



July 29, 2008

Ms. Mary Craig
Working Group on Liquidity
Member of Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002
Basel, Switzerland

Dear Ms. Craig:

CBA Comments on Principles for Sound Liquidity Risk Management and Supervision

CBA members appreciate the opportunity to comment on the revision of liquidity risk principles by the Basel Committee's Working Group on Liquidity (WGL). Given the recent financial market turmoil, our members acknowledge the importance of ensuring that robust liquidity risk management is integrated into bank-wide risk management processes. We are particularly supportive of the concept expressed in the document which suggests that the implementation of the sound principles should be proportionate to the size, nature of business and complexity of a bank's activities.

Overall, CBA members support the principles outlined in the WGL's document and find them to be thoughtful and fair. The outlined principles are generally not too prescriptive or detailed and will help raise the bar on liquidity risk management. We do note however that the manner in which these principles are interpreted by supervisors, individually and on a coordinated basis, will be a key determinant of their effectiveness on a global basis. Our members warn of an overly prescriptive and one 'size fits all' approach to liquidity standards, which might focus solely on quantitative requirements.

We offer our comments in the attachment for your consideration before the principles are finalized. Once the principles are published, we believe ongoing discussion would be useful for some of the concepts introduced in this revision of the liquidity risk principles. In particular, we suggest that it would be useful to further discuss how banks:

- Identify and manage contingency liquidity risk for special purpose vehicles (para. 35 – 37),
- Coordinate between liquidity, credit, and operational risk for intraday liquidity management (para. 75 – 83),
- Review the range of practices for appropriate public disclosures for liquidity risk (para 126 – 129).

Please do not hesitate to contact me if you have any questions regarding the CBA members' attached comments.

Sincerely,

Attachment

cc: Mr. Robert Hanna, Assistant Superintendent, Regulation Sector, OSFI

CBA Comments on the Basel Committee's Liquidity Risk Working Group's

Principles for Sound

Liquidity Risk Management and Supervision

Governance of liquidity risk management

Principle 2 – Liquidity risk tolerance

A bank should clearly articulate a liquidity risk tolerance that is appropriate for the business strategy of the organisation and its role in the financial system.

CBA members support the principle that risk tolerances should be determined by each bank. Our members also support the concept that supervisors' liquidity risk management guidelines should not be prescriptive, as stated in paragraph (10), *"There are a variety of ways in which a bank can express its risk tolerance."*

However, our members are concerned that supervisors might look to one set of quantitative metrics to compare liquidity risks between banks. A direct comparison of liquidity risk tolerance may not be useful (and could be misleading) since they are typically based on 'cash flow' or 'balance sheet', not revenue-based quantitative metrics. Also liquidity metrics are often supported by detailed qualitative assumptions and methodologies, which are tailored to each bank's capabilities and capacities. For meaningful comparisons, both qualitative and quantitative criteria should be considered when reviewing banks' liquidity risk tolerance.

Our members believe that Principle 2 supports the position that a bank should determine its liquidity risk tolerance in quantitative and qualitative terms that are appropriate for the bank, and expect that national supervisors' liquidity risk rules will confirm this practice.

Measurement and management of liquidity risk

Principle 5 – Sound processes

A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk.

Paragraph 27 – All material risk exposures

CBA members support the principle that banks should develop processes for managing their liquidity risk. However, our members are concerned with paragraph 27's reference to "all" future cash flows, currencies, and sources of contingent liquidity demand and triggers from off-balance sheet positions. Our members believe it would be preferable to stress the need to focus on all "material" exposures. Each bank would determine materiality based on its own context. We note that paragraph 6 supports this concept of proportionality.

The CBA recommends that paragraph 27, and subsequent paragraphs, be amended to include "all material" where it currently lists only "all" liquidity risk positions.

Paragraph 29 – Stickiness

CBA members support the principle that banks should assess the stickiness of their funding sources (i.e. the tendency not to run off quickly under stress). In assessing the stickiness of funding sources, our members offer the recommendations below to be more complete and effective:

- For retail funding sources, it is preferable to consider “core or relationship” deposits instead of “retail” deposits. This would acknowledge the importance of business/commercial deposits and interactions between product categories within a firm.
- For wholesale (or non-core) funding sources, a customer-by-customer assessment of non-core depositors’ likely behaviour in stress situations would be overly burdensome and subjective. Our members believe a bank could achieve the same understanding through a broad assessment of likely behaviour of pools or portfolios of their non-core depositors.

Paragraph 35 - 37 – Special purpose vehicles

CBA members support the concept that banks should have a detailed understanding of their contingency liquidity risk exposures and event triggers from relationships with special purpose vehicles (SPVs). However, it may not be consistent with a risk-based approach to measure liquidity risk for SPVs on a gross or consolidated basis, especially for a bank’s third-party asset conduit business (versus own asset conduits), unless there is a high degree of probability that this contingent risk will end up on the balance sheet. Requiring consolidation of SPV liquidity risk raises a number of questions about consolidation from a capital and accounting perspective (i.e. risk transference) and may have unintended consequences on the future of this market.

While our members acknowledge that these paragraphs outline options to improve understanding of SPVs, CBA members recommend that more discussion is required regarding measuring contingency liquidity risks for SPVs. Our members believe there are more effective ways to measure and manage this risk, e.g., conduit cash flow limits, notional or risk-adjusted limits for committed liquidity lines, business exit strategy if the firm is downgraded, and dedicated pools of liquid assets to mitigate contingent risk.

Therefore, the CBA recommends that the last sentence in paragraph 35 and all of paragraphs 36 and 37 be replaced because these proposals are not risk-based under most contemplated circumstances. These sections should be replaced with language that states that this contingent liquidity risk, once understood, should be measured, controlled, and managed using techniques such as those listed in the paragraph above.

Principle 7 – Diversification of funding sources

A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding.

Paragraphs 59, 63 - 64 – Reliance of internal vs. wholesale funding

CBA members support the concept that banks should monitor their concentration in any one particular funding source. However, our members recommend that any analysis of the reliance on wholesale funding should consider both the funding terms (short- vs. long-term) and the bank’s capacity (used vs. unused). Over-reliance on internal funding can be a risk in some instances, but in others not maximising internal funding creates unneeded additional costs and potential credit, wholesale funding coordination, consolidated balance sheet management, and funding access issues. Our members do not believe that limits are necessarily the best way to address the concentration of funding sources. Our members suggest that targets, ranges, or ongoing monitoring processes would better provide the required flexibility in evaluating the related risks.

The CBA therefore recommends that the principles be more flexible to allow for a more dynamic monitoring of funding sources. This approach would allow for other options in addition to concentration limits.

Principle 8 – Intraday liquidity positions

A bank should actively manage its intraday liquidity positions...and contribute to the smooth functioning of payment and settlement systems.

Paragraphs 75 – 83 – Interdisciplinary management of intraday liquidity

CBA members support the principle that banks actively manage intraday liquidity risk. However, intraday cash and collateral management goes beyond liquidity risk management. The risks related to these positions, processes and systems are managed by several specialist groups, and are not the sole responsibility of the liquidity risk manager. Liquidity managers focus on the net maximum intraday cash or collateral requirements. Credit and operational risk managers handle a broader range of risks for gross and net cash and collateral flows. As such, there should be a flexible demarcation between what firms choose to cover in their liquidity policies and other risk policies.

While we accept that each firm should ensure “wholesome” management of intraday liquidity risk across its various disciplines and that liquidity managers should understand how other risks impact intraday liquidity risk, our members recommend that these principles be more focused on the liquidity risk manager’s role in intraday liquidity management. While roles overlap, there should be further discussions regarding coordination between liquidity, credit, and operational risk managers to ensure that intraday liquidity risk is appropriately managed. Also, a review of the role of the banking supervisor vs. the central bank in intraday liquidity management and settlement systems would be useful.

Paragraphs 90 – Intraday collateral management

CBA members understand that collateral management for intraday positions should consider the impact of situations when there is uncertainty or a disruption. Our members believe that sequential duty should also be considered. Sequential duty refers to the ability, where demonstrated by a bank, to use the same collateral sequentially, intraday and overnight (i.e., not at the same time). In assessing a bank's liquidity requirements, more specifically as they relate to collateral management and pledging, the concept of sequential duty should be recognized where demonstrated by the bank. We note, however, that payment systems are extending their operations to close to 24 hours a day.

Therefore, the CBA recommends that footnote 10 should be augmented to address the option of sequential duty.

Principle 9 – Collateral management

A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets.

Paragraphs 88 – Liquidity of tied assets

CBA members support the principle that they should actively manage their collateral positions. However, they question the premise that collateral positions should always be adjusted for any tied assets, as stated in the first sentence of paragraph 88. Measures of available collateral do not necessarily need to be adjusted down for tied assets if the firm can demonstrate that these assets can be funded with third parties on a secured basis (e.g., under normal course of business conditions, or a predefined stress scenario). The ability to fund the asset on a secured basis should be a consideration over and above a firm's ability to sell both the assets and any related derivatives in separate transactions or as a package. Furthermore, business strategies and other considerations may also need to be considered (e.g., accounting treatment) to assess the real liquidity of these tied assets.

Therefore, the CBA recommends that this paragraph be amended to acknowledge that banks could demonstrate that a tied asset can be liquid in a number of circumstances.

Principle 10 – Stress tests

A bank should conduct stress tests on a regular basis...for stress scenarios...to ensure that current exposures remain [within] established liquidity risk tolerance.

Paragraphs 93 – Unit stress tests

CBA members support the principle that stress tests should enable a bank to analyse the impact of stress scenarios on the liquidity positions of the consolidated groups, as well as its individual entities. However, it may not be meaningful to conduct separate stress tests at the unit level, especially if the unit is integrated. This should only be required if the unit operates with a high degree of independence from the parent, and when more can be learned through segregated testing than through using an integrated approach. Our members are concerned with recent increased requests for individual unit stress testing from host regulators.

The CBA recommends that home and host supervisors coordinate requests for liquidity risk testing at the group-wide and individual unit levels.

Paragraphs 97 – Implausible stressed scenarios

CBA members support the principle that more than historical-based scenarios should be used in stress testing. However, instead of recommending that banks not discount severe scenarios as “implausible”, it would be preferable to include scenarios that are “extreme but plausible”. The list of “extreme but plausible” scenarios should be updated as circumstances warrant. In some instances, banks may present some scenarios to the Board for their ‘information only’, having explained why they do not actively plan to manage or mitigate to these extreme cases.

The CBA recommends that the term “extreme but plausible” replace “implausible” scenarios in paragraph 97.

Principle 12 – Liquidity risk cushion

A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios [...]

Paragraphs 121-125 – Liquidity buffer and high quality liquid assets

CBA members support the principle of maintaining a highly reliable access to additional liquidity with high quality liquid assets. Our members believe that what should be allowed to qualify as a liquidity buffer merits more attention, especially as it relates to acceptable highly liquid assets, how they should be funded, and whether sources of liquidity other than liquid assets could qualify as buffers. Our members also suggest that high quality liquid assets should not be limited to a prescribed list, such as those that are eligible at central banks. Our members are concerned about the potential moral hazard and the unintended consequences that could arise from adopting such a definition. It should be up to each firm to defend their choice of highly liquid assets after consideration is given to its demonstrated capabilities and capacities to monetize these assets under various conditions. There are other potential sources of liquidity beyond high quality liquid assets, such as short term money market assets and excess funding capacity, that could under defined circumstances be considered as buffers.

The CBA recommends that liquidity buffers and high quality liquid assets be determined as appropriate to a bank's capabilities and capacities.

Public Disclosure

Principle 13 – Liquidity risk public disclosures

A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.

CBA members support the principle of enhanced public disclosure for liquidity risk. Indeed, Canadian banks were some of the first to provide enhanced public disclosures in 2008 for other international initiatives:

- In February 2008, large Canadian banks issued Advanced Internal-Ratings Based (AIRB) Basel II Pillar 3 disclosures for Q1 2008.
- In May 2008, large Canadian banks provided enhanced market disclosures following recommendations by the Financial Stability Forum for Q2 2008.

Our members welcome ongoing dialogue on appropriate public disclosures for enhanced transparency. However, we note the possibility that making quantitative information publicly available, especially during times of market volatility, could mislead investors and further aggravate liquidity pressures (i.e. contagion effect). Assumptions used for quantitative disclosures can be discussed with informed readers, such as regulators and rating agencies, but it is much more difficult to do so with the public at large. For example, Survival Horizon metrics can produce different results depending on assumptions used by rating agencies, supervisors, and banks, which could lead to material misunderstandings.

CBA members recommend further discussion regarding the range of practices that are appropriate for public disclosures related to liquidity risk.

The Role of Supervisors

Principle 17 – Coordination between supervisors

Supervisors should communicate with other relevant supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management. Communication should occur regularly during normal times, with the nature and frequency of the information sharing increasing as appropriate during times of stress.

CBA members support the principle of both international and domestic communication between supervisors and public authorities. Our members would benefit from collaboration between home and host supervisors for liquidity risk supervision, such as the mutual recognition of results of consolidated group-wide stress testing. We believe home supervisors should be given a lead responsibility for enhanced cross-border coordination, which would facilitate the elimination of trapped pockets of liquidity such as local reserve requirements, capital equivalency deposits, large exposure limits and any other rules that restrict the flow of funds between units of the firm. However, while our members acknowledge a better understanding of other jurisdictions' practices is useful (e.g. understanding different assumptions, metrics, and structures), there should not be "one size fits all" standardization of liquidity risk management practices.