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Joint Industry Trade Associations' Response to the CEBS Consultation Paper: "Technical Advice to the European Commission on Liquidity Risk Management"

Introduction

We support the work that is being undertaken by CEBS, through its June 2008 draft paper "*Technical Advice to the European Commission on Liquidity Risk Management*" which sets common standards for liquidity risk management and how they should be applied in Europe 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 the authorities, 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 colleges of supervisors in Europe and beyond. The harmonisation of these standards across national boundaries should be a primary objective for supervisors, to reduce regulatory complexity and simplify the risk management processes of firms across multiple legal entities and jurisdictions. Thus we would suggest that recommendation 29 be expanded to encourage consistency and harmonisation 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 recommendations will more closely reflect the way in which internationally active firms already manage their liquidity – based on a holistic, group wide approach.

A consistent liquidity supervision regime, within an international framework to coordinate supervisory requirements and actions, will reduce both regulatory duplication and the possibility of trapped pockets of liquidity in cross-border funding. We strongly support 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 firms. Therefore in general terms we support the paper's emphasis on:

- Central focus on financial groups at the consolidated and entity level
- Sound governance and endorsement by senior management
- Appropriate risk tolerance levels and alignment of risk taking incentives
- Strategy and systems for liquidity measurement and management
- Robust 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 of relevant branches and/or subsidiaries to host supervisors. This will minimise the possibility of 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

The international financial industry fully recognises the need for the regulation and supervision of liquidity. The principal concerns held by the industry are the heterogeneity of regulatory approaches across borders and overly prescriptive liquidity regimes. A concerted approach by regulators to establish a supervisory framework is fundamental to efficient liquidity risk management and international capital markets. We therefore broadly agree with the CEBS's recommendations to the European Commission but would like to provide the following comments:

General Comments

Principle Based Approach and Proportionality

We welcome the general concept of proportionality, as set out in the provisions on Supervisory Review Process provisions of the Capital Requirements Directive (CRD, Directive 2006/48/EC) and highlighted in the introductory statements of CEBS's Guidelines on the Supervisory Review Process. However, we encourage further convergence with the concurrent proposals of the Basel Committee on Banking Supervisions' (BCBS) revised "*Principle for Sound Liquidity Risk Management and Supervision*". In order to achieve international consistency of liquidity standards we recommend that careful examination is given to the possibility of common principles and common language. We appreciate the fact that the CEBS principles may be incorporated into CRD text and if this is the case then it is

vital that care is taken by the legislators to ensure that the outcomes intended in the wording of the guidelines can be achieved. It is also vital that any wording used continues to encourage dialogue between firms and supervisors.

Internal Methodology

We support CEBS's view on the eligibility of internal methodologies subject to supervisory approval on a case by case basis as potential substitutes for standardised quantitative requirements. We strongly agree with the assessment in paragraph 20 of the introductory remarks and Recommendation 25 that supervisors should assess the internal methodologies of firms. For complex financial institutions, we believe that regulatory emphasis should be on obtaining and evaluating information derived from a firm's internal reporting framework. We would therefore encourage CEBS to more strongly recommend that supervisors rely on internal methodologies in their evaluation of the liquidity risk of institutions, subject to regulatory assessment. Firms' liquidity needs and strategies vary widely for good business reasons. Using a standard approach is contrary to the fact that firms manage their liquidity differently based on their business models and risk tolerances. Any standard measures are not likely to be truly comparable between firms and could potentially be misleading. For example, this could be re-emphasised again in paragraph 220 and 221.

Cooperation between the industry and supervisors

We agree with the recent IIF discussions related to the need to balance constructive clarity with constructive ambiguity as it relates to central bank actions in a crisis.

One of the tensions that exists, but is not expressly discussed in the paper, relates to the balance between the central bank's role in supporting markets and the firm's responsibility to meet its obligations and to support the system.

An example in the draft paper is whether central bank eligible assets can be included in the "liquidity buffer." Paragraph 1 suggests that assets that can be converted to cash in the markets or via central bank are examples of the most common sources of liquidity.

We applaud the additional clarity provided by paragraph 21 in determining that assets can be considered liquid if central bank facilities are made available in business-as-usual and there are no concerns related to "stigma" of the use of the facility.

Related to paragraph 58, we understand the need for central bank's to maintain a certain level of discretion concerning liquidity support and the risks related to moral hazard. However, we believe that central banks can provide greater transparency related to the process and the conditions under which they will support markets and firms in unusual circumstances (As noted in the 2007 IIF paper, this could include "types of collateral, haircuts, limits for asset classes and the delivery form for such assets" as well as information requirements that would be imposed on firms).

Timing of Implementation

The joint industry associations welcome the timely introduction of CEBS's recommendations to the European Commission, but we advocate that the implementation of these standards, whether via Level 3 guidance or through inclusion in the CRD framework should be timed to ensure a smooth interaction with Member State initiatives to revise local liquidity standards. In order to avoid a 'regulatory overload' for national supervisors and firms we suggest that CEBS and the European Commission sufficiently consult and coordinate with relevant member states to establish meaningful and achievable implementation dates and to guarantee a smooth transition between national and European wide liquidity regimes.

Concentration and Large Exposure Limits

Although not directly related to liquidity standards per se, there is concern about the Commission's proposals to amend the current large exposure limits in the CRD for intra-group and inter-bank funding. If such limits are imposed and/or reduced there is a risk that these changes will create serious obstacles for liquidity funding which will effectively mean that concentration and counterparty risks will be replaced by increased liquidity risk. We urge CEBS to ensure that it takes an integrated approach to its advice to the Commission, so as to avoid such potential unintended consequences.

Specific Comments

Nature and Definitions of Liquidity and Liquidity Risk

Para 20 - We believe that operational constraints and haircuts are also important determinants of the liquidity value of an asset.

Para 37 - We agree with the assertion in paragraph 37 that "some" institutions were forced to defer securitisations. However, we would encourage CEBS to distinguish between firms with broad and diversified presence in these markets and those that are only infrequent users. Although expensive, our members were able to undertake incremental securitisation in some markets to raise additional funds.

Liquidity Risk Environment

In "point of interest / lesson 5" on page 20, we would encourage a more balanced approach to this issue. Although we agree that there are risks in placing too much reliance on any single funding source, securitisations have been an important component of diversified funding models and have had positive public policy applications.

We agree with the general principles in paragraph 45 and in "point of interest / lesson 7". To limit the risks from cross-border liquidity issues, CEBS should recommend the elimination of barriers to the free flow of funds across borders and the harmonisation of regulatory regimes. As we also noted in the BCBS paper, at every turn regulators should encourage, rather than restrict, the ability of firms to borrow from entities that have excess liquidity and

for firms to be able to borrow freely on an intra-bank basis. In general, we believe that the reduction of barriers to the transfer of liquidity enhances the liquidity risk management of firms and would reduce risk to the financial system.

As a point of reference, paragraph 46 should include the general topic of reliance on wholesale funding and that the disintermediation of deposits have created more of a concentration in that many of these funds may come back to the banking system from money funds in other forms (CP, ABCP, etc.). Similarly, “point of interest / lesson 8” should also address the need to analyse the behaviour of corporate counterparties, particularly those that have broad relationships with the firms’.

Recommendation 1 - Internal Governance

In para. 81 it is stated that liquidity management should remain a cost source implying that liquidity risk management should not be a profit centre. We believe that this paragraph, and all other mandates to make liquidity risk management functions non-profit centres in this paper, should be omitted. We fundamentally object to such mandates as they violate free market principles by prohibiting firms to choose their own business model.

Recommendation 2 - Liquidity Pricing Mechanisms

In aligning prices with liquidity costs the industry cautions the use of liquidity pricing models not to be 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. In line with the principle based approach, alternative transfer mechanisms should be used where the cost for pricing mechanisms would be too excessive.

Recommendation 3 – Organisational Structure and Segregation of Duties

We believe that Recommendation 3 on “organisational structure and” “segregation of duties” is superfluous and should be deleted as it is a self evident component of sound governance principles. We find that the current wording is too prescriptive and would allow supervisors to enforce unnecessary requirements on firms’ governance structure and management decisions which should be solely the responsibility of the firm.

Suggestion: We therefore suggest the following addition to Recommendation 1:

*The Board of Directors should define a liquidity risk strategy and set management policies that are suited to the institution’s level of liquidity risk, its role in the financial system, its current and prospective activities, and its level of risk tolerance. The Board should have a clear view of the risks implied by its degree of reliance on maturity transformation, and should ensure that an adequate level of long-term funding is in place. Its strategy and policies should consider both normal and stressed times and should be reviewed regularly, including (at a minimum) when there are material changes. Senior management should define adequate processes **and organisational structure** to implement these strategies and policies.*

The former Recommendation 3 could be inserted in between para. 69 and 71 to serve as further clarification to Recommendation 1.

Recommendation 6 - Definition of Liquid Assets

The only relevant criterion is the liquidity raising capacity of an asset. Firms are currently reviewing their assumptions of what constitutes a 'liquid asset', with many agreeing that 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.

Recommendation 7 – Collateral

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 regards to the collateral management process are currently being discussed by 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 twelve months (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.

We note 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 so 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. Collateralised 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.

Recommendation 9 - 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 harmonise the *acquis communautaire* regarding 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 definitions 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. The EFMLG/ISDA proposal is currently with DG Markt at the Commission.

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.

Recommendation 11 - Intraday Liquidity

We agree that managing intraday liquidity is an important task and challenge for firms. We do not however accept that it would be feasible to manage intraday liquidity on a gross basis as suggested in Recommendation 11 and we wish to confirm our understanding that it is not CEBS' intention to suggest this.

Further, a convergence of national intraday liquidity standards beyond the European Union and European Economic Area is highly desirable as short-term liquidity risk poses the largest threat to the international financial system. Therefore, with regard to Recommendation 11 we suggest that CEBS adapt similar wording as in Principle 8 of BCBS's "*Principles for Sound Liquidity Risk Management and Supervision.*" This would help eliminate the potential for divergent policy interpretations in this area.

Suggestion: (Principle 11) “Regardless of whether institutions uses net or gross payment and settlement systems, they should manage intraday liquidity on a gross basis, due to the time necessary to have cash available and collateral posted.”

We propose that the strikedthrough text be replaced with the following wording:

“...it should actively manage its intraday liquidity positions and risks, including the risk arising from its membership of payment and settlement systems, to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.”

Also, para. 128 is particularly unclear and we believe should be replaced or modified with the following clarification:

Intraday exposures are supported by collateral placed into settlement systems and controlled by close monitoring of payments through the settlement systems. The amount of collateral required is based on exposure to the flows of a group of counterparties allowing for the off-setting nature of the portfolio effect and the market best practices (e.g. in the UK 50% of the values need to be processed by noon and 75% by 2.30pm). Whilst this can increase and decrease during the day, a bank should utilise experience of the normal flows, the communication processes with relationship managers and clients to forecast large intra payment needs (i.e. have processes in place to manage peaks), and have controls to ensure the exposure to any one counterparty does not exceed intraday limit for that counterparty. The latter ensures that, if one counterparty were to become insolvent intraday, the contagion impact is restricted to the agreed intraday credit limit and not the totality of all payments processed on behalf of that counterparty during the day.

It is clear that a bank will have a minimum need for collateral to support its settlement activity and that this should be seen as separate from any liquidity buffer held against stress events. However, banks may choose to put more collateral into the payments systems than the minimum it needs to support the systems to enable fast processing of larger payments particularly where market conditions are running normally. There is a danger of forcing banks to treat all collateral in payment systems as ring-fenced i.e. the minimum it needs plus discretionary amounts. If this happens banks may look to minimise collateral in settlement systems and this could slow down the settlement process. This risk could be further exacerbated if banks look to recover the cost of intraday liquidity through charging those counterparties who are, for example, time sensitive.

Recommendation 13 - Internal Methodology

Related to paragraph 133 (and again with paragraph 211), we disagree with any explicit linkage between capital and liquidity. The paper needs to emphasise that capital levels should not be correlated with liquidity risk. Although the capital position of the firm may help

the liquidity position through the confidence of knowing that there is a strong financial position, capital itself is not a substitute for adequate liquidity. Reviewing the ability to finance illiquid assets through a combination of long-term liabilities and capital may be one metric that firms employ in evaluating their overall liquidity position. Paragraph 211 does a good job explaining this, but we believe that it should be emphasised further. This is also explicitly recognised (and somewhat contradictory with) paragraph 225 that notes “the existence of a reasonably robust capital base and high capital ratios should not lead supervisors to minimise their assessment of liquidity risk.

We agree with the assertion in paragraph 134 that there is not really a best practice model related to the identification, measurement, monitoring and mitigation of liquidity risk. These practices need to be tailored to the firm’s specific business model, risk tolerance and presence in the markets. This is one of the key arguments for adopting an approach that relies on firm specific models in the supervision of liquidity risk management.

Recommendation 15 - Testing of CFPs and Role of Central Banks

There is concern that requirements to have CFPs tested in 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 and testing of 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, the status and operation of standing facilities should be clarified and communicated to the media and general public as regular and routine operational funding measures, in order to avoid the negative stigma associated with central bank borrowing.

As recognised in paragraph 174, there is no single set of predetermined actions that can be prescribed for a liquidity event. Rather, the actions taken will reflect the facts and circumstances at the time. The purpose of a CFP is to provide management with a series of alternative actions depending on the timing, nature and extent of a liquidity event. This contrasts with the BCBS paper in Paragraph 113 that implies that there can be prescriptive actions designated ahead of a crisis.

Recommendation 18 - 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. However, disclosure of quantitative data is more sensitive. We agree that it is appropriate that firms should actively consider what information might be useful and relevant. Quantitative data is particularly vulnerable to misinterpretation and misunderstanding and it is important to avoid adverse outcomes – such as exacerbating a liquidity squeeze. Each firm is managed differently based on its business model and disclosures are not likely to be truly comparable between firms. The joint trade associations’ response therefore endorses the caution expressed in

the CEBS drafting and suggests this be reflected in the recommendation itself by adding that firms themselves should consider carefully what data can be meaningfully disclosed in a manner that will not exacerbate problems.

Recommendation 28 - Duplication of Reporting

References to the use of standardised supervisory reporting frameworks seem to indicate that regulators will be able to access both standardised and internal reporting data. This would again open the burden of dual reporting (to the extent that one regulator's reporting requirements differs 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.

Recommendation 29 - College of Supervisors, Home Country Supervision and Cross Border Cooperation

Differences between home and host regulators typically create significant obstacles for cross-border liquidity management within financial groups. Under current EU legislation, responsibility for the supervision of branch and subsidiary liquidity rests with the host supervisor as liquidity is the last non-harmonised aspect of prudential regulation. Nevertheless, as supervisors understand most cross border groups manage their liquidity centrally at the head office in the home country. Although EU supervisors must work within their legal constraints, we support to the greatest extent possible, the cooperation between home and host regulators to achieve the effect of group liquidity supervision by the home state regulator of the parent entity in the group. This would have the benefit of encouraging greater consistency and convergence in the supervision of liquidity risk management. We also believe that the development of a framework for colleges of supervisors based on the consolidated EU group will further assist in this role and where possible achieve the delegation of tasks for the supervision of cross-border financial groups.

In this framework we recommend that the principle should be that branches and subsidiaries can 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 between home and host supervisors.

Conclusions

We welcome the CEBS proposals on liquidity risk management and supervision, and encourage its implementation in Europe. It is essential in this process that a thorough industry consultation is performed 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, it is encouraged that EU policy makers coordinate with other international policy makers 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 member and non-member states' regulators should especially focus on eliminating diverse supervision practices and regulatory constraints that can hinder intragroup funding and result in potential trapped pockets of liquidity.

In terms of the proposed CEBS's recommendations for liquidity risk management in financial firms, we are confident that these already reflect current best practices amongst our largest members. We therefore encourage national regulators and central banks to support these practices and supplement them with a principle based approach and also by playing an active role in contingency planning.

While we recognise the concerns of individual countries to maintain control of liquidity supervision to protect 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, including large exposure limits, 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.

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