

Mr. Leonard Matz
3186 Mercer Road
New Castle, PA 16105

Dr. Robert Fiedler
Wetzbach 26a
D-64673 Zwingenberg
Germany

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland.

Sent via email to: baselcommittee@bis.org

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Dear Committee Members,

We would like to commend the Committee on Banking Supervision for publishing very timely and informative guidance. We applaud the comprehensive scope of the document and we are very pleased to see the extent to which it promotes what we think is industry best practice.

We respectfully submit the following comments and suggestions in response to your most recent draft and request for comment.

Definitions

In our observation, the terms sensitivity analysis, scenario analysis and stress testing are used inconsistently. Some risk professionals use the term “scenario analysis” to identify deterministic tests while “stress testing” refers to probabilistic tests. Some risk professionals define “stress testing” as uni-variant testing while “scenario analysis” is then defined as multi-variant testing. Sometimes, “sensitivity analysis” is used to refer to uni-variant testing while “stress testing” refers to multivariate testing.

We suggest that your liquidity guidance explicitly refer to the existing BIS definitions for these terms as first set forth in “A Survey of Stress Tests and Current Practice at Major Financial Institutions”, report by a working group established by the Committee on the Global Financial System, Bank for International Settlements, April 2001, page 7.

General

Many of the provisions in this draft focus very specifically on key measurement and management issues – particularly measurement and management issues that were important contributors during the events of 2007-2008. It is wonderful to see regulators reminding bankers of the “hidden” risks, the need for scenario analysis, the need for conservative assumptions, the need for severe stress tests and similar prudent actions.

At the same time, however, we would like to see more discussions that focus less on process and more on outcomes. Outcomes, of course, should be:

1. liquidity risk exposure in form of cash flow mismatch forecasts,
2. quantification of “counter-balancing capacity” in relation to forecasted cash needs or “survival horizons”,.
3. an analysis of liquidity risk mitigation possibilities (netting across currencies, legal entities, payment systems, business lines, ...) together with its contingent shortfalls (imperfect FX markets, even currency restrictions; 23a/b type restrictions; ...)
4. an assumptive cost analysis for the balancing of liquidity deficits as well as surpluses
5. reports of key risk indicators, and
6. reports of essential diversification / concentrations

In other words, after carefully studying all of the proposed recommendations, how can bank risk managers, bank directors, auditor or regulators judge the effectiveness of a bank's liquidity risk management as a whole?

If possible, we would go further and request that the committee provide specific examples. For small banks, some sort of “safe harbor” minimums would be particularly helpful.

Paragraph 16:

It can be extremely difficult for small banks to have operationally independent personnel for ensuring the adequacy of internal controls. Furthermore, inside auditors, if any, rarely have the necessary training or experience.

We suggest that the regulatory guidance permit alternatives in addition to operationally independent personnel. Possible alternatives include: strong internal controls that require board approval before they can be modified, annual reviews by outside auditors and/or periodic reviews by outside experts.

Paragraph 19:

We fully support the committee's inclusion of liquidity pricing as part of sound liquidity risk management. Certainly, we agree that events of 2007-2008 were exacerbated by both the fact that some banks under-valued stable deposits and the fact that other firms underestimated the liquidity cost of off-balance sheet commitments.

We would like to see a more carefully articulated discussion of attributing liquidity costs and benefits at the product or transaction levels versus at line of business or more aggregated levels. Both deposits and contingent liabilities merit particular attention. Unless the debits for sticky deposits, the credits for the liquidity cost of off-balance sheet commitments and other key costs can be passed to the products or transactions which incur those costs or benefits, neither the risk incentives nor the risk measurement will be optimized. Off balance sheet commitments are a major area requiring more attention. As the recent Senior Supervisors report emphasized:

“Those firms that avoided more significant problems through our year-end review period.... had created internal pricing mechanisms that provided incentives for individual business lines to control activities that might otherwise lead to significant balance sheet growth or unexpected reductions in capital. In particular, these firms had charged business lines appropriately for building contingent liquidity exposures to reflect the cost of obtaining liquidity in a more difficult market environment.”¹

¹ “Observations on Risk Management Practices during the Recent Market Turbulence”, Senior Supervisors Group. March 6, 2008, page 3.

Banks need to disaggregate contingent liabilities by type. Once that is done, appropriate analytical methods must be applied to each type. For example, research and experience show a correlation between borrower draws under lines of credit with the credit rating of the borrower. Therefore stress scenarios involving deteriorating credit conditions should include additional funding requirements due to credit grade migration. Another example is the potential that bank credit and/or liquidity support commitments previously given to special purpose entities may all have to be replaced with cash in the event that a bank specific problem leads to a reduction in the bank's rating.

Paragraph 26:

We suggest that the time horizon guidelines be a bit more specific. For example, experience shows that wholly funded banks need to focus on daily time buckets over short time horizons while predominately retail deposit funded banks may find longer time horizons more appropriate. Similarly, bank specific liquidity events triggered by credit problems seem to unfold over quarters while market driven problems unfold much more quickly.

Paragraphs 28 and 29:

Cash flows determining the future liquidity exposure should not only stem from the existing assets and liabilities on the balance sheet (contractual transactions), but in specific scenarios as well from anticipated new business. In paragraph 29 the modeling of the stickiness of liabilities via renewed transactions is requested, however all cash flows stemming from assets which are not yet contractual, but are very likely to exist in the regarded forward period should be included as well. In a business-as-usual scenario, for example, it has to be assumed, that the bank will not stop its lending activities and therefore future, hypothetical loans should be included. Furthermore, cash flows without underlying financial transactions, e.g. tax payments, salaries to be paid out etc. need to be incorporated.

Paragraphs 46, 106, 107, 109 and 122

One of our biggest concerns is the presentation of key elements as if they were almost stand-alone risk controls.

We suggest that both the funding mismatches discussed in paragraph 46 as well as vulnerabilities revealed in stress tests be more clearly connected to both the requirements for holding a liquid asset cushion and potential remedial actions enumerated in the CFP.

In this context, we want to particularly commend the last two sentences in paragraph 92 and the first sentence in paragraph 107. Similar inter-relationships may be highlighted for the following:

- The potential amounts of liquidity needed are not just from mismatches in the normal course of business but primarily from mismatches in stress scenarios.
- The amount of liquidity available (counter-balancing capacity) is meaningless unless it can be compared to the sums potentially required (which is true also vice versa).
- Unfavorable stress test outcomes require either larger holdings of unencumbered liquid assets, resulting in a larger counter-balancing capacity, as well as reduced structural risk or a mix of both.

It may even be appropriate for the committee to add an additional Principal that addresses the dynamics of these inter-relationships. If stress test reveal that the level of risk exceeds the bank's risk tolerance, either the liquid asset reserve must be increased or the structural cash-flow risk must be decreased. If a stress test reveals the survival horizon is too short, either the liquid asset reserve must be increased or the cash-flow profile expected in that stress scenario must be altered. If a stress test reveals that amount of additional funds required to avoid failure at the survival horizon date is too small, either the remedial actions identified in the CFP must be enhanced or the risk level for that stress situation must be reduced.

Paragraphs 51-53 and 108-110

The proposed guidance frequently mentions triggers in various types of contracts as well as these three paragraphs on early warning indicators. We would like to see more discussion of “early warning” or “key risk” indicators. In particular, we suggest that the guidance include a suggestion the bank contingency funding plans should be “invoked” or “put into effect” based on observed changes in KRIs. For example, without specifying any numbers, the guidance could recommend that the CFP be invoked when a predetermined, bank selected number of KRIs are breached.

Paragraph 123

We suggest that the text in this paragraph be expanded to reflect the lessons learned during the 2007-2008 crisis. We note that the UBS after-event analysis described the mistake of managing its liquid assets to avoid negative carry. “US Short Term Asset Backed Portfolio – This DRCM desk invested in AAA rated short term instruments as part of investing DRCM's spare liquidity to obtain a positive carry (since the (expected) yield on these positions exceeded the internal cost of funding and the hedging costs).²

As Principal 12 makes abundantly clear, the liquidity reserve is “insurance” against the possibility that a stress event will occur. Consequently, it is valuable to mention that insurance is a cost, which is inconsistent with “positive carry”.

Paragraph 128

We are very pleased to see the sentence: “Examples of quantitative disclosures currently disclosed by some banks include information regarding the size and composition of the bank's liquidity cushion, as well as the values of key metrics that management monitors....”

Nevertheless, we would like to suggest some “fine-tuning”.

- As other portions of the guidance makes clear, there is no single value for the bank's liquidity cushion. “Marketability” is partially a function of the scenario.
- Disclosures of the composition of a bank's liquidity reserve may be counter-productive. Experience shows that potential counter-parties will take advantage of information about the seller's positions.
- The size of a bank's liquidity cushion is meaningless by itself. That counter-balancing capacity is only meaningful to the extent that it is sufficient or insufficient to meet potential risks. Instead of disclosing the size of the liquidity cushion, we suggest that banks be required to disclose a range of survival horizon forecasts much like they currently disclose rate risk for a range of different future interest rate environments.

Minutiae

Paragraph 8:

² “Shareholder Report on UBS's Write-Downs, UBS,” 18 April 2008, page 12.

The guidance requires “a bank to demonstrate that its liquidity cushion is commensurate with the complexity of its on- and –off balance sheet activities ...” We respectfully submit that the complexity of an activity is far less relevant than “transparency” .

Paragraph 11:

We suggest that you add “maturity or rollover risk” to the list in the second sentence of this paragraph.

Paragraph 22:

We suggest that “currency and payment systems” be added to the list in the first sentence.

Paragraph 45:

The use of the terms “static ratios” and “forward-looking” in the second sentence of this paragraph seems to imply that all static ratios are not forward-looking. We suggest that the guidance refer to both static and dynamic risk metrics. All of which should be stress scenario specific and forward-looking. In this context, we would also like to endorse the observation: “§Retrospective and concurrent measures of liquidity (e.g., loan-to-deposit ratio, funding ratio) have little value, while prospective views—including off-balance-sheet exposures and instability scenarios of deposits—are critical.”³

Paragraph 48

Where the text uses the phrase “risk escalation procedures” we believe you mean to say: “risk management escalation procedures”.

Respectfully submitted,

Leonard Matz

Via email

Robert Fiedler

Via email

³ Peter Neu and Philippe Morel ,”All Dried Up: The Impact of the Subprime Crisis on Liquidity Risk Management”, BCG Discussion Paper, 25 April 2008, page 2.