Z E N T R A L E R K R E D I T A U S S C H U S S

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Basel Committee on Banking Supervision

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10178 Berlin
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Comments on the Basel Committee Consultation Document
"Principles for Sound Liquidity Risk Management and Supervision" of June 2008

Dear Madam, dear Sir,

On 17 June 2008, the Basel Committee on Banking Supervision issued a consultation document on revising its "Sound Practices for Managing Liquidity in Banking Organisations", which was published in 2000. We welcome the opportunity to comment.

1. General comments

We warmly welcome the **principles-based nature** of the Basel Committee's paper and believe that the 17 proposed principles cover all major aspects of the banks' liquidity management and its supervision by the competent authorities. Principles-based regulation is essential if adequate account is to be taken of the diverse business models and design of risk management. Furthermore, principles are the only way of ensuring the flexibility which is needed to adapt risk management practices to changed conditions. When the Basel Committee writes in its introduction (para 6) that it expects banks and supervisors to "implement the revised principles promptly and thoroughly", we assume that this refers only to the principles themselves and not to the explanations of the principles. These explanations are often excessively detailed and describe only one of many examples of effective risk management (e.g. when discussing contingency funding plans, stress tests, public disclosure and intraday liquidity management).

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These cannot, therefore, be viewed as best practices, especially in light of the tried and tested range of practices already in place at German big banks. In our view, the explanations should be seen as illustrative examples which the banks can, and should, use as general guidance but from which it is also possible to diverge in justified circumstances. A “comply-or-explain” mechanism of this kind was strongly advocated by the Institute of International Finance (IIF) in its March 2007 paper “Principles of Liquidity Risk Management”. This comply-or-explain approach should be explicitly spelled out by the Basel Committee in the individual principles or added as a principle in its own right. Otherwise, there is a danger that excessively detailed requirements will make it impossible to take adequate account of the specificities of individual banks or for banks to adapt risk management and monitoring practices to changing business conditions and refine them with a view to gaining a competitive edge.

We support the statement in para. 6 that the implementation of the sound principles by banks **and** supervisors should be tailored to the size, nature of business and complexity of the bank’s activities (**proportionality principle**). The rest of the document fails, however, to make adequate reference to this principle. We therefore suggest either explicitly mentioning the concept of proportionality in the individual principles and their explanations or making this an overarching principle in its own right alongside the comply-or-explain approach.

To avoid excessively detailed regulation, the paper should also expressly point out that the principles and their explanatory comments relate only to what a bank considers **material risks and material issues** (**materiality principle**). This should be formulated as a third overarching principle applying to the entire paper.

2. Specific comments

Principle 1 (liquidity risk management framework)

Para 8 stresses that liquidity risk management should be "well integrated into the bank-wide risk management process". It goes without saying that liquidity risk management practices should be coordinated with the practices applied in other relevant risk management areas wherever there are major interfaces with other types of risk. Integration should not be excessively deep, however, nor should it be automatically required in all areas because this would overextend the banks' operational and organisational capabilities. Furthermore, excessively far-reaching rules would generate considerable costs in the areas of documentation and auditing, among others.

Principle 2 (risk tolerance)

Banks are expected to set their liquidity risk tolerance at a level which would enable them to withstand a "prolonged period of stress". We welcome this definition, but would like to point out that there is an important difference between short-term and long-term stress. Short-term stress lasts for a period within which no adjustments to a bank's business model are possible or necessary and for which an appropriate liquidity cushion therefore needs to be maintained. By contrast, banks normally respond to long-term stress by adjusting their business activities. It needs to be borne in mind, however, that banks are sometimes prevented by their bylaws from changing their business models. These banks will take alternative countermeasures.

We would point out that liquidity risk tolerance cannot be defined and evaluated independently of other significant types of risk. As the consultation document points out, risk tolerance can be expressed in a variety of ways, i.e. on a quantitative or qualitative basis. Irrespective of this point, we would draw attention to the special nature of liquidity risk in the context of a bank's risk-bearing capability (see comments on para 71).

Principle 4 (liquidity costs)

Principle 4 requires banks to incorporate liquidity costs and benefits and risks in the product pricing, performance measurement and new product approval process for all significant business activities. It is true that a failure to take account of liquidity costs can lead to errors in

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risk management. Risks are then usually identified too late and it is very difficult and costly to remedy the adverse effects – if indeed they can be remedied at all. When monitoring the implementation of this principle, however, supervisors should keep the concept of proportionality in mind and allow the banks' methods of calculating liquidity costs to reflect their business model. It should also be remembered that, in contrast to rating methods, there are no standard methodologies for calculating liquidity risk which supervisors consider empirically watertight. It should therefore be recognised that banks can deal with liquidity costs in a variety of ways. Regulatory requirements should not go into excessive detail. In particular, they should not require liquidity costs to be calculated in such a way as to ensure that all exposure to loss is excluded or transferred. The decisive point – and the real objective of Principle 4 – is essentially to avoid adverse incentives.

We have reservations about interference in product pricing. It is not possible put an exact figure on liquidity costs, especially where off-balance sheet business is concerned. This is because of the complexity and uncertainty involved regarding, for example, when and how much liquidity will be drawn on, the rollover of positions and follow-up business. In addition, different national interpretations of requirements concerning the price of liquidity may place at a competitive disadvantage banks "forced" to pass on higher risk components to customers.

The requirement in para 19 to allocate a liquidity charge to each individual transaction is too demanding, in our view. In principle, it ought to be sufficient to allocate such charges to business segments. Whether or not a further breakdown would improve risk management and deliver added value for supervisors would depend entirely on the bank's business model and size.

Principle 5 (identifying, measuring, monitoring and controlling liquidity risk)

Para 24 requires banks to recognise "strong interactions" between liquidity and other types of risk. As mentioned in our comments on Principle 1, this should not be interpreted as automatically requiring a detailed examination of all possible interaction. The paper is correct to point out that liquidity risks can result from difficulties in managing other risks. Nevertheless, a clear distinction needs to be made between the tasks and responsibilities associated with liquidity risk management and those relating to other types of risk if the smooth functioning and efficiency of day-to-day risk management is to be ensured. Adequate consideration is given to other types of risk in stress testing and the analysis of knock-on effects (e.g. the effects of loan defaults on liquidity lines).

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The requirement to consider interaction with operational risk in projecting cash flows should be dropped. We also believe it unnecessary to project cash flows on an intraday basis, as might be inferred from para 26, since we consider the existing special requirements for the management of intraday liquidity (Principle 8) to be sufficient.

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 must 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.

We agree that it is advisable when managing credit risk to evaluate the creditworthiness of each counterparty in off-balance sheet positions. It would be inconsistent with the materiality and proportionality principles, however, to require this evaluation always to be considered when determining the liquidity demand relating to every off-balance sheet position (para 30).

Portfolio-level analysis must also be permitted for financial derivatives (para 38). Given the sometimes considerable number of derivatives, the inclusion of financial derivatives in the liquidity risk analysis should be strictly confined to products which may be considered material from a risk point of view.

Financial derivatives are normally already measured at their market value and their associated risks are thus adequately captured in the context of margining. There is controversy surrounding the mathematical basis on which to model calculations of the liquidity risk of optional or derivative cash flows. In particular, modelling possible cash flows from possible liabilities is subject to various market fluctuations, counterparty risks and the risk associated with being unable to determine the actual point in time of the payment flow in question.

The Basel Committee takes the view that the banks should consider not only outgoing and incoming nominal amounts when projecting cash flows but also outgoing and incoming interest (para 46). We believe it is inappropriate to make the consideration of interest mandatory. The principles of materiality and proportionality demand that this decision also be left to the banks.

Principle 6 (solo/group level)

Para. 56 requires banks to manage liquidity risk at the level of individual legal entities, branches, subsidiaries and business lines and also at group level. This requirement is at odds with many current risk management practices and would involve a disproportionate amount of additional time and effort. Depending on their organisational structure and business model, some banks are increasingly managing liquidity risk at group level by systems which cover all (material) units of the group. With the materiality principle in mind, no additional view is taken, for example, at the level of individual legal entities with no material impact on the group's liquidity risk because this would offer no further insight. The requirement always to manage risk at both solo/business line and group level should therefore be dropped. The sole key point should be for liquidity risk management to be **organised in a way which is appropriate to the structure of the group involved**. It should be able to **capture all material risks adequately** while avoiding duplicate and unproductive work.

Principle 7 (funding strategy)

The objective of Principle 7 is not only to ensure the diversification of funding sources, which makes good sense, but also to require the banks to evaluate on a regular basis how quickly they would be able to access funds from each source. It is certainly desirable in principle for banks to be able to raise funds in the event of a sudden liquidity shortage also from sources which they rarely or never use and for them to be aware of the extent to which these sources can be tapped. In practice, however, it is not possible for a bank to regularly "test out" markets in which they are not normally active. This requirement should therefore be limited to evaluating actively used funding sources and the possibility of raising additional funds from them at short notice.

We are not clear on how to interpret the requirement for a bank to "regularly gauge its capacity to raise funds quickly…". Even in actively used markets it is only possible to test the availability of a funding source, not the maximum amount which could be raised.

Paras 63-65 point out the need for funding sources to be adequately diversified and expand on this requirement. We basically agree with the requirement because concentration on one or only a few funding sources can result in liquidity problems if these sources dry up. Nevertheless, the Basel Committee fails to take adequate account of the network structures in the German banking market. These are based on the principle of concentrating funding via the

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network's internal central banks. The positive diversification effects of group and network structures should also be taken into account when evaluating liquidity risk.

In para. 64, banks are called on to limit concentration on *any* one particular funding source. This major restriction is not logical 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 also 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. Banks which fund themselves primarily in the capital market should not automatically be required to hold a higher proportion of liquid assets. Instead, banks should merely be required to have adequate arrangements in place if their refinancing structure makes this necessary. 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.

Excessive limits, especially through large exposure limits or on wholesale funding, can have an adverse effect on the functioning of entire market segments. The subprime crisis showed in recent months that reciprocal limits on or the withdrawal of money market facilities from individual banks had negative consequences for the entire functioning of the money market and thus of a market with a major role in managing the banks' (short-term) maturity transformation activities. When setting limits, it is essential to take adequate account of their effect on the international banking system.

Under para 69 banks should identify current and potential investors and build strong relationships with them. We would point out that it is not always possible to identify all investors, e.g. in the case of bearer bonds with a broad investor base. Banks should also be permitted to rely to experts' assessments.

Para 71 establishes a direct link between a bank's "capital cushion" and its ability to find funding. (We would suggest, incidentally, not using the term "cushion" at this point, since it might lead to confusion with the liquidity cushion introduced in Principle 12.) The German banks do not believe such a link exists in this form and consider that the role of regulatory capital in avoiding liquidity risk is significantly exaggerated. Regulatory capital is not a suitable instrument for absorbing liquidity shortages. It should also be borne in mind that liquidity risk is by its nature very different from a bank's other risks, against which it sets aside capital, and that for this reason it is not included in the ICAAP.

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Principle 8 (intraday positions)

The aspects of managing intraday liquidity positions outlined in paras 75-85 represent a significant addition to existing requirements when it comes to the obligation to have measuring methods in place and apply stress tests to intraday liquidity. The smooth functioning of payment and settlement systems is certainly an element which banks need to consider as part of their risk management strategy. It should nevertheless be borne in mind that it is primarily operational risk which arises in this area and that this must be managed by the appropriate section of the risk management team. We believe there is a danger here of risks being captured twice and of responsibilities becoming blurred. As things stand, the settlement and trading units are together responsible for ensuring that clearing routines are in place to enable intraday payments to be made on schedule. The risk of these processes failing in the absence of sufficient liquidity and of the associated penalties are captured in the context of operational risk. This approach is appropriate, in our view. By contrast, liquidity risk management staff would first have to familiarise themselves with these details.

The important link between payment and settlement systems and liquidity risk management is that a portion of the liquidity cushion must be earmarked for payment and settlement services. This is the link on which discussions should focus. Requirements for intraday management should also be formulated with the proportionality principle in mind.

The requirement for banks to manage liquidity over the course of a day in such a way as to ensure that the need for intraday liquidity is covered even in stressed conditions should consequently apply only to banks which play a major role in central bank clearing. The general requirement to stress test intraday liquidity positions should be dropped, in our opinion. The phrase “under both normal and stressed conditions” should therefore be removed from Principle 8.

In addition, the documentation of liquidity risk management in this area should be kept to a reasonable scale despite the level of detail set out in the paper.

Principle 9 (collateral)

Principle 9 envisages that banks should monitor both the legal entity and the physical location where collateral is held. Although this requirement is reasonable in principle, it would be unnecessarily cumbersome where the ECB system is concerned. Owing to the ECB's common money market and collateral policy, it is irrelevant in which country of the euro area collateral is held.

We would also appreciate clarification of whether the expression "funds from private counterparties" in para 87 refers to repos and which other instruments, if any, are meant.

Principle 10 (stress tests)

Under para 93 stress tests should be used to analyse the implications on liquidity positions at group level and at the level of individual entities and business lines. In light of letters of comfort, central risk management and reputation risk, we do not consider it necessary to conduct stress tests at the level of individual banks and business lines. As we pointed out in our comments on Principle 6, a group-level view is sufficient. Analysis at the level of an individual bank or business line should be limited to cases where these units are examined individually in the context of an effective overall risk management strategy. The Basel Committee also envisages that the impact of stress scenarios on the intraday supply of liquidity should be analysed. This requirement should be dropped, as mentioned in our comments on Principle 8. Factors other than overnight liquidity are relevant if a stress scenario is to ascertain whether intraday overdraft facilities at the central bank and on nostro accounts are sufficient to meet all intraday payments on schedule. Staff with the expertise to undertake analyses of this kind are more likely to be found in settlement than in risk management departments.

Para. 97 lists a number of possible stress scenarios and combinations of scenarios, thus suggesting that banks should analyse the implications of a whole range of stress scenarios. In principle, a certain amount of variety is certainly 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. There are problems regarding how to set "appropriate" parameters for a large number of scenarios since reliable historic time series are naturally not available and expert opinions have to be obtained. On top of this, designing stress scenarios is not a standardised procedure but one which must be

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continuously updated and adjusted. This process requires the investment of considerable resources, without which the quality of the scenarios would suffer. A wide variety of insufficiently well-founded stress tests might suggest a robustness which does not in fact exist. In addition, the question arises as to their real added value since it is not possible to draw meaningful conclusions from or hold liquidity for an excessive number of scenarios and combinations of scenarios. Furthermore, the results of the various scenarios (including combined scenarios) will often not differ so substantially that they will all provide productive lessons for risk management. The number of stress tests to be carried out should therefore be kept to a reasonable level. Otherwise, there is a risk of excessive constraints being placed on the banks' business.

In addition, a bank's business model should determine the type of stress scenarios conducted. Different stress situations may be relevant and have differing implications for different kinds of business model. Prescribing the same scenarios for all banks, as suggested in para 133, will consequently not produce meaningful results and is therefore rejected.

The Basel Committee also 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.

Para 101 requires the banks to take a conservative approach when setting stress test assumptions. It would be sufficient in our view to require "appropriate" assumptions to be made. The obligation to evaluate the appropriateness of future balance sheet growth estimates should be dropped because this figure relates to future business development and is of secondary importance from a risk management perspective.

Banks are recommended in para 105 to conduct analyses of the sensitivity of stress test results to individual assumptions. We support the recommendation of sensitivity analyses and warmly welcome the fact that this is a recommendation only. With cost-benefit considerations in mind, these analyses should, however, be limited to risk drivers or real major relevance to liquidity risk.

Principle 11 (contingency funding plan – CFP)

We assume that the regular testing of the CFP referred to in para 119 is *not* meant to involve banks selling portfolios or parts of portfolios on a test basis. This would give rise to considerable costs and could quickly spark rumours in the market. It must be sufficient to ascertain in the tests whether the envisaged measures function as planned (e.g. by conducting test runs of telephone chains, etc.). Owing to the variety of potential crises, contingency plans cannot, moreover, contain strictly detailed instructions or inflexible procedures. Each individual crisis will need to be handled in an individual way. CFPs can therefore only set a sensible framework for action and define a basic structure within which to act. Our understanding is that there should be *one* CFP setting out a basic structure and various options for action for different types of crisis.

Para 119 also requires the CFP to be approved by the board at least once a year. It should be enough for the approval to be given by the responsible members of the board. A resolution adopted by the entire board should not be necessary.

Principle 12 (cushion)

It makes good sense to require banks to maintain an adequate cushion of high quality liquid assets. Most banks probably already do so. We welcome the fact that the Basel Committee has refrained from setting any quantitative rules concerning the size of the cushion. The second sentence of para 121, which states that the size should relate to estimates of liquidity needs under stress, could give rise to problems, however. There is a need, first, to clarify that the liquidity cushion is not intended to cover needs in an unlikely stress scenario. Second, the cushion should not be so big that it enables the bank to overcome a serious stress scenario without the need to make any adjustments to its business model, for instance (see also our comments on Principle 2). In our view, the cushion should serve primarily to cover liquidity needs arising if unexpected circumstances occur during times of normal business activity. We would also like to point out that, while it is appropriate to use the results of stress tests as a guideline, there should be no requirement for the size of the cushion to be an exact reflection of these results. The differences in methodologies used by the banks when conducting stress tests are too wide. What is more, there would be a danger that banks conducting severe stress tests would be placed at a competitive disadvantage by the ensuing need to maintain large amounts of liquidity. The natural response would be for banks to ensure that their scenarios were comparatively “harmless”. This is obviously not the outcome supervisors are aiming at.

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For practical reasons it is, moreover, important not require the cushion to be an amount kept separate from existing liquidity risk management systems; it must be possible to integrate it into these existing systems. In fact, a lot of banks probably already include a cushion implicitly when calculating their liquidity position – namely that portion of liquidity potential incorporated in calculations of their forecast payment profile (as incoming liquidity). An implicit inclusion of reserves enables banks, in particular, to adequately describe temporal and qualitative aspects of their capacity to realise liquidity. In addition, it is then possible over time (during a prolonged crisis) also to use some portions of "less" liquid funds to gradually generate liquidity.

There is no doubt that banks should be realistic about how much cash their central bank will make available (para 125). We nevertheless believe that, when problems arise in the market as a whole, central banks need to make additional liquidity available against eligible collateral without stigma becoming attached to banks seeking this liquidity. This should be clearly spelled out in the paper.

It should, not least, be clarified that a liquidity cushion does not necessarily have to consist exclusively of saleable assets. It should also be possible to include lending commitments as long as they cannot be terminated and come from sources of high credit quality.

Principle 13 (public disclosure)

The amount of information to be disclosed should be kept to a reasonable level (paras 128 and 129). This is important not only for cost considerations but also to avoid banks making themselves vulnerable by disclosing overly sensitive data (e.g. core ratios, stress test results and liquidity reserves) or becoming the subject of rumours if their disclosure policy is modest. The objective of disclosure is, after all, to promote stability. In addition, the emphasis should be on qualitative information. Quantitative information could prompt the market to overreact, especially if the disclosed data is not really comparable, making it possible or even probable that it will be misinterpreted. It should not be made mandatory to disclose the examples mentioned in the paper of "values of key metrics that management monitors". We also see a need for differentiated disclosure, meaning that not all the information disclosed to parties such as regulators, credit rating agencies and supervisory boards should also have to be made available to the general public.

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Principle 15 (information for supervisors)

Principle 15 recommends supervisors to base their regular assessments on the banks' internal reports, market information and also on prudential reports. Prudential reports should not be made mandatory in our view because this would not provide for the possibility of obtaining regulatory recognition for internal liquidity risk management systems. This possibility was proposed by the IIF as early as in March 2007 and is also advocated by the Committee of European Banking Supervisors (CEBS) in its "Technical Advice to the European Commission on Liquidity Risk Management" of 17 June 2007. The German Liquidity Regulation, which took effect in 2007, already gives banks the option of obtaining regulatory recognition of their internal liquidity risk management systems and thus exempting themselves from calculating prudential liquidity ratios. Banks which exercise this option no longer have to prepare prudential reports and instead submit agreed sections of their internal reports to the supervisory authorities.

Principle 16 (remedial action)

Requiring a higher capital ratio is mentioned in para 140 as a possible response by supervisors to weaknesses in a bank's liquidity risk management. Given the paper's subsequent admission that regulatory capital is not an adequate solution to liquidity problems or inefficient risk management, additional capital charges should be dropped from the list of supervisory responses. Liquidity risk is of a very different nature from other types of risk, management of which largely involves calculating how much regulatory capital is needed to cover unexpected loss. If shortcomings are identified in a bank's management of liquidity risk, supervisors should focus rigorously on bringing about improvements in the quality of its risk management or adjustments to its business model. They should refrain from imposing capital charges because these could even be counterproductive and suggest that weaknesses have been eliminated or compensated when the underlying problems have not been tackled at all.

Principle 17 (cooperation between supervisors)

We warmly welcome the recommendation for supervisors to cooperate with one another on monitoring liquidity risk. Cooperation in the sense of mutual recognition of internal models and primary supervision by the home supervisor is essential to improving liquidity risk

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management. As pointed out in our comments on Principle 6, liquidity risk is increasingly being managed at group level. If contradictory requirements and costly duplication of work are to be avoided when supervising banks which operate across borders, supervisors need not only to exchange information and cooperate closely but also to agree on a common understanding of appropriate group risk management. With this in mind, mechanisms such as joint training workshops for staff and joint on-site inspections can be very helpful in promoting the convergence of supervisory practices.

We would naturally be happy to discuss any of the issues raised in our comments at any time.

Yours sincerely
on behalf of the Zentraler Kreditausschuss,
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