



Basel Committee on Banking Supervision
Bank for International Settlements

baselcommittee@bis.org

cc: CEBS
cp19@c-ebs.org

European Commission
Mr. Patrick Pearson
Patrick.pearson@ec.europa.eu

25 July 2008

EAPB comments on the principles for Sound Liquidity Risk Management and Supervision

The EAPB would like to thank the Basel Committee for the possibility to submit our comments on the principles for sound liquidity risk management and supervision.

1. General remarks

We expressly welcome the **principle-oriented approach** of the paper presented by the Basel Committee. In our opinion, the 17 proposed principles mean that all the key aspects of the liquidity risk management of the institutes, and its monitoring by the supervisory authorities, are covered. A principle-oriented regulation is essential in order to take the diverse business models and forms of the risk management into sufficient account. Furthermore, only a principle-oriented approach guarantees the necessary flexibility for an adjustment to changed business conditions. When the Committee writes in its introduction (point 6) that it expects banks and supervisory authorities to 'implement the revised principles promptly and thoroughly', we assume that this only refers to the principles themselves and not to the explanations of the principles. In many places, the explanations are too detailed and regularly depict only one of several options for an effective risk management (e.g. in the areas of Contingency Funding Plan, Stress Tests, Public Disclosure and Intraday Liquidity Management). In our opinion, the explanations should thus be seen as illustrative examples which institutes can and should orient themselves to but which can be

deviated from in substantiated cases. The Institute of International Finance (IIF) had already emphatically spoken out in favour of such a comply-or-explain mechanism in the paper 'Principles of Liquidity Risk Management' published in March 2007. This comply-or-explain approach should be taken up by the Basel Committee in a prominent position in the principles, or included as a separate principle. Otherwise, there is the risk that the particular characteristics of the individual institutes will not be sufficiently taken into account due to excessively detailed requirements and, furthermore, the adjustment of management and monitoring approaches to changed business conditions, and their continuous improvement in competition, will be hampered.

The note in point 6 that the size of the institute, the type of business and the complexity of the business activities are to be taken into account by the institutes and the supervisory authorities when using the sound principles (**principle of proportionality**) is to be positively assessed. In the subsequent explanations, however, insufficient reference is made to these, which is why we are in favour of explicitly establishing the proportionality concept in the connection with the different principles and the relevant explanations, or making them clear, together with the comply-or-explain approach, as an overarching principle.

To prevent an excessively detailed regulation, the paper should also include a note that the principles and their explanations are only relevant with regard to **key risks and key circumstances (principle of essentiality)**. This idea should be seen as the third overarching principle for the overall paper.

2. Detailed comments

Principle 2 (Risk Tolerance)

The risk tolerance to be defined by the banks should be designed in such a way that it permits the withstanding of a 'prolonged period of stress'. We welcome this definition. In this context, we would like to point out the important difference between short-term and long-term stress. Short-term stress is to be seen as the time period during which no adjustments to the business model are possible or necessary and for which the corresponding liquidity cushion must be retained. Long-term stress, however, is primarily reacted to with adjustments in the business model.

Principle 4 (Liquidity Costs)

In accordance with Principle 4, the institutes should include the liquidity costs and/or the 'risks and benefits', respectively, for all important business activities in the product pricing, performance measurement and the new product process. In actual fact, a lack of settlement prices may result in controlling errors. In such cases, the risk management usually recognises the risks too late; the negative consequences at best can then be corrected only with difficulty and at great cost. In the application of the principles, however, the supervision should recognise the diversity of options available for banks to handle liquidity costs. The supervisory specifications should not be inappropriately detailed. In particular, specifications from supervisory bodies should not be designed to exclude or pass on any loss risk in the settlement of the liquidity costs; it is essential that – in accordance with the objective and purpose of Principle 4 – disincentives are fundamentally avoided.

A pricing in full of liquidity costs is not feasible, in particular with off-balance-sheet transactions, due to the complexity and uncertainties involved (e.g. with regard to the amount and time of the drawdown, the prolongation characteristics and the follow-up contracts). Furthermore, different national interpretations of the price definitions can lead to competitive disadvantages for banks that 'have to' pass on higher risk shares on to the client.

Furthermore, the requirement to allocate a liquidity component (liquidity charge) to individual transactions (point 19) appears too demanding to us. Here, it should be sufficient if this allocation is done at divisional level. In our opinion, a further 'refinement' of the allocation does not improve internal control and also does not provide any additional benefit for bank supervision.

Additionally, it should also not be required for the liquidity costs to be taken into account in the performance measurement. These have no direct link to the liquidity control, so such an extensive intervention by the supervisory authorities in the internal calculation of the institutes does not appear justified.

Principle 5 (Identifying, Measuring, Monitoring and Controlling Liquidity Risk)

Pursuant to point 24, banks should take into account ‘strong interactions’ between the liquidity risk and other types of risk. As already mentioned in the comments on Principle 1, this must not be understood in the sense of a rigid automatism that goes into great detail. Although liquidity risks, as indicated in the paper, can result from problems in the management of other risks, the clear division of tasks and responsibilities between liquidity risk management and other parts of the risk management must be adhered to in order to guarantee the functionality and effectiveness of the operational day-to-day risk management. A consideration of the other types of risk is being done increasingly in the area of stress testing and second-round effects (impact of e.g. credit losses on liquidity lines). Furthermore, the request to consider the interaction with the operational risk in the projection of cash flows should be deleted. In our opinion, it is also not necessary to project the cash flows for a time horizon of less than a day, as required in point 26. At this point, the special requirements of the management of the intraday liquidity are sufficient in our opinion.

In point 29, it is recommended that banks carry out a client analysis on an individual case level for ‘large wholesale deposits’ with regard to the roll-over probabilities. Due to the large range of business models and client profiles, it has to be left to the banks here which deposits are to be defined in individual cases as ‘large’ and how the assessments – taking into account cost-benefit considerations – are conducted and documented. In particular, it must be possible to carry out this analysis at portfolio level if this leads to comparable results.

Even if it is appropriate for the purposes of credit risk control to form an opinion about the creditworthiness of each counter-party with off-balance-sheet positions, it should not be required for proportionality considerations to also take this judgment into account in the determination of the liquidity requirements for each off-balance-sheet position (point 30).

A portfolio view must also be possible with regard to the consideration of financial derivatives (point 38). In light of the, to some extent, substantial number of derivatives in place, the inclusion of financial derivatives in the liquidity risk analysis must remain strictly limited to products that are important from a risk perspective.

Pursuant to point 41, all currencies should be included in the calculation of the liquidity requirements. It should be made clear that only currencies need to be included in which the bank has a substantial liquidity requirement. Furthermore, in our opinion it is also not proportional that a bank has to obtain a credit line or define an emergency strategy in each currency (point 43). Accordingly, the decision on this should be made by the bank, taking into account the principle of proportionality and materiality.

With regard to the projection of the cash flow, in the opinion of the Basel Committee, the incoming or outgoing interest should also be taken into account in addition to the issued or received nominal amounts (point 46). The obligation to take into account interest seems inappropriate to us. In our opinion, this decision too should be made by the bank, taking into account the principle of materiality and proportionality.

Financial derivatives are usually already sufficiently recorded at the current market value as part of the mutual margining. A model-theoretical determination of the liquidity at risk of optional and derivative cash flows, respectively, is mathematically dubious. The modelling of possible cash flows from contingent liabilities is subject in particular to different market fluctuations, counterpart risks and the risk of not being able to determine the actual time of the respective payment stream.

Principle 6 (Solo/Group Level)

Pursuant to point 56, banks should control the liquidity risk both at group level, at the level of the individual company (legal entity, subsidiary, branch) and at the divisional level. Such a requirement partially contradicts the current practice of risk management and would entail substantial additional effort that would not be compensated by an appropriate benefit. Depending on the organisational form and the business model, some banks are increasingly controlling the liquidity risk at group level with systems that incorporate all (key) units of a group. In accordance with the concept of proportionality, individual companies that are not important for the liquidity management of the group, are, for example, controlled centrally as an individual consideration would not bring any additional insights. The fundamental requirement of a co-existence of a management at group level and the solo and/or divisional level should therefore be refrained from. The sole decisive factor should be that the liquidity risk management has an organisational form suitable for the respective group

structure via which all key risks can be adequately recorded and redundancies and non-essential effort avoided.

Principle 7 (Funding Strategy)

Through Principle 7, banks should not only be obliged to provide a – meaningful – diversification of their refinancing sources but also to estimate on a regular basis how quickly they can gain refinancing funds from various sources. As a basic principle, although it is desirable in the event of possible bottlenecks to be able to resort to refinancing sources that are used only infrequently or not at all by banks and to know about the scope of this option. In practice, however, it is not possible to enter markets regularly in which a bank is not usually active and/or test them. The request should therefore be restricted to having the knowledge of the short-term potential expansion for actively used refinancing sources.

In point 64, it is required that institutes should limit a concentration with regard to any refinancing source. With regard to deposits from the retail business, this clear restriction is not comprehensible as in particular the sub-prime crisis has shown once again that retail deposits represent a very reliable form of refinancing. In this regard, point 64 contradicts itself somewhat as explicit and repeated reference to the special quality of retail deposits is made in conjunction with the aforementioned request. A clear differentiation must also be made, in the area of wholesale funding, between volatile funding and those wholesale refinancing means that are provided reliably and in the long term by the capital market. In particular, banks that refinance themselves primarily via the capital market should not automatically be obliged to reserve a higher equity cushion. Instead, the banks should only be obliged to make appropriate measures insofar as this is necessary due to the refinancing structure. In summary, the requirement of a concentration limitation should be dependent on the reliability of the individual sources of refinancing; otherwise, an undifferentiated limiting could even be counter-productive.

According to point 69, the banks should identify current and future investors and develop strong ties with them. We would like to point out in this regard that identification, for example with bearer bonds, is not always completely possible with a large investor base. At this point, it should also be permissible for the bank to refer to expert appraisals.

Too comprehensive limits and in particular limits on intra-group refinancing sources (e.g. through major credit limits) or of the wholesale segment can have a negative influence on the functional capability of entire market segments. The sub-prime crisis has shown over the

past months how mutual limits/deletions of money trading lines of individual companies had a negative influence on the overall functionality of the money market – and thus a key market for the regulation of the (short-term) term transformation activity of the banks. In the determination of requirements of limits, the effects on the international banking system should be taken into sufficient account.

In point 71, a direct link between the equity base of a bank and its refinancing capacity is established. Editorial note: The term 'Capital Cushion' should be avoided as it can easily result in confusion and be mistaken for the liquidity cushion introduced in Principle 12. From our viewpoint, no such link exists in this form and the importance of the equity base for the avoidance of liquidity risks is consequently substantially overrated. As a basic principle, equity is not suitable for cushioning liquidity bottlenecks that occur. It also needs to be taken into account that the liquidity risk is, by nature, very different from the other funded risks of a bank and for this reason can also not be included in the ICAAP.

Principle 8 (Intraday Positions)

Although the functionality of payment-and-settlement systems is to be taken into account within the framework of an adequate risk management, it needs to be considered that risks from this area fall primarily under the category of operational risk, and consequently must also be controlled by the responsible part of the risk management. At this point, we believe there is a risk of risks being recorded in duplicate and responsibilities overlapping each other. Up to now, the handling and the trading units are jointly responsible for ensuring that intraday payments can be made based on scheduled clearing routines. The resulting risks of the failure of these handling procedures due to insufficient liquidity availability, and any 'punitive payments' that this entails, are recorded within the framework of the operational risk. In our opinion, this is appropriate. The liquidity risk controlling unit, however, would first have to familiarise itself with the details.

The key and thus to be focused upon connection between payment and settlement systems and the liquidity risk management is the reserving of a part of the liquidity reserve (cushion) for payment and settlement services.

The requirement that a bank must ensure through the management of liquidity in the course of the day that the intraday liquidity requirements are also assured in the event of stress

should be deleted. In our opinion, stress tests are only suitable for periods of one day or more.

Furthermore, the documentation required by the liquidity risk management for this area should be kept within an appropriate framework despite the comprehensive statements in the paper.

Principle 10 (Stress Tests)

Pursuant to point 93, stress tests should be used to analyse the impact on the liquidity bottlenecks both at group level and at the level of the individual companies of a group and at divisional level. Against the background of declarations of patronage, central risk management and reputation risks, the carrying out of stress tests at the level of individual companies and divisions appears fundamentally expendable. In accordance with our comments on Principle 8, a consideration should fundamentally only be made on a consolidated basis. The analysis at individual level or at the divisional level should remain restricted to those cases in which these units are actually taken into account accordingly within the framework of an effective risk management. Furthermore, according to the concepts of the Basel Committee, the impact of the stress scenarios should also be analysed with regard to the intraday liquidity provision. As already mentioned in our comments on Principle 8, this requirement should be deleted. For stress scenarios by means of which it can be assessed whether the intraday overdraft potential at the Central Bank and on nostro accounts is sufficient to be able to meet all intraday payments in time, other factors are relevant than for the overnight liquidity. The specialist competence for corresponding qualified analyses lies more with the handling units than with the risk controlling.

In point 97, a large number of possible stress scenarios and combinations of stress scenarios are listed, thus suggesting that a bank should analyse the impact of a whole range of stress scenarios. As a basic principle, a certain variety of scenarios is desirable, as this means that the probability is higher that possible future trends have already been analysed beforehand. However, it should be considered that this also entails substantial effort that is to be weighed up against possible additional insights. There are thus problems with regard to an ‘appropriate’ parameterisation of a large number of scenarios, as by their nature there are no reliable historical time series for stress scenarios and expert opinions need to be obtained. Stress scenarios are also not a standardised process but have to be maintained and adapted continuously. Without the necessary substantial effort for this, the quality of the

scenarios would suffer and a large number of – not sufficiently well-founded – stress tests suggest a precautionary measure for stress situations that is not actually given. In addition, the question arises as to the additional benefit, as an excessive number of scenarios cannot be meaningfully interpreted or safeguarded or the results of the different stress scenarios do not differ frequently enough to enable proprietary control impulses to arise from them. In this respect, the number of stress tests to be carried out should be restricted to an appropriate extent.

Furthermore, stress scenarios should be defined depending on the respective business model of the bank. Depending on the business model pursued by the bank, different stress situations can be relevant and can have a different impact. A standardised specification of scenarios for all banks, as mentioned in point 133, does not therefore result in meaningful results and is rejected by us.

The Committee also points out that very unusual scenarios should not be dismissed as ‘implausible’. As a basic principle, the credit industry supports the carrying out of less plausible scenarios too. This must, however, be done with a sense of proportion. In particular, it would be counter-productive if, as a consequence of such less plausible scenarios, a substantially increased liquidity provision (cushion) was automatically derived from this, with correspondingly negative consequences for the refinancing of the bank.

According to point 101, the banks should not adopt a conservative approach in the determination of stress test assumptions. In our opinion, it would be sufficient if a requirement was that ‘appropriate’ characteristics are to be assumed. The obligation to assess the appropriateness of the assumptions regarding the future growth of the balance sheet should be deleted as this variable refers to the future business development and is of subordinate significance from the perspective of the risk management.

In point 105, it is suggested that sensitivity analyses be carried out for individual assumptions used with the stress tests. As a basic principle, we support the recommendation of sensitivity analyses and expressly welcome that it only involves a recommendation here. From cost-benefit aspects, however, these analyses should be restricted to those risk drivers that are actually important for the liquidity risk.

Principle 11 (Contingency Funding Plan – CFP)

We assume that with the regular test of the CFP mentioned in point 119 it is not meant that banks should tentatively make sales of (sub-) portfolios which would entail substantial costs and could very quickly result in market rumours, but that it is sufficient within the framework of the tests to check whether the measures envisaged work as planned (e.g. carry out test runs for telephone chains etc.). Incidentally, due to the diverse courses of crisis situations, emergency plans cannot depict any strict detailed instructions and rigid automatisms. In light of the necessary procedure in individual crises, CFP could only give a, sensible, framework of action and define a certain basic structure, within which action is then taken. It is our understanding that there should be a CFP that defines the basic structure and the different alternatives for action for different crisis scenarios.

Furthermore, the emergency plan pursuant to point 119 should be confirmed at least once a year by the 'Board'. Here, it should be sufficient if this confirmation is expressed by the Board members responsible. A decision by the whole board should not be necessary.

Principle 12 (Cushion)

As a basic principle, it is appropriate to ask banks to reserve an appropriate cushion of high-quality and highly liquid assets for stress situations. In actual fact, the majority of the institutes are probably already doing this. In this regard, we welcome the fact that the Basel Committee does not make any mandatory specifications for the extent of the liquidity cushion. However, problems could arise from the statement in point 121 Clause 2, according to which the extent of the liquidity cushion depends on the estimate of the liquidity requirement in the event of stress. Initially, it should be made clear that the liquidity cushion is not intended to serve as cover for an improbable stress scenario. Furthermore, the cushion should also not be so high that it enables the bank to withstand a serious stress scenario without further adjustments, for example in the business model (see also our comments on principle 2 in this regard). In our opinion, the cushion should initially rather serve to cover the liquidity requirement arising in times of normal business activities. We would also like to note that, it is of course suitable as a basic principle to orient oneself to the results of the stress tests; however, a '1:1' relationship should not be required as here the methodological differences between the banks in the execution of stress tests are too great. In addition, there would be the risk that in particular banks that carry out strict stress

tests are disadvantaged in competition due to high liquidity cushions. As a natural reaction, this could result in the institutes consciously defining stress scenarios as 'harmless' which cannot be what is desired by the supervisory bodies.

For practical reasons, it is also important that the cushion does not have to be a separate quantity existing alongside the existing liquidity risk management system, but that it can be integrated into the existing systems. In actual fact, many institutes probably already (implicitly) consider a cushion in the determination of the liquidity positions, namely as a part of the liquidity potential that has already been included in the determination of the forecast payment profile (as incoming liquidity). Through an implicit recording of the reserves, the temporal and qualitative aspect of the accounting liquidity can in particular be depicted in an appropriate manner. Over the course of time (crises lasting a long time), 'less' liquid funds can also be used on a pro-rata basis – to generate liquidity gradually.

Without a doubt, institutes have to have realistic ideas with regard to the expected provision of payment means on the part of the Central Bank (point 125). However, from our point of view, it is necessary that in situations in which problems occur in the overall market, additional liquidity must be provided by the central banks against appropriate securities and without institutes seeking liquidity being exposed to a 'stigma effect'. This should also be expressed in the paper.

Not least, it should be clarified that a liquidity cushion does not have to consist solely of disposable assets. It should therefore also be possible to count credit assurance received if the latter is non-redeemable and has been provided by addresses with a strong credit standing.

Principle 13 (Public Disclosure)

Overall, the amount of information to be disclosed (points 128 and 129) should be appropriate. This is not only necessary for reasons of expense but also to avoid a bank becoming susceptible to attack through the disclosure of data that is too sensitive (the disclosure should after all contribute to stabilisation) or, with a reticent policy of disclosure, becoming the subject of rumours. Furthermore, the focus of the disclosure should be on qualitative information. Quantitative information harbours the risk of overreactions by the market, in particular when data are not really comparable and thus misinterpretations are possible or probable. A disclosure of the 'values of key metrics that management monitors'

named as examples should not be required as an obligation. The disclosure should also be staggered, i.e. that not all information received by other players (supervision, rating agencies, supervisory body) is communicated to the general public.

Principle 16 (Remedial Action)

As a possible reaction by the supervisory authorities to deficits in the liquidity risk management, point 140 lists the requirement of a higher equity base. As at the same time it is conceded that equity does not represent an adequate solution for liquidity problems and inefficient risk management, the need for additional equity requirements should be done without in their entirety as part of the reactionary instruments of the supervisory authorities. The nature of liquidity risk is different from other funded risks, with which a main function of the risk management is in the calculation of the right amount of equity that is to be reserved for unexpected losses. In the event of deficits, the focus of the supervisory authority in the area of liquidity risk management should therefore be consistently on the improvement of the quality of the risk management and/or the adjustment of the bank transactions; capital supplements should be done without as these have a counter-productive effect and could suggest an apparent elimination and/or compensation of defects without any actual change to a critical situation.

Should you have any questions, please do not hesitate to contact us.

Kind regards,

A handwritten signature in black ink, appearing to read 'Schoppmann'.

Henning Schoppmann
EAPB

A handwritten signature in black ink, appearing to read 'Hemetsberger'.

Walburga Hemetsberger
EAPB

The European Association of Public Banks (EAPB) represents the interests of 29 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.