deposits should be admitted in this category (and not be treated like wholesale deposits).

On run-off rates for wholesale funding: §51 onwards:

In order to apply the 'stable' run-off rate (25%) to deposits and other extensions of funds made by non-financial corporate customers (other than SMEs), sovereigns, central banks and public sector entities, banks generally have to show that such deposits are needed for operational purposes. WSBI-ESBG stresses that this requirement is not acceptable – especially for smaller banks –, as it de facto imposes on banks to investigate into the cash-management of their customers and apply the 'run-off rate' on a case-by-case basis.

Therefore, WSBI-ESBG strongly urges to apply the run-off rate of 25% to all such funding, in particular as the 'less stable' run-off rate of 75% is greatly exaggerated.

Draws on committed credit and liquidity facilities: §66

The Basel proposals assume that committed liquidity facilities to non-financial corporate customers will be fully (i.e. to 100%) drawn down. WSBI-ESBG believes this to be excessive, even if a systemic crisis would cause liquidity hoarding by the wider economy. Furthermore, if left unchanged, this assumption may easily lead to an outcome where banks will either stop writing commitments or significantly increase charges.

On cash inflows

Lines of credit, liquidity facilities etc: §76

It is assumed that neither credit nor liquidity lines a bank has with other institutions will be drawn upon under the stress scenario. WSBI-ESBG points out that this treatment of possible cash inflows is inconsistent with the treatment of outflows, i.e. the draw-on rates assumed for the corresponding facilities provided by the bank itself (see §66). This is an unfounded assumption which artificially increases outflows versus inflows and discourages the granting of credit lines by banks. This point therefore needs to be corrected. Furthermore, given the current ineligibility of bank debt for HQLA's (prescribed for the LCR), it is not even sure whether there would be sufficient demand on wholesale markets in order to provide the substantial amount of additional long-term funding needed.

iii. On the usefulness of the LCR as a 'liquidity buffer'

This being said, WSBI-ESBG also needs to point out another substantial conceptual weakness of the current approach: given that the LCR is a regulatory standard, banks will need to organize themselves in such a way that they can fulfill this requirement at all times – i.e. even if they are indeed undergoing a period of (milder) liquidity stress. This means that the HQLAs which are earmarked in order to maintain the LCR at 100% cannot be used in order to mitigate a liquidity shortage the bank is experiencing in reality.

In this sense the HQLAs do not function as a true liquidity buffer, but rather constitute 'dead assets'.

As a consequence, banks will have to hold even more high quality liquid assets than stipulated by the regulation. This, however, implies an even greater hoarding of high quality liquid assets, as well as an even more severe crowding out of long-term loans and other forms of commitment to the real economy. In addition, should the LCR become depressed during a crisis (either if banks' stock of HQLA lose value, or due to sudden unpredicted cash outflows), banks may even be forced to restock the HQLAs, an outcome which could worsen an already adverse situation.

For the LCR to be useful it is therefore necessary to, under certain conditions, tolerate a fall of the LCR under 100%. Should this occur, banks would need to immediately inform the competent supervisor and agree on an action plan to restore compliance with the standard.

iv. Combined impact on traditional retail banks' activities

WSBI-ESBG is very apprehensive of the combined effects of the narrow definition of eligible HQLAs in combination with the prescribed run-off rates for funding. In particular for traditional retail banks the current proposal will hit banks twice:

- The assumed run-off rates for retail deposits are excessive and hence significantly undermine traditional retail banks' funding side. Not only would the competition for retail deposits become very heated, aggravating the disadvantages of traditional 'comprehensive banks' vis-à-vis their large competitors, for instance those aggressively competing via internet banking facilities. The

current proposals could furthermore force regionally oriented retail banks to seek extra (and otherwise unneeded) funding on wholesale markets, which may not even be compatible with their business models.

- The effect of the treatment of retail and SME deposits becomes even more aggravated by the fact that retail banks' main assets, i.e. loans to the real economy are not considered among the stock of liquid high quality assets. Hence traditional retail banks may be forced to drastically reduce lending, and credit/liquidity commitments.

Taken together, it stands to fear that the current proposals will put great strain on regionally oriented and traditional retail banks and will undermine their ability to fulfill their role as lenders to the regional and local economy. However, regulators must be aware that it is precisely the traditional retail banking model which has proven stable and sustainable during the crisis and forms a cornerstone for economic prosperity in many markets.

In view of the other regulatory initiatives[1], WSBI-ESBG can only warn against adding a leverage ratio to the currently discussed liquidity requirements. Obliging banks to hold significant amounts of HQLAs expressly for liquidity purposes, while tying absolute balance sheet size to the capital stock, will further decrease banks ability to invest in long-term, illiquid assets. The combination of LCR and leverage ratio may lead to a drastic under-provision of lending to the real economy. Should the leverage ratio (in spite of its serious disadvantages) become reality, it is vital that the assets held in context of the LCR are *not* included among the factors contributing to an institution's leverage

WSBI-ESBG trusts that these cumulating dismal effects cannot be the intention of regulators and that the proposal will be corrected accordingly.

b. Net Stable Funding Ratio (NSF)

The second requirement proposed by the Basel Committee has the purpose to promote more medium and long-term funding of the assets of banking organizations. This, too, is a goal WSBI-ESBG fully supports. Indeed, the crisis has shown that it is necessary to give many banks the incentive to structurally change their liquidity risk profiles and to reduce excessive short-term funding in favor of more stable, longer-term funding.

However, WSBI-ESBG also has significant concerns on some of the aspects of the details put forward of the NSF. Here we see a great danger in the current one-size-fits-all approach, which is not by far adequate for the various business models coexisting in the financial sector.

i. Construction of the NSF

The NSF as a long-term structural liquidity ratio determines which minimum amount of stable funding banks must hold depending on their projected funding requirements, taking into account a prolonged stress scenario. The NSF stipulates that such funding requirements need to be at least fully met:

[1] For instance the Basel consultation on "strengthening resilience in the banking sector" (BCBS 164)

$$\text{NSF} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

Available stable funding is defined as those types and amounts of equity and liability financing that are expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress.

The stress scenario for the NSF is firm-specific and therefore less trying than the one assumed for the LCR. However, again it is not foreseen that the central bank will act as a lender of last resort, even if in reality intervention by the central bank could be expected when 'material events' occur.

As regards the proposed time-horizon of one year, WSBI-ESBG has to point out a certain degree of arbitrariness. A more gradual approach – i.e. including in the assessment the stability of funding for six months and 18 months – could help reduce potential 'cliff effects' and would yield a more representative picture.

WSBI-ESBG also considers it a conceptual weakness that the current set-up ignores that in reality, within one year of experiencing bank-specific stress, banks may already have made some mitigating changes in their business model or activities. Furthermore, WSBI-ESBG urges to consider business model specific elements in the assumed stress scenario instead of insisting on a one-size-fits-all approach. Here the use of internal models and contributions by national supervisors would be a great improvement.

Remarks on the specification of 'available' and 'required' funding

As a general remark, WSBI-ESBG stresses that the treatment of assets and liabilities needs to be much more granular. In particular the categories 'other assets' and 'other liabilities' need to be more detailed, with fine-tuned 'availability' or 'required' factors. Furthermore WSBI-ESBG sees no justification why in the category of 'required funding', better quality low risk assets should be treated in the same way as long-term risky assets.

With regard to the calibration put forward, WSBI-ESBG needs to stress its concerns. As a general comment, the uniform, strict run-off and draw-down factors cannot be considered evidenced based and do not reflect correctly the general behaviour of retail and wholesale clients experienced during the recent crisis.

On the derivation of 'available stable funding factors': § 86

WSBI-ESBG finds it exaggerated to assume zero rollover for inter-bank deposits maturing within one year. Such a drastic shutdown of wholesale funding over one year does not appear evidence based. WSBI-ESBG therefore strongly objects especially to the inclusion of secured inter-bank deposits among the 'other liability categories' receiving a 0% availability factor.

WSBI-ESBG also is extremely concerned with the low availability factors assumed for retail and small business deposits maturing within one year or without specified maturities. A total loss of 15-30% (i.e. a 70-85% availability factor) is not evidence based. This is a critical point since the present calibration will have a detrimental effect for institutions that draw strongly on such deposits for funding. It furthermore is not consistent with the recognition that retail deposits are among the

most stable sources of funding and the general observation that bank-client relationships tend to be very stable especially for retail clients.

An unintended consequence of such a scenario also is that even 100% deposit funded retail banks would have to resort to wholesale markets in order to obtain extra funding, which for their real business they would not even need. Furthermore, given the current ineligibility of bank debt for HQLA's (prescribed for the LCR), it is not even sure whether there would be sufficient demand on wholesale markets in order to provide the substantial amount of additional long-term funding needed. WSBI-ESBG therefore strongly urges the Basel Committee to reconsider these 'run-off' factors.

On the derivation of 'required stable funding factors': §87 - §91

WSBI-ESBG understands that the Basel Committee is concerned with securing long-term stable funding for long-term assets, the more so if the assets concerned are found to be (relatively) illiquid. However, the current focus on liquidity and maturity implies that important banking activities are assigned disproportionate funding requirements.

This is a critical – and harmful – shortcoming. Especially the proposed treatment of long-term corporate lending is very harsh (included among 'other assets' with a 100% RSF factor). Equally included in this category are long-term loans to retail clients, and hence for instance mortgage loans. Such required stable funding demands may even discourage retail banks from keeping such assets on their balance sheets or from committing to long-term corporate loans in the future. These effects cannot have been intended by regulators given the experiences made during the last two years. Furthermore it is problematic that even for loans to retail and corporate clients that mature within one year, the amount of required stable funding is very high.

ii. Combined impact on traditional retail banks' activities

A NSF of 100% questions the very core principle of banking, which is maturity transformation (and which implies at least some liquidity risk).

In this context, WSBI-ESBG also needs to highlight that as a result of the assumptions for the NSF, three standard retail banking activities (deposit taking, lending to households and loans to businesses) are severely penalized. The resulting constellation is dangerous:

- On the one hand the stability of traditional retail banks' funding source (retail deposits) is underestimated, reducing its potential to serve as 'available stable funding'.
- On the other hand traditional retail banks' main assets (long-term loans to the real economy and to households) require an excessive amount of net stable funding.

A direct effect may well be that for traditional retail banks, engaging in long-term commitments towards corporate customers may become very expensive in 'required funding terms'. As a consequence, given that a large part of banks' portfolio cannot be re-priced, banks will have the incentive to run down their loan books and to reduce overall lending. However, discouraging long-term commitments or making them much more expensive would have grave effects on the wider economy and on those, especially smaller enterprises, for which long-term bank loans are a vital source of financing.

Furthermore, the present discouraging treatment of very safe assets may increase the impulse for banks to turn to very high risk activities in order to generate return. Equally, this outcome may lead to dynamics where fierce competition for retail banking deposits makes them a less stable funding source.
This being said, from a macroeconomic perspective it is not even clear whether in all markets the amount of stable funding required will actually be available.

WSBI-ESBG understands that the objective of the NSF is to "ensure that investment banking inventories, off-balance sheet exposures, securitisation pipelines and other assets and activities are funded with at least a minimum amount of stable liabilities in relation to their liquidity risk profiles". Against this background it is even more vital that the NSF does not inadvertedly increase the regulatory hurdles for a business model which has a completely different focus, and which furthermore proved among the safest during the crisis.

3) Remarks on monitoring tools

In addition to the previously outlined regulatory standards, the Basel Committee proposes four metrics as monitoring tools for supervisors. The proposed metrics concern contractual maturity mismatch, concentration of funding, available unencumbered assets and market-related monitoring tools.

While per se the additional monitoring tools will be useful, WSBI-ESBG is not fully convinced of all the presented approaches.

a. Remarks on metric 1: contractual maturity mismatch

The metric would map contractual cash and security inflows and outflows according to defined time bands based on their respective maturities. The Basel Committee argues that the identified maturity gaps indicate how much liquidity a bank would potentially need to raise in each of these time bands if all flows occurred at the earliest possible date and give insight on the bank's reliance on maturity transformation under its current contracts.

Here, WSBI-ESBG has the following comments:

On the focus on contractual maturities: **§ 97**

WSBI-ESBG has to point out that the present focus on contractual maturities is not realistic. In particular in the retail banking area, customer deposits are very often open-ended, i.e. there are no contractual maturity dates. Clients can withdraw their money (depending on the conditions of their account) – yet, generally it has been observed that bank-customer relationships are long lasting, which means that even in 'open ended' deposits there is generally little outflow of funding. Accordingly WSBI-ESBG urges that there needs to be room for national supervisors to take an assumption based approach on the treatment of such deposits, since otherwise the perceived maturity mismatch will be grossly overstated for retail deposit taking institutions.

b. *Remarks on metric 2: concentration of funding*

The metric is designed to identify those sources of wholesale funding where, if they are withdrawn, the bank would face liquidity problems. The approach is to derive the importance (relative to balance sheets) of funding liabilities from individual counter parties and from significant products/instruments, as well as the prominence of assets and liabilities in significant currencies. Here, the following issues need to be addressed:

On the definition of 'significant counterparties': § 107

The current proposal sets the volume threshold above which a counterparty is considered 'significant' at 1% of total liabilities. WSBI-ESBG finds this to be overly conservative and cannot recognize any concentration risk at this level. However, the definition not only appears unnecessarily strict. It also has the conceptual weakness that it leads to a biased assessment: focusing only on a counterparty's share of total liabilities in order to determine its significance automatically implies a larger number of 'significant' funding sources for those institutions with a large capital base (and a smaller amount of liabilities) than for highly leveraged banks.

On the definition of 'significant instruments / products': § 109

The current proposal sets the volume threshold above which an instrument/product is considered 'significant' at 1% of total liabilities. Here, too, WSBI-ESBG finds the threshold to be overly conservative and cannot recognize any concentration risk at this level. In addition it disregards that especially smaller institutions mainly draw on customer deposits for funding, while refinancing on the inter-bank market plays a much smaller role. Hence, such banks finance themselves on the basis of a small number of products (i.e customer accounts) – however, this does not imply any concentration risk, given the great heterogeneity of retail deposit holders.

On the definition of 'significant currencies': § 111

The current proposal determines that a currency is 'significant' if summed-up liabilities denominated in this currency amount to 1% of total liabilities. WSBI-ESBG is highly doubtful that a 1% threshold is meaningful, given the fact that of the ca. 160 existing currencies, only a very small number are anchor currencies and hence globally important. In addition it stands to reason that for a bank its domestic currency will always be 'significant'.

This remark also applies to § 119, in context of the metric for available unencumbered assets.

4) Remarks on application issues for standards and monitoring tools

As regards the application issues for standards and monitoring tools, WSBI-ESBG has the following comments:

On public disclosure: §135

The Basel Committee states that standards and monitoring metrics should be publicly disclosed and that disclosure should take a high degree of granularity. While WSBI-ESBG can understand the reasoning behind this requirement, we strongly advise against it for two reasons.

Firstly, public disclosure is generally based on figures, which are at least a few months old. Since the liquidity situation itself changes continuously, the published figures will be outdated already at publication. Hence the disclosed information of very simple metrics and figures will be misleading.

Secondly, we need to warn that a public disclosure requirement could actually lead to greater instability. In particular there is the risk that the market may misunderstand the effects of business cycle volatility and interpret them as first signs of bank specific problems. Also, if, for whichever reason, the disclosed LCR and NSF are observed to decline and to approach the Basel limits, the market reaction could lead to trigger runs and draw-downs.

About WSBI-ESBG (World Savings Banks Institute – European Savings Banks Group)

WSBI-ESBG – The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via ESBG, the European Savings Banks Group). It works closely with international financial institutions and donor agencies and promotes access to financial services worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to more than €9,000 billion, with operations through more than 180,000 branches and outlets.

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of more than € 6,000 billion (1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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