LIBA

LONDON INVESTMENT BANKING ASSOCIATION
6 Frederick's Place
London, EC2R 8BT
Telephone: 44 (20) 7796 3606
Facsimile: 44 (20) 7796 4345
e-mail: liba@liba.org.uk
website: www.liba.org.uk

bba

The voice of banking & financial services
British Bankers' Association
Pinners Hall
105-108 Old Broad Street
London EC2N1EX
T +44(0)20 7216 8800
F +44(0)20 7216 8811
E info@bba.org.uk
W www.bba.org.uk

ISDA

International Swaps and Derivatives Association, Inc.
One Bishops Square
London, E1 6AD
Telephone: 44 (0)20 3088 3573
Facsimile: 44 (0)20 3088 3555
website: www.isda.org

Joint Industry Trade Associations' Response to the

BCBS Principles for Sound Liquidity Risk Management and Supervision

Introduction

We support 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 for individual firms 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.

Firms, regulators and central banks alike have learned much from the market disruptive events of the past year in particularly the importance of cooperation between all the authorities involved including central banks, not just domestically but internationally as well. So we support the paper's recommendations promoting the greater consistency and convergence of supervisory practices on liquidity risk management to enhance cross-border regulation and supervisory cooperation through international colleges of supervisors. The harmonization of these standards across national boundaries should be a primary objective of supervisors to reduce regulatory complexity and simplify the risk management processes of firms across multiple legal entities and jurisdictions. Thus we would suggest that Principle 17 be expanded to encourage consistency and harmonization of regulation. This is consistent with the recommendations of the Financial Stability Forum in their April 2008 report on "Enhancing Market and Institutional Resilience". When introduced these principles will more closely reflect the way in which internationally active firms already manage their liquidity – based on a holistic, group wide approach.

A consistent, principle based liquidity supervision regime, within an international framework to coordinate supervisory requirements and actions will reduce regulatory duplication and reduce the possibility of trapped pockets of liquidity in cross-border funding. We encourage a proportionate and flexible approach to liquidity risk management and supervision that allows global firms to utilise their own integrated, internal methodologies while providing less complex firms with a universal standardised approach. Such an approach allows for strong, integrated cross border supervision by regulators and management by the firms. Therefore, in general terms 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
- Adequate strategy and systems for liquidity measurement and management
- Firm structure for funding market access, intraday liquidity and collateral management
- Stress testing, Contingency Funding Plans (CFPs), liquidity cushions
- Public disclosure and communication 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 view that the supervision of liquidity risk management should be subject to a consistent and convergent 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 the actual mitigation of the risks to the financial markets.

Key Messages

The international financial industry fully recognises the need for improved regulation and supervision of liquidity. The principal concerns held by the industry relate to the heterogeneity of regulatory approaches across borders and overly prescriptive liquidity regimes. A concerted approach by regulators to establish a coherent supervisory framework is fundamental to efficient liquidity risk management and must recognise the interconnectedness of the 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

Principle Based Approach and Proportionality

The industry welcomes the approach based on guiding principles and we advocate a proportionate approach whereby the standard and intensity of a group's liquidity risk management is appropriate to the complexity of its business and the scale and nature of the liquidity risks to which it is exposed. In our view an overly prescriptive approach to liquidity standards which focuses solely on quantitative requirements would not deliver the requisite level of proportionality or necessary flexibility in managing liquidity. Furthermore, it would divert the regulators' focus from the crucial higher level oversight of a firm's liquidity governance and its strategies, policies and practices which we believe are equally important to a focus on numbers and ratios.

Internal Methodology

The industry respondents felt that the eligibility of internal models was only implicitly mentioned in the paper. We support and appreciate indications that supervisors are willing to engage with firms in the development of internal methodologies. We believe that the diversity of approaches that firms 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 firms' internal methodologies and models have reached a stage of sufficient development that, subject to appropriate supervisory scrutiny and assessment, can be acceptable for regulatory purposes by 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 firms to update their methodology more dynamically when the need arises through new business ventures or changed market conditions, rather than waiting for regulators to amend their prescribed approach. This has the added advantage of allowing regulators a more flexible review of a banks liquidity risk management processes and allows for changes in process and metrics to adapt to changes in products and markets.

<u>Collateral</u>

We would like to draw your attention to the on going industry initiatives seeking to improve collateral management practices at major dealer firms with regards to OTC derivative transactions.

A number of aspects with regard to the collateral management process are currently being discussed by our member firms. ISDA hopes to develop a paper on collateral management experiences over the last 12 months. This paper would observe that collateralisation has essentially functioned as intended in the past year (in the sense of protecting market participants against credit exposure), although there are areas where further development could be helpful. These include the portfolio reconciliation process, staff training, monitoring of counterparty compliance, optimisation of threshold levels and minimum transfer amounts and management reporting, and legal support automation.

ISDA notes that the efficient functioning of the derivatives market and the effective management of risk are both well-served if counterparties are able to identify portfolio mismatches and resolve disputed margin calls rapidly, and to subsequently settle collateral movements. It has been noted by collateral practitioners that periods of volatility can give rise to valuation difficulties for individual trades, which may lead to disputed collateral calls. This is most notably for transaction portfolios between large dealers.

ISDA reports that collateral practitioners across the industry have responded positively to the challenge of resolving disputed margin calls, with greater collaboration across firms to investigate and resolve differences as they arise. Firms have made considerable investments in people and technology to permit faster, more accurate and more frequent electronic reconciliation of portfolios between market participants, matching both trade population and mark-to-market value. Certain vendor services have been instrumental in these efforts. Collateralized portfolios between dealers subject to these new measures have proven to be easier and faster to reconcile, thus permitting prompt resolution of disputed margin calls.

Finally, it is worth noting that the harmonisation of acceptance of collateral across jurisdictions should be an important objective that will allow firms to more efficiently manage collateral and would reduce risk to the system.

Netting Agreements

It is worth pointing out that there is little current international or EU legislation that sets out close-out netting rules. There are merely references to close-out netting in various instruments (e.g. in the EU: Settlement Finality Directive, Collateral Directive). Art 7 Collateral Directive is more than a reference, but sets out no principles.

ISDA is therefore in the process of proposing further legislation at an international and EU level to strengthen and promote convergence of domestic regimes and provide guidance to various jurisdictions.

In its Evaluation Report on the Implementation of the EU Collateral Directive (Dec 2006) the European Commission acknowledged the need to harmonize the *acquis communautaire* re set-off and netting. Together with the EFMLG, ISDA has made a proposal to the European Commission to develop a directive on close-out netting. Such an instrument is meant to harmonise the various divergent definition of set-off and netting contained in various EU legal instruments currently (e.g. Settlement Finality Directive, Collateral Directive, Winding-up Directives, and Insolvency Regulation).

The proposal is two-pronged suggesting to either expand the Collateral Directive or add substantive provisions on netting or to draft a separate instrument focusing on netting/set-off only.

ISDA has also made a proposal to UNIDROIT to develop an international convention on netting (applicable globally, but with a primary focus on emerging markets). The Commission considers the interrelation between the ISDA netting proposal to UNIDROIT and the EFMLG/ISDA proposal on the EU level as mutually beneficial. This is in line with ISDA's thinking also. Provided the two timetables get synchronised, having the EU take the lead on netting will be helpful to our cause.

Specific Comments

Principle 4 - Liquidity Pricing Mechanisms

In aligning prices with liquidity costs the industry cautions that the use of liquidity pricing models should not to be overly complex and burdensome. Although cost of liquidity can be calculated in theory the actual process of doing so rigorously would be highly time intensive in terms of research, modelling and analysis. A principles based approach should be applicable where cost for pricing mechanisms would be too excessive. What matters is that a firm recognises that an internal allocation of liquidity has a cost associated with it, not that the cost is calculated to the last basis point.

Principle 5 - Measurement and Management of Liquidity Risk

We believe that measurement and management or liquidity risk is most important in the short term for banks. 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.*

In para. 38 there is no reference made regarding to 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 data would be disproportionately costly to produce relative to the risk.

Also, Principle 5 should explicitly recognise the advantages of a diversified funding base.

<u>Principle 6 – Solo Entity and Group</u>

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 experts with systems allowing them to consider all legal entities and business units within the group. This supports an integrated, stronger risk management culture in the group as a whole, which we believe is the key to improving firms' liquidity management practices. An additional, separate analysis is not undertaken at the level of these individual legal entities with no material impact on the group's liquidity risk because this would offer no further insight. Any differentiation below group level predominantly considers business lines rather than individual entities or groups of and individual countries or currency areas. The requirement in para. 56 to "<u>*manage*</u>" risk at both solo and group level should therefore be amended to "<u>*manage risk at group level, taking into account any circumstances, including legal impediments that may impede liquidity flowing into/out of any individual entity as required*</u>." The key point is 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 unnecessary and unproductive work.

<u>Principle 8: Intraday Liquidity</u>

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.

Concerning intraday liquidity management in paragraph 78, we would like to confirm that the intent of the Basel Committee 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, depending on how a firm's circumstances changes.

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 wide variety of insufficiently well-founded stress tests might suggest a robustness which does not in fact exist. 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 as this would have an adverse effect on the bank's refinancing.

Further suggestion: In para. 101 the list should include the "firm's presence in markets".

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 funding plans with the industry. The role of central banks as lender of last resort should be recognised and incorporated in contingency planning by the firm when formulating its risk tolerance which will subsequently be discussed with the supervisor. There should be recognition that in more extreme stress scenarios there will be a close relationship between the central bank's role, actions and any liquidity provision and a firm's own internal liquidity risk management decision-making processes. Additionally, the status and operation of standing facilities should be clarified, communicated and explained as regular funding measures to the media and general public to avoid the negative stigma that can be attached to central bank borrowing.

Regarding para. 113: Although we agree with designating clear roles in decision making related to liquidity disruptions, and identifying a range of alternatives through the liquidity planning process, we disagree with any suggestions that there can be prescriptive actions designated ahead of a crisis. A response will need to be tailor made based on the facts and circumstances existing at the time of a disruption.

Regarding para. 115: These items are really more appropriate for the discussion of stress testing, rather than for a discussion of a CFP.

Principle 12 - Liquidity Cushion and Definition of Liquid Assets

This principle raises the question of how much of a liquidity cushion shall 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.

Also in the context of what defines liquid assets the only relevant criterion is the liquidity raising capacity of an asset, not its accounting treatment or whether it is held in the banking or trading book. Firms are currently reviewing their assumptions of what constitutes a 'liquid asset', with many agreeing that in extremes the only assets that can be considered consistently liquid now are those that are eligible at central banks. Central banks should assist in the definition of what constitutes a liquid asset and we of course favour a wider rather than narrower definition which is broadly harmonised amongst major central banks.

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. Firms wholly encourage the public disclosure of qualitative liquidity indicators and information. We caution however that quantitative data can be particularly vulnerable to misinterpretation and misunderstanding and it is important to avoid adverse outcomes – such as exacerbating a liquidity squeeze. We therefore caution against publicly disclosing too much quantitative liquidity information prematurely but encourage the public disclosure of qualitative liquidity indicators, with no more quantitative information than is already required under IFRS 7. Some of our members have augmented the liability disclosure required by IFRS by providing asset data as well, thus creating a maturity ladder which is a very sensible approach.

It is again well worth noting that each firm's liquidity risk is managed differently based on its business model and that disclosures are not likely to be truly comparable between firms. The CEBS document acknowledges the limitations of quantitative disclosures and the misleading comparisons that may result. CEBS recommends that nature, depth, and frequency of the information disclosed should be appropriate for different stakeholders (liquidity providers, counterparties, investors, rating agencies and the market in general). We believe that this should be adopted by BCBS.

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 - we encourage central bankers to work together with industry to undertake desktop testing, working with supervisors where appropriate in a college type environment.

Supervisors should consider such factors as asset size, business model and liquidity stress levels as well as the options and resources available when assessing each bank's liquidity risk management. Furthermore, it needs to take into account the role of supervisors and central banks. 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 and that there needs to be flexibility in these definitions as risk tolerances will evolve in 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 seems to indicate that regulators will wish to access both regulatory and the bank's own internal reporting systems. 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). We hope that supervisors working together in a college type environment will cooperate with the bank to identify mutually acceptable and relevant liquidity reports which would then be communicated by the home state regulator to the appropriate host regulators. We believe that regulatory emphasis should be on obtaining and evaluating information derived from a firm's internal reporting framework.

Principle 16 - Relationship between Regulatory Capital and Liquidity

The reference in para. 140 to higher capital requirements as a remedial tool contradicts our belief 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. Likewise the capital position of the firm may help the liquidity position through the confidence of knowing that there is a strong financial position – including for example, the maintenance of strong ratings. 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.

A more suitable mitigant to poor liquidity risk management practices identified by supervisors is the requirement that a firm improves its systems and controls. Any supervisory decision to impose higher capital requirements should only be a measure of last resort.

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

Differences between home and host regulators typically create unwelcome obstacles for cross-border liquidity management within financial groups. All supervisors currently have responsibilities in respect of an entity incorporated in their jurisdiction, even though that entity may be a subsidiary of the global parent. A supervisor will also have responsibility in respect of liquidity supervision of a branch of an overseas parent. These legal responsibilities cannot be put to one side. However, supervisors understand and broadly encourage cross-border groups to manage their liquidity centrally at the head office in the "ultimate" home country. Therefore, although global supervisors must work within their legal constraints, we support to the greatest extent possible, the cooperation between home and host regulators (of branches and of subsidiaries) to achieve the effect of group liquidity supervision by the home state regulator of the parent entity in the group. This would have the additional benefit of not only reflecting the way firms operate but also encourage greater consistency and convergence of approaches between supervisors in their oversight of a firm's liquidity risk management.

We also believe that the development of a framework for colleges of supervisors will further assist in this role. The delegation of tasks within an international college of regulators (one not confined purely to the EU) may or may not be possible within the acknowledged legal constraints, but the effect of group supervision is an important objective to be aimed at and one that will support the strong management of liquidity risk within the group, yielding benefits to the local supervisors and jurisdictions as well as to the financial group in question.

In this framework we recommend that the principle should be that subsidiaries and branches should be exempted from detailed local supervision by host countries when parent firms are supervised by a home supervisor with equivalent standards (and liquidity management information of the group is communicated from the home to the host supervisor).

Suggestion: In para. 144 we recommend "rating agency action" be added to the list.

Conclusions

We welcome the BCBS proposals on liquidity risk management and supervision and encourage 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 maintaining as far as is possible a harmonised approach. Furthermore, we urge policy makers to 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 firm 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 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 a principle based approach and also by playing an active role in our members' contingency planning.

While we recognise the concerns of individual countries who wish to maintain control of liquidity supervision to protect local 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 firms 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.

July 2008