

IBFed Response to

BCBS Principles for Sound Liquidity Risk Management and Supervision

Introduction

The countries represented by IBFed collectively represent more than 18,000 banks with 275,000 branches, including over 800 of the world's top 1000 banks which alone manage worldwide assets in excess of \$68 trillion. The Federation represents every major financial centre and its members' activities take place in every time zone. This worldwide reach enables the Federation to function as the key international forum for addressing legislative, regulatory and other issues of interest to the global banking industry. The members of the IBFed are the American Bankers Association, the Australian Bankers Association, the Canadian Bankers Association, the China Banking Association, the Indian Banks Association, the Japanese Bankers Association and the European Banking Federation.

IBFed supports the work that is being undertaken by The Basel Committee on Banking Supervision (BCBS), through its June 2008 draft revision of its *Principles for Sound Liquidity Risk Management and Supervision* (the principles) which seek to identify current good practices for liquidity risk management and how these should be applied globally to prevent future liquidity shortfalls from resulting in industry wide systemic shocks.

The credit crunch has highlighted the international threat that liquidity shortfalls pose not only on individual banks but the entire global economy. As the aftermath is still unfolding it has become evident that liquidity risk management and supervision practices need to be reconsidered to adequately reflect the true risks of current business lines and products as well as the behavioural reactions of other market participants.

Banks, regulators and central banks alike have learned much from the market disruptive events of the past year in particularly the importance of cooperation between the authorities, not just domestically but internationally as well. So we support the paper's recommendations promoting the international harmonisation of the principles of liquidity risk management to enhance cross-border regulation and supervisory cooperation through colleges of supervisors. When introduced these principles will reflect the way in which internationally active banks already manage their liquidity – based on a holistic, group wide approach.

A harmonised liquidity supervision regime will reduce regulatory duplication and avoid trapped pockets of liquidity in cross-border funding. We encourage a proportional approach to supervision allowing for recognition of internal methodologies on a case-by-case basis and calling for an international framework to coordinate supervisory requirements and actions.

The IBFed believes that there should be a flexible approach to liquidity risk management and supervision on an overarching cross-border level that allows global banks to utilise their own

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integrated, internal methodologies while providing smaller banks with a universal standardised approach. Therefore we support the paper's emphasis on:

- Central focus on financial groups at the consolidated level
- Sound governance and endorsement by senior management
- Appropriate risk tolerance levels and alignment of risk taking incentives
- Reinforced strategy and systems for liquidity measurement and management
- Resilient structures for funding market access, intraday liquidity and collateral management
- Robust stress testing, Contingency Funding Plans (CFPs) and liquidity cushions
- Informative public disclosure and communication of plans on liquidity management

Effective liquidity risk management and supervision demands close cooperation between entities in financial groups and between regulatory bodies and central banks on both a national and international level so we support the paper's proposals that the supervision of liquidity risk management should be subject to a harmonised supervisory assessment by the home supervisor who will communicate liquidity positions to host supervisors. This will minimise the possibility of multiple reporting formats and multiple regulatory contacts at times when market liquidity is stressed which can lead to 'analysis paralysis' rather than a mitigation of the risks to the financial markets.

Key Messages

While the international financial industry recognises the need for the regulation of liquidity it is predominantly concerned with the current heterogeneity of regulatory approaches of individual countries. A concerted approach by regulators to establish a coherent supervisory framework is fundamental to efficient liquidity risk management and international capital markets. Thus, we agree with and welcome the BCBS's analysis of recent market events and current liquidity risk practices and would like to provide the following comments on the principles:

General Comments

Principles Based Approach and Proportionality

The industry welcomes the approach based on guiding principles and warns of an overly prescriptive approach to liquidity standards which focuses solely on quantitative requirements - the explanations of the various principles should therefore primarily be regarded as illustrative examples. As it will often be possible to apply alternative appropriate practices, our members must be permitted to diverge from the guiding principles under a "comply or explain" approach. We support a proportionate approach where the required degree of sophistication of liquidity risk management and supervision should reflect the relative liquidity risk and business profile of a bank.

Internal Methodology

The industry respondents felt that the ability to use our own bank specific internal models was only implicitly mentioned in the paper but we do support and appreciate indications that supervisors are willing to engage with banks in the development of internal methodologies. We believe that the diverse approaches that banks have taken in the field of liquidity risk management has of itself provided some strength to the market. As with other major risk areas, such as market and credit risk, we believe that banks' internal methodologies and models have reached a stage of sufficient development that, subject to appropriate supervisory scrutiny and assessment, they can be acceptable for use for regulatory purposes by the supervisors. This development would have the advantage of bringing regulatory and risk management practices closer together and eliminating to the greatest extent possible regulatory duplication, conflict and potentially alleviating intra-group funding constraints.

Furthermore, this internally based approach incentivises banks' to update their methodology more dynamically, when the need arises through new business ventures or changed market conditions.

Specific Comments

Principle 4 - Liquidity Pricing Mechanisms

If Principle 4 requires banks to incorporate liquidity costs, benefits and risks quantitatively and precisely, we believe this principle should be re-assessed. We understand that liquidity cost should be considered in terms of pricing and performance measurement. However, we recognise that there will in many cases be substantial difficulty in complying with the detailed discussion of paragraphs 19 and 20 with respect to the exact quantification of costs, benefits and risks. In addition, it should be recognised that on many occasions, liquidity costs, benefits and risks may only be considered and reflected qualitatively in liquidity risk governance, and not quantified and incorporated explicitly. While the principle sets out appropriate goals, we request that reasonable flexibility will be allowed in evaluating how banks go about meeting this principle. We encourage the insertion of a concept of materiality into this principle.

In aligning prices with liquidity costs the industry cautions against the use of liquidity pricing models which are overly complex and burdensome. Although cost of liquidity can be calculated in theory the actual process would be highly time intensive in terms of research, modelling and analysis. A principle based and proportionate approach should be applicable where cost for pricing mechanisms would be too excessive.

A slight rewording of the Principle might therefore be:

A bank should ~~incorporate~~ recognise liquidity costs, benefits and risks in the product pricing, performance measurement and new product approval process for all ~~significant~~ material business activities (both on-and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole

Principle 5 – Measurement and Management of Liquidity Risk

We believe that measurement and management of liquidity risk is most important in the short-term for banks - a bank's liquidity crisis resolves itself either way quite quickly. We therefore recommend that a reference is made to the significance of monitoring and managing liquidity in the "immediate future," as longer term liquidity projections are very difficult to make in anything but the broadest terms. The term "immediate future" is perhaps appropriate as it allows the necessary flexibility for banks to choose relevant individual timings for risk measurement subject to their own risk horizons and business models.

Principle 5 could then be reworded in the following way:

*A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk **in the immediate future**. This process should include robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.*

Regarding para. 26 on page 10: "... These include vulnerabilities to changes in liquidity needs and funding capacity on an intraday basis; day-to-day liquidity needs and funding capacity over short and medium-term horizons up to one year; longer-term, fundamental liquidity needs over one year; and vulnerabilities to events, activities and strategies that can put a significant strain on internal cash generation capability."

- We would like to confirm the meaning of the underlined segment.

Question: In regards to calculation of gaps over one year, does this refer to structural gaps between expected cash inflows and cash outflows in the context of asset/liability management?

Para. 29 recommends that for "large wholesale deposits" banks should undertake a customer-by-customer analysis of the probability of roll-over. In view of the broad range of business models and customer profiles, it should be left to the banks to define "large" and to decide, with cost-benefit considerations in mind, how to carry out and document these analyses. In particular, it must be possible to carry out the analyses at portfolio level if this produces comparable results. Portfolio-level analysis must also be permitted for financial derivatives (para. 38). Given the sometimes considerable number of derivatives involved, their inclusion in the liquidity risk analysis should be strictly confined to products which may be considered material from a risk point of view.

Suggestion: (Para. 30, pg. 11) "A bank should identify, measure, monitor and control potential cash flows relating to off-balance sheet commitments and other contingent liabilities. ..."

- We would like to confirm the meaning of the underlined segment "control."

Regarding potential cash flows relating to off-balance sheet commitments, we believe that "control" includes reconsidering the upper limit of the commitment line.

This principle could then be reworded as follows:

A bank should have a sound process for identifying, measuring, monitoring and mitigating ~~controlling~~ liquidity risk. This process should include robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.

In para. 38 there is no reference made regarding the materiality of financial derivatives. As with other assets which typically exhibit low volatility we suggest that only month-end or month average input values are required rather than data inputs for each day. For a number of firms daily activity would be disproportionately costly to produce relative to the risk.

Principle 6 – Individual Entities and Groups

Para. 56 requires banks to manage liquidity risk both at the level of individual legal entities, branches and subsidiaries and at group level. This requirement does not reflect current risk management practices and would involve a disproportionate amount of additional time and effort. Liquidity risk is increasingly managed at group level by systems which consider all units of the group. An additional view is not generally taken by our members at the level of individual legal entities with no material impact on the group's liquidity risk as this would offer no further insight. Any differentiation below group level considers groups of business lines rather than individual entities and individual, countries (e.g. Euro area). The requirement to manage risk at both solo and group level should therefore be removed. The key point is for liquidity risk management to be organised in a way which is appropriate to the structure of the group and able to capture all material risks adequately while avoiding unnecessary and unproductive work. Generally we suggest that the role of cross-border groups could be more thoroughly taken into account by stressing the need for enhanced flexibility with regard to the international transferability of collateral and liquidity.

Principle 7 – Funding Strategies

In para 64, banks are called on to limit concentration on any one particular funding source. This major constraint is illogical where deposits in the retail sector are concerned since the subprime crisis underlined once again that retail deposits are a highly reliable source of funding. Furthermore, this paragraph is contradictory because it goes on to refer explicitly and repeatedly to the quality of retail deposits. Moreover, a clear distinction needs to be made in the wholesale sector between

volatile funding and funding sources provided by the capital markets in a reliable and long-term manner. In summary, the requirement to limit concentration should differentiate between funding sources of differing reliability; a one-size-fits-all limit could even turn out to be counterproductive.

Principle 8: Intraday Liquidity

The role of central banks in ensuring the smooth functioning of payment and settlement systems and their pivotal role in minimising operational and reputational risk to our members when they access central bank liquidity management support mechanisms, such as standing facilities, should be recognised.

Suggestion: (Para. 76, pg. 20) "...a) identify and prioritize time-specific and other critical obligations in order to meet them when expected..."

- We request that the underlined segment "and prioritize" be reconsidered.

Justification: In regards to prioritization of customer transactions and individual settlement transactions, we believe that exerting enough control over these would prove too difficult at this time from an operational standpoint. This requirement would be meaningful only for wholesale payment system, subject to the consent of all participants for prioritizing transactions.

Suggestion: (Para. 78, pg. 21) "... A bank should ask key customers, including customer banks, to forecast their own payment traffic to facilitate this process."

Given the volume and additional labour necessary to fully monitor and understand the daily cash-flows and settlements, we believe this requirement would be applied not in the normal times but in emergency times. So, we request that "*as appropriate*" should be added.

Concerning intraday liquidity management in paragraph 78, we would like to confirm that the intent of the BCBS is not to require banks to centrally identify risks on a permanent basis. We believe the intent of this paragraph is to ensure that the risks are managed appropriately, reflecting each banks' business and structure. For example, risks may be broken down by currency types and regions.

Principle 10 – Stress Testing

Banks seek clarification that the reference to "market wide risk" includes force majeure. If this is the case we suggest that the principle specifies the use of "plausible" tail end operational risk events.

Para. 97 lists a number of possible stress scenarios and thus suggests that banks should consider a range of scenarios. In principle, a certain amount of variety is desirable because it increases the likelihood that possible future developments will be analysed ahead of their occurrence. It should nevertheless be borne in mind that a considerable amount of time and effort is involved and this needs to be weighed against the possible additional insight gained. Designing stress scenarios is not a standardised procedure but one which must be continuously updated and adjusted. This process requires the investment of considerable resources, without which the quality of the scenarios would suffer. A potpourri of insufficiently well-founded stress tests might suggest a robustness which does not in fact exist. Supervisors should not expect a high degree of precision in scenario modelling, in that a scenario is by its very nature an imprecise abstraction; rather, scenarios should be considered as a tool to consider the rough magnitude and range of the effects of potential stresses.

In addition, the BCBS points out, that highly unusual scenarios should not be dismissed as implausible. The banking industry agrees in principle that unusual scenarios also need to be considered. It is important, however, to retain a sense of proportion. In particular, it would be counterproductive if the need for a significantly larger cushion were automatically inferred from highly unlikely scenarios since this would have an adverse effect on the bank's refinancing.

Principle 11 - Testing of CFPs and Role of Central Banks

There is concern that requirements to have Contingency Funding Plans (CFPs) tested in operation as actual 'dry runs' could be misinterpreted by markets and negatively impact a firm's reputation in terms of its funding ability. We recommend that central banks actively involve themselves in the formulation of testing funding plans with the industry. The role of central banks as lender of last resort should be recognised and incorporated in contingency planning. There should be a close relationship between the central bank's role, actions and provisions and a firm's internal liquidity risk management decision-making processes. Additionally, standing facilities should be clarified and communicated as regular funding measures to the general public to avoid the negative stigma of central bank borrowing.

Principle 12 - Liquidity Cushion

This principle raises the question of how much of a liquidity cushion may be required by supervisors. We therefore recommend the reference to a bank's risk tolerance as a flexible tool to establish appropriate individual liquidity requirements.

In terms of the definition of liquid assets the only relevant criterion is the liquidity raising capacity of an asset. It should not be based, for instance on an accounting or banking/trading book split. Firms are currently reviewing their assumptions of what constitutes a 'liquid asset'.

Principle 13 - Transparency and Disclosure

The industry supports supervisors working towards obtaining a clearer picture of the liquidity positions of the markets and of individual firms. However, we caution against requiring too much quantitative liquidity information to be made publicly available especially during times of stress as potential early warning indicators could be misunderstood as and themselves exacerbate a liquidity squeeze. We therefore encourage the public disclosure of qualitative liquidity indicators, with no more quantitative information than is already required under IFRS 7.

Suggestion: (Para. 127, pg. 29) "A bank should describe this structure with regard to its funding activities, to its limit setting systems, and to its intra-group lending strategies."

- We would like to confirm the meaning of this sentence.

Justification: Does this paragraph require banks to note qualitatively if they have a centralised or decentralised system in terms of liquidity risk management in a group? In regards to group segmentation and interactions as well as intra-group lending strategies, given that each bank is likely to have different ideas and definitions, we believe that standardised and unified disclosures will be difficult and also fear they may cause further misunderstanding.

Suggestion: (Para. 128, pg. 30) While we agree with and understand the need to increase and improve disclosure of explicit quantitative information related to liquidity risk positions, we believe that now is too early.

Justification: Given that there is no established market standard relating to liquidity risk management, the sudden release of information using proprietary definitions and terminology seems likely to cause confusion and misunderstanding in the market. We believe that disclosure requirement should be developed in a dialogue between banks and market participants, not initiated by regulators.

Principle 14 – The Role of Supervisors

Supervisors and central banks should clarify their role and requirements during times of stress as it is not feasible for each bank to make such preparations in isolation. Central banks should provide clarity as to the stress situations under which they will provide liquidity to the markets, learning from the current stress situation.

Also, supervisors should consider such factors as asset size, business model, liquidity stress levels, and the roles of central banks when assessing each bank's liquidity risk management. But to avoid any divergent or static definition of risk tolerance levels for banks we recommend that this principle clarifies the proportionality of risk tolerances to individual bank business models. There is also a necessity for flexible definitions by banks as their risk tolerances will evolve over time with market conditions.

Principle 15 - Duplication of Reporting

References to the use of supplemental monitoring, perhaps via standardised liquidity reporting frameworks devised by supervisors, seem to indicate that regulators will wish to access both regulatory and a bank's own internal reporting system. This would open the burden of dual reporting (to the extent that one regulator's reporting requirements differ from another and ignore the point that internal methodologies best reflect firm's liquidity positions as they are able to cater for differences in business models and risk tolerance. However, it should be stressed that internal management reports are dedicated to management and should not automatically be included into the standardised reporting framework to the supervisor. Where a bank uses an internal methodology it would of course be reasonable that high level reports would be shared with the supervisor.

Principle 16 - Relationship between Regulatory Capital and Liquidity

The reference in paragraph 140 to higher capital requirements as a remedial tool contradicts the principle that capital is not – and cannot be – a solution for inadequate liquidity. We acknowledge, clearly, that there is ultimately a relationship between liquidity and solvency as gravely impaired liquidity may force the fire sale of assets which may in turn undermine the solvency of the institution. However, capital is no substitute for liquidity and it is important for the paper to be explicit on why it introduces this suggestion and it will be likewise important for supervisors to be very clear about the reasons for which they may deem greater regulatory capital to be necessary. Clearly supervisory decisions to impose higher capital requirements should be a measure of last resort. Diversification of funding sources, contingency planning, and factoring liquidity needs into risk and stress analysis is more critical to liquidity planning than adding capital.

Principle 17 - College of Supervisors, Home Country Supervision and Cross Border Cooperation

The division between home and host regulators creates one of the greatest obstacles for cross-border liquidity management within financial groups. Currently, the host supervisor carries the main responsibility setting liquidity standards for a bank's subsidiaries, despite the fact that most cross border groups manage their liquidity centrally at the head office in the home country. Assigning home country responsibilities for liquidity of subsidiaries would further alleviate regulatory constraints, eliminating trapped pockets of liquidity and facilitating the harmonisation of liquidity standards for cross-border groups. We encourage the development of a framework for colleges of supervisors to delegate tasks for the supervision of cross-border financial groups. In this framework branches and subsidiaries should be exempted from supervision by host countries when parent firms are supervised by the home supervisors and liquidity management information of the group is communicated to host supervisors.

Suggestion: We would like to request the strengthening of coordination among central banks of different countries in times of liquidity stress not only in terms of information-sharing but also the

commonality for collateral acceptability (for example, taking foreign currency from a foreign central bank in exchange for home currency-denominated governmental bonds held on the account of the central bank of the home country).

Justification: Liquidity risk management in stressed times requires both substantial resources and highly conservative discipline to ensure that the system meets all currency liquidity needs. In these stress periods, currency swap agreements or equivalent measures among relevant authorities concerned, i.e. central banks, are very useful in terms of managing liquidity risk.

Conclusions

The IBFed welcomes the BCBS proposals on liquidity risk management and supervision, and encourages its implementation on a global scale. It is essential in this process that a thorough industry consultation is performed in each jurisdiction to fine-tune the details underlying supervisory requirements for assessment, regulatory reporting and remedial actions whilst maintain as far as is possible a convergent approach. Furthermore, policy makers should coordinate with each other at an international level to seek policy convergence on liquidity standards and build an international framework to handle future global systemic shocks. Supervisory colleges with the full involvement of the bank in question can be very instrumental in promoting this.

An effective liquidity regime should clearly define the roles of home and host supervisors and central banks both on national and international levels. Discussions between international supervisors and regulators should especially focus on eliminating diverse supervision practices and regulatory constraints that can hinder intra-group funding and result in potential trapped pockets of liquidity.

In terms of the proposed BCBS's principles for liquidity risk management in banking firms, we are confident that these already reflect current best practices amongst our larger members. We therefore encourage regulators and central banks to support these practices and supplement them with supervisory assessments to ensure their validity and also by playing an active role in our member banks contingency planning.

While IBFed recognises the concerns of individual countries to maintain control of liquidity supervision to protect its depositors and investors, it must be recognised that a harmonisation of liquidity standards and the elimination of local obstacles to funding will enhance the overall liquidity risk management of banks while also creating more efficient capital markets. We therefore encourage countries to eliminate legal barriers and assist in the development of international settlement platforms to ease the flow of cross-border capital funding. In turn we support the international dialogue between supervisors and central banks to coordinate their efforts to mitigate local and regional risks and to act in concert to alleviate future liquidity crises.

International Banking Federation
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