The Clearing House
At the Center of Banking Since 1853

September 14, 2012

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Monitoring indicators for intraday liquidity management

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**"), an association of major commercial banks,[1] appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (the "**Basel Committee**") July 2012 consultative document, *Monitoring indicators for intraday liquidity management* (the "**Consultative Document**").

The Clearing House has consistently voiced strong support for ongoing regulatory reform efforts that aim to make financial systems safer and more robust. The Clearing House supports the notion that it is critical that intraday liquidity risks be managed such that payment and settlement obligations are met on a timely basis under both normal and stressed conditions. We further recognize that the interdependencies that exist among payment systems and the inability to meet certain critical payments have the potential to lead to disruptions that can hinder the smooth functioning of financial markets. In fact, the Payments Risk Committee[2] **("PRC")** published a study in March 2012 on intraday liquidity flows that provides an understanding of the magnitude of the flows and highlights the significant interconnectedness of the infrastructure needed to support more than $14 trillion of USD denominated payments and the associated $9 trillion of cash needed to settle those payments

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] The Payments Risk Committee is a private sector group of senior managers from U.S. banks that is sponsored by the Federal Reserve Bank of New York. The Committee identifies and analyzes issues of broad industry interest related to risk in payments and settlement systems.

The Clearing House Association L.L.C. : 450 West 33rd Street : New York, NY 10001
Phone 212.613.0100 : Fax 212.613.0184 : www.theclearinghouse.org

over the course of a business day around the world.[3] The Clearing House does not believe that the use of the proposed indicators for monitoring intraday liquidity will allow supervisors to have a complete understanding of how banks manage intraday liquidity including peak flows and govern the overall payments process. Moreover, we believe that the current proposal lacks clarity with respect to purpose, scope, cost and individual measurements.

I. The Consultative Document lacks transparency on what is intended to be monitored.

The Consultative Document rightfully focuses on required intraday liquidity and the timing of payments. However, while the Consultative Document explains what should be measured, it lacks explanations on what risks are to be assessed and ultimately mitigated through the monitoring of the proposed indicators. The relevance of such indicators needs to be clarified and the scope/applicability should be further developed as it relates to mitigation of the risks.

While the intent of the Basel Committee appears to be the monitoring of intraday flows, the actual outcome is an overlap of both intraday risk and standard liquidity risk. The Clearing House believes that there are different risks inherent in processing a payment for a client in advance of receiving funds as compared to processing a payment for a client who has pre-funded via their existing demand deposit account balance. The former is intraday risk in that the bank must have sufficient liquidity or collateral to accommodate the client request and the bank runs the risk that the client may not reimburse it by end of day; while the latter is a simple deposit outflow for which the bank holds liquidity reserves. While this alone is not a major concern, it does complicate the determination of a bank's available liquidity resources. In practice, it is difficult for banks to segregate the collateral or liquidity dedicated to clearing needs (true intraday risk) from collateral or liquidity required to support deposit runoff (structural liquidity risk). We believe that because the measures in the Consultative Document capture both intraday risk and the risk of deposit outflow, they are of limited meaning and utility.

Although Paragraph 6 in the Consultative Document notes that the proposed indicators are for monitoring purposes only and do not represent the introduction of new standards, it is important for banks to understand (i) what will be done with the data, (ii) how the data will influence decision-making and (iii) who will have access to the data. Without this information, there could be several unintended consequences and it is important that care be taken such that the monitoring of the activity does not affect the activity itself. For example, if a negative perception is attached to an indication of insufficient intraday liquidity based on the proposed indicators, banks could be incentivized to withhold payments in order to improve their metrics. As an example, many CHIPS[4] participants run negative intraday positions at the beginning of the clearing day but provide critical liquidity to the network so that payments may flow. If these

[3] See "Intraday Liquidity Flows" Report of the Payments Risk Committee, March 30, 2012.
[4] The Clearing House Interbank Payments System ("**CHIPS**") is the main privately held clearing house for large-value transactions in the United States, settling well over US$1 trillion a day in around 250,000 interbank payments.

participants were to withhold liquidity, the flow of payments would be slowed potentially creating gridlock situations that may hamper the effective functioning of the payment markets particularly in times of stress when prefunding requirements increase. We also note that if this requirement is not harmonized globally, the opportunity for arbitrage between systems may be created, shifting liquidity from one system to another.

The Consultative Document focuses almost exclusively on monitoring intraday liquidity and fails to address other important aspects such as governance and control. In our view, these aspects are risk mitigating and are equally as important as monitoring and should be acknowledged. Sound liquidity risk management involves the Board of Directors and senior management's development and oversight of a comprehensive process that identifies, measures, monitors, and controls a bank's liquidity risk exposure. Well-managed banks have their liquidity risk management process integrated into their overall risk management framework and have developed intraday liquidity strategies that allow the institution to do, *inter alia*: monitor and measure expected daily gross liquidity inflows and outflows; manage and mobilize collateral when necessary to obtain intraday credit; identify and prioritize time-specific and other critical obligations in order to satisfy them when expected; settle other less critical obligations as soon as possible; and control credit to customers when necessary.

II. <u>The scope of application of the Consultative Document is unclear.</u>

Although the scope is defined in Paragraphs 1 to 5 of the Consultative Document to include clearing and settlement systems for securities and derivatives, the monitoring indicators proposed are described in terms of payment systems. The Clearing House recommends that the Basel Committee provide additional clarification for the application of the indicators to securities and derivatives settlement and clearing systems within the context of intraday liquidity management.

We believe that the scope of the Consultative Document should be limited to direct participants. Several of our members who are indirect participants in a particular system (*i.e.*, because they participate via the services of a correspondent) have little influence over when a transaction is settled, are dependent upon the service provider to receive data, or receive data of varying quality as there are no uniform standards yet in place. Accordingly, we believe that indirect participants pose little or no systemic risk and therefore the scope of application of the Consultative Document should be limited to direct participants. Moreover, we recommend that the term "financial Institution" be expressly defined since it is currently unclear if this term includes banks only, or also includes broker dealers, mutual funds, insurance companies, and other types of financial service entities.

Paragraphs 47 and 48 define the scope of application as it relates to systems and specifically address technical bridges between systems. As per Paragraph 48, we are unclear what would be satisfactory for a bank to "demonstrate that it regularly monitors and uses formal arrangements to transfer liquidity intraday between systems with no technical bridge" in order to allow for aggregation. For example, a bank could monitor and acknowledge

unreleased payments in CHIPS as part of its overall intraday liquidity management process despite the lack of a technical bridge or that excess funds are not released until end of day ("**EOD**"). Additionally, items that are submitted but not yet released in CHIPS are considered un-settled. The Consultative Document clearly states that activity should be based on settlement rather than submission; however, there could be unintended consequences from banks holding back on the loading of payments to avoid exceeding of the maximum use indicator as indicated previously. This could impede the flow of funds and actually increase intraday liquidity risk. The Clearing House recommends that payments given to net settlement systems where there are liquidity-saving mechanisms in place should receive some consideration (as noted below in Section V). Perhaps, for example, the notion of a technical bridge could be replaced with a process bridge.

Although Paragraphs 55 and 56 attempt to define scope of application as it relates to intercompany liquidity, the requirements remain ambiguous. Specifically, it is unclear if intercompany transactions (*i.e.,* when a bank uses one of its affiliates as its correspondent bank or maintains its Nostro[5] with an affiliate) should be monitored given that they may not be material and are generally accounted for in the particular entity's internal liquidity stress testing process. We also note that there is a potential unintended consequence of encumbering liquidity twice for the same activity. In an effort to provide equal measurements globally, we recommend that some fundamental principles for the scope of the measurements be published for use by local regulators.

III. The implementation costs associated with the reporting required by the Consultative Document should be studied further.

The reporting as stipulated in the Consultative Document represents significant costs as banks currently lack the ability to report the data to the level of granularity required. Banks will need to create a series of new reports and make significant investments into their information technology and reporting infrastructures. Accordingly, a materiality threshold should be considered as there could also be material costs to archive much of the data. Finally, since some of the required data would need to be sourced from the payment and settlement systems (*e.g.*, timing of automated liquidity transfers) as well as from correspondents (timing of outgoing and incoming payments), a large reporting framework not only within individual banks but also across the financial services industry could be required. The Clearing House respectfully requests that an analysis of the perceived benefits of the proposed reporting changes be undertaken and the results disclosed prior to defining the final scope of the reporting. Also, this additional analysis should consider all other new legal/regulatory, liquidity, capital, financial reporting and tax reporting requirements currently being imposed upon the banks and to avoid duplicative efforts.

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[5] A Nostro account is a bank account held in a foreign country by a domestic bank, denominated in the currency of that country. Nostro accounts are used to facilitate settlement of foreign exchange and trade transactions.

In order to alleviate these concerns, at least in part, we recommend the development of a systemic solution that would be available to all participants. Developing the required reporting capabilites on the actual clearing system would result in significant efficiencies and cost savings for the overall market. Furthermore, it would ensure a level of consistency in data reporting across multiple systems. Consideration should be given to the participation of the clearing system operators in the reporting of this measure, as they may be best able to provide uniform, objective reports. In the United States, The Clearing House believes that much of the required data could be easily extracted from the Federal Reserve's Daylight Overdraft Reporting and Pricing Systems ("**DORPS**"). Where feasible, we urge that this data be used rather than requiring duplicative reporting from the banking sector.

IV. Additional clarification of several individual measurements should be provided.

We respectfully request that the following individual measurements be clarified:

1. Daily maximum liquidity requirement

   The liquidity requirement as defined in the Consultative Document in Paragraph 15 is actually the liquidity a bank uses, but not necessarily what it requires to timely fulfill its payments obligations. As noted above, the PRC study highlighted that fact that only $9 trillion of cash was required to settle $14 trillion of payments. Examples for differences in "used liquidity" and "required liquidity" are payments released to the market earlier than the market rules require or payments following the pre-funding of market accounts. We note that payments released early often are essential for avoiding gridlock situations and, therefore, for the proper functioning of the payment markets. We recommend that the definition of an indicator describing "required liquidity" should take these aspects into consideration.

   The frequency of data collection is similarly unclear. We request clarification of the "period of time" over which this indicator is to be calculated. For example, should data be gathered hourly as in Figure 1 or minute by minute? Is a "follow the sun" approach acceptable for multinational banks? We note that a uniform application of the requirements across entities and geographies would be helpful.

   Determination of the "actual settlement time" by a correspondent bank within an unspecified "period of time" may present operational challenges. Often, the direct participant within the clearing network supplies confirmation of settlement to the indirect participant, but does not supply the time of settlement. Additionally, the indirect participant typically has little influence over the release of a payment by their correspondent. Absent the capability to affect the timing of a payment, the ability to mitigate any related risk may be substantially reduced, rendering the indicator of limited utility.

2. Available intraday liquidity

The definition of intraday liquidity and its sources in Paragraphs 11 and 12 do not consider applications where the central bank does not operate the clearing system, such as CHIPS. Since such clearing systems have significant influence over the intraday liquidity of a participant, we recommend inclusion within the calculation of the constituent elements of a bank's intraday liquidity sources.

Likewise, available intraday liquidity is not clearly defined in the Consultative Document, especially as the document also refers to stress scenarios. We note that all forms of liquidity buffers and reserves will, when used, become intraday liquidity. Thus, the Consultative Document should elaborate on what forms of liquidity are considered as intraday liquidity and to what extent "Double Duty"[6] is considered acceptable. That is, banks should be expected to address any stressed scenarios as either as part of an intraday indicator buffer or as part of a buffer for deposit runoff. Additionally, the sources for available intraday liquidity should include sources such as unencumbered, non-central bank-eligible collateral.

As noted above, we request clarification regarding the "period of time" over which this indicator is to be calculated. While the calculation of available liquidity across currencies and jurisdictions is welcome, the "period of time" used for the calculation should be specific, highlighting the potential inability to transfer liquidity outside of the business day of any given jurisdiction.

As per Paragraph 27, our understanding is that this indicator should not include central bank lines for direct participants. If central bank lines are included, we recommend taking account only of the uncollateralized lines in order to avoid a double count with the other entries which detail collateral.

3. Time-specific and other critical obligations

We believe that consideration should be given to the type of obligation: those that are initiated on behalf of a client are subject to broad review beyond those control functions responsible for liquidity risk (*e.g.*, credit, sanctions, etc.). The failure to make a payment timely for a reason other than insufficient liquidity should not negatively impact the measurement of intraday liquidity.

Clarification also is requested as to the purpose of a volume measurement for this criterion. The need to count the number of payments adds an additional cost, perhaps outweighed by an incidental benefit if the only purpose of the counting is to measure intraday liquidity exposure for critical payment obligations.

[6] A phrase coined by the Bank of England that relates to the practice of settlement banks pledging as collateral intraday the same low-risk securities which they were required by the regulators to hold in their liquid asset buffers at the close of business.

4. <u>Value of customer payments made on behalf of financial institution customers</u>
   We recommend that this indicator should be expanded to include reporting on value of payments made by non-Financial Institution customers (*e.g.*, broker-dealers, insurance companies, corporate customers) and Financial Institution customers with whom the bank has no correspondent banking relationship. We would, however, add a materiality threshold of 10% of a bank's total payments business based on aggregate volume. This test could apply over a quarter. That is, any customer payments made that are less than 10% of the total business should be considered *de minimis* and not be required to be reported. We also propose that an indicator for value of receipts from these customers should be created in order to comprehensively assess a bank's exposure to these customers.

5. <u>Intraday credit lines extended to financial institution customers</u>
   We agree that the value of this measurement indicator for internal use or during external regulatory or other audits is well understood. Usage outside these parameters however, is unclear and could cause potential damage to clearing mechanisms. We note that intraday credit lines to financial institution clients are often granted without commitment. In some jurisdictions, the simple reporting of the line externally causes this line to be treated as committed, exposing the bank to additional risk. As a result, a requirement to externally report these lines could result in the granting of fewer or limiting the size of such lines. Given that these lines facilitate the flow of payments through a network by indirect participants, limiting the size of the lines could impact the overall efficiency of the payment network.

6. <u>Timing of intraday payments</u>
   We recommend that the use of this indicator be limited to internal comparisons within a single institution over time. We believe that comparisons across institutions would not be meaningful.

7. <u>Intraday throughput</u>
   We note that settlement timing is difficult to calculate for indirect participants. It would be helpful if clarification could be provided that this measurement applies only to direct participants.

V. <u>Other Recommendations.</u>

Blocking statutes are in force in a handful of jurisdictions which specifically prohibit the sharing of sensitive information with any government other than the government of the home jurisdiction. The Consultative Document should include data confidentiality protection and permitted disclosure guidance. Our preference would be to keep all data within the financial institutions and share it with the supervisors when requested until these issues can be reviewed and addressed by qualified counsel working with the Bank for International Settlements in the relevant jurisdictions.

The Clearing House also believes that there are missing indicators that should be collected. For example, there is a large focus on outflows but little mention of inflows. Without looking at inflows clearly, the view of total needs may be skewed. We would recommend that there be an additional requirement, Timing of Intraday Receipts, which is identical to the payments requirements.

Finally, The Clearing House believes that any approach must take into account the nuances that distinguish the various clearing and settlement infrastructures. For example, the concept of hybrid infrastructures, like CHIPS, which use a liquidity savings mechanism (algorithm) are not accounted for in the Consultative Document. These systems employ highly sophisticated release engines which permit the clearing members to settle amounts that are multiples of the liquidity originally injected into the system. The amount of liquidity a bank maintains in such a system cannot be reflected or evaluated in the same way as liquidity maintained with a Central Bank for purposes of a real time gross settlement ("**RTGS**") system for example. This is particularly relevant as the Bank of England introduces an algorithm into CHAPS[7] in the near term, and TARGET2[8] now uses a series of algorithms. In addition, the interconnectedness between infrastructures, or the timing impact that the settlement process in one system has on others, should be considered. For example, the CLS settlement window for USD or Tri-Party Repos or securities, all have a bearing on the flows of liquidity during the day. Any introduction of metrics could disturb or unduly influence the pattern of these flows and care should be taken when designing reporting requirements such that behavior is not affected.

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We thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org) or Michelle Hubertus at (212) 613- 9804 (email: michelle.hubertus@theclearinghouse.org)

Respectfully,

David Wagner
Senior Vice President
Finance Affairs

[7] The Clearing House Automated Payment System ("**CHAPS**") is a British company established in London in 1984, which offers same-day sterling fund transfers.
[8] TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer system. TARGET2 is the second generation of TARGET.

cc: Mr. Scott Alvarez
General Counsel
Board of Governors of the Federal Reserve System

Mr. Michael S. Gibson
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

Mr. Marc Saidenberg
Senior Vice President
Federal Reserve Bank of New York

Mr. Richard Osterman
General Counsel
Federal Deposit Insurance Corporation

Mr. George French
Deputy Director, Policy
Federal Deposit Insurance Corporation

Ms. Julie Williams
First Senior Deputy Comptroller and Chief Counsel
Office of the Comptroller of the Currency

Mr. Charles Taylor
Deputy Comptroller for Capital and Regulatory Policy
Office of the Comptroller of the Currency

Mr. Martin Pfinsgraff
Deputy Comptroller for Credit and Market Risk
Office of the Comptroller of the Currency