Ms Aimee Staude  
Committee of European Banking Supervisors  
Tower 42 (level 18)  
25 Old Broad Street  
London EC2N 1HQ  

Dear Ms Staude,

Sent by e-mail to liquidity@c-ebs.org

Response to CEBS CP 28:  
Liquidity Buffers and Survival Periods

The industry welcomes this opportunity to comment on the proposed CEBS Guidelines for “Liquidity Buffers and Survival Periods” as outlined in its Consultation Paper (CP) 28. Our members, including members of the Association of Foreign Banks, recognise the CEBS paper as a first step towards creating an international harmonised approach to liquidity standards which is of paramount importance to us. Also we welcome and fully endorse the application of the principle of proportionality.

We believe that international consistency is essential to facilitating cross-border liquidity management as well as supporting a level playing field. Thus, we encourage and support CEBS in its efforts to work closely with the global standard setters.

We are conscious that the Basel Committee will release proposals for a new minimum global liquidity standard by the end of the year. We support such top down approaches to policy making as this facilitates efficient cross-border supervision for globally active firms. Therefore, we urge CEBS to direct its work as far as possible to be consistent with the global agreements endorsed by the G20 so that regional inconsistencies can be avoided.

As some national jurisdictions are already designing their own liquidity regimes, cross-border groups face a growing number of local liquidity buffer and self sufficiency requirements. The CEBS paper is therefore an important contribution to the achievement of greater consistency in the interpretation of liquidity buffers. This is welcome but we still urge the need for an international liquidity framework to eliminate barriers to efficient liquidity allocation and to enhance global supervision and management of liquidity. We see the CEBS paper in this light as an influencing tool in the international debate. Should the international debate coalesce around a different solution to that proposed in this CEBS paper, then it should be amended accordingly.
In practical terms we note that the disparate range of liquidity reports that internationally active firms supply to the home and host regulators are a significant obstacle in efficient cross-border liquidity management and result in an unnecessary multiplication of effort for our members. A fully harmonised reporting “lexicon” and format are vital for any mutual recognition amongst regulators that we hope will lead to a more efficient treatment of cross-border firms and promote the delegation of the liquidity supervision task to the home state regulator.

Further high level observations

Term of funding

One dimension of liquidity management that we think could fruitfully be discussed in the context of liquidity buffers is that of the term of funding. As a basic premise longer term funding should be preferred with the minimum tenor to cover the survival period in question. There are concerns, however, that with all firms seeking longer-term liabilities there will be insufficient providers of these funds, which is explored further in the response to Question 3(d).

The CP suggests that firms should draw up a mismatch ladder on both a normal and stressed basis looking at the mismatch gap as a measure of the liquidity risk being run. In drawing up that ladder the marketability of assets (via sale or repo) has traditionally been recognised by allowing the inflow from certain "marketable" assets to be included at dates prior to their final maturity. In so doing firms and regulators have applied haircuts to the Market-to-Market (MTM) value of the assets to reflect a) their forced sale risk and b) the price volatility of the asset over the horizon being considered.

Assets deemed to be in the liquidity buffer are specifically excluded from the mismatch ladder and, instead, their marketable value (via sale or repo) are compared with the size of the resulting mismatch gap. To be prudent a firm is expected to have sufficient value in the liquidity buffer to cover any net outflow in the mismatch gap over the horizon period. Two points emerge from this:

1. The length of the horizon for which the liquidity buffer is required means that those assets must be funded at least for the term of the horizon period. It may be argued that the term of the funding is implicit within the ladder as short-term funding to cover the outflow within the ladder. However, there is also a need to take a more holistic view of the overall balance sheet structure. For example, if the funding is for one month and one day, then the position at one month will be strong on the first day, but will then fall on the second day as the funding comes in to maturity. It is therefore necessary to look at the longer term profile of the book, suggesting that the buffer needs to be considered not in the context of a single cut-off date, but over an extended series of dates. For some firms this may be accommodated by identifying specific and appropriately structured funding attributable to the buffer; for others this may be accommodated within the overall balance sheet structure.

2. It should also be borne in mind that not all liquidity structures give rise to the need to hold a buffer. For example, if a firm placed funds in an accessible reserve account with a central bank, and funds it with a longer-term guaranteed deposit from its parent such that their cashflow for the first 30 days remains positive with no net outflows of cash, then the firm’s liquidity reports would not show any cash shortfall needing to be secured with a liquidity buffer. In this case we suggest that there be no additional requirement to hold a pool of liquid assets.
Indeed, there is likely to be a significant shift in the market as new liquid assets are purchased, and ineligible assets sold to adjust to CEBS’s proposed regime. Possibly assets that are not eligible for the buffer would be less acceptable in bilateral repo in the wholesale market and the consequential effects of such a shift would need to be worked through.

Central Bank eligibility and marketability

With regard to central bank eligibility we seek further clarification of what is considered a normal circumstance, and what are the criteria for marketability.

Equities

One issue that arose in the preparation of the response to this CP was whether equities can be considered as eligible assets as the equities market has remained highly liquid over the past two years. This matter was raised at the open hearing on 22 September and the understanding is that most authorities would be unlikely to agree to the inclusion of equities on the grounds that this asset class typically exhibits volatility and therefore does not demonstrate predictability of value which is a quality the supervisors are seeking to find in the buffer. However, we also understood that in the context of a supervisory dialogue supervisors might be willing to listen to arguments for the inclusion of equities, above a suitable quality threshold and with a suitable haircut. Similarly we would be keen to include commodities such as precious metals as a possibility to consider subject to appropriate haircuts. It would be helpful if the final guidelines clarified this understanding.

Proportionality

Proportionality as an overarching principle is much welcomed, so it is essential that there is an open dialogue with supervisors when examining the specific situation of each firm. In this context we suggest that CEBS highlight the parameters where firms and supervisors can vary liquidity requirements commensurate with the level of systemic risk. The following three principal areas where supervisors indicated (at the 22 September CEBS open hearing) that proportionality would be exercised were:

- Granularity of data
- Frequency of model calculation
- Sophistication of model

We believe that a reference to these three parameters would be a useful guide for the industry. With regard to the recent implementation of the BCBS “Principles for Sound Liquidity Risk Management and Supervision” in the UK, we note that funding diversification; liquidity risk pricing and contingency funding plans present areas of particular difficulty for smaller firms. In particular smaller banks were concerned about not having repo capabilities for government bonds. In the UK these concerns have been somewhat alleviated as the Bank of England will now allow smaller banks access to its reserve accounts, while the FSA have also agreed to permit the use of money market funds for liquidity purposes if they invest in government bonds – a move we very much welcome. This issue will no doubt reappear at the European level where small firms will need access to European repo markets in order to stay competitive.
Limits vs Trends

In the context of implementing policies based on liquid buffers, we believe that the focus should be on trends rather than on hard limits. Hard limits will freeze the use of liquid assets needed to meet the limits i.e. they cannot be sold as the sale would cause a breach of limit. Thus the very reason why the liquid assets are there - to be sold in stressed times - becomes self-defeating. We believe it would be better to allow the levels of liquid assets to move up and down and track this movement in the levels as an indicator of the degree of stress the firm is under. Furthermore no one metric can capture the whole risk. Instead a number of metrics and their trends should be used.

We thus maintain that liquidity buffers are there to be used in stressed times even if this means they may need to temporarily be run below the levels set by supervisors. We concede however that there needs to be an appropriate governance structure for the use of the buffer (and for its level to be considered in the light of other liquidity measures and metrics). If there is a crisis - which may be measured by the firm triggering certain liquidity or other metric levels - then the Contingency Funding Plan (CFP) will be activated internally and, if necessary, supervisors will be advised. Such plans will, of course, include the plan of the subsequent build up of the buffer after the regulatory buffer level has been breached.

There may be further merit in testing the liquidity buffer during normal times, from time to time, to demonstrate that the assets are indeed liquid, sufficient and their sale or repo does not trigger any reputational damage in the market. In this context supervisors should expect the buffer to fluctuate above and below the supervisory limits set, as firms go about demonstrating the liquidity of the buffer assets. We also note that in the absence of repo markets such activity will impose a significant cost on the industry in maintaining the buffer.

We attach two appendices. In Annex A, we respond to the questions raised in the CP. In Annex B we highlight other specific comments and offer drafting suggestions. We hope that you find these comments helpful in finalising the CEBS guidelines on Liquidity Buffers and Survival Periods. We would be happy to discuss our comments in further detail, so please do not hesitate to contact us if you have any questions.

Yours sincerely,

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Director, LIBA

Simon Hills
Executive Director, BBA

Edward Duncan
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Appendix A: Answers to CP Questions

1) If the composition of liquidity buffers was to be restricted to assets that are both highly liquid in private markets (including in stressed time) and central bank eligible:

1.1 Would you foresee any shortage of eligible assets, such as government bonds, or any increase in the concentration or cost of holding such assets? Any impact on less liquid assets?

It is not possible to offer meaningful speculation on the impacts and effects of the liquidity buffer in any but the most general terms as it would be necessary to base any estimate on firm specifics and ultimate buffer calibration. In general terms, we do perceive the potential for market distortion, although, we think it unlikely that there would be any shortage of government paper in the short to medium term, given the volumes of debt governments have been issuing and expect to issue in the medium term. At some point, beyond the mid term, there is a possibility that there would be a scarcity of supply as governments seek to reduce their debt burdens possibly even ahead of term. Clearly there is likely to be an increase in concentration risk, especially with cheapest-to-deliver incentives, and opportunity cost in terms of yield. If non-government assets cannot be included in liquidity buffers or in CFP this will significantly remove the incentive to hold these assets. Thus, liquid assets will dramatically increase in value while non-liquid assets will deteriorate in price. The reduced attractiveness of non-liquid assets will reduce the opportunities for firms to raise longer-term liabilities. This also emphasises the possible tension between the regulatory regime for liquidity and the setting of monetary, fiscal and economic policy by central banks and governments.

Once specific details are known, however, it remains the case that costs will vary considerably from firm to firm, depending on firms’ ability to raise term funding, and at what price. The extra demand to fund the liquidity reserve will compete with the ongoing need to raise term funding to cover illiquid assets, and thus could considerably restrict a firm’s ability to lend to the economy. The benefits of less risky balance sheets need to be balanced against the cost of paying for them for both banks and the economy as a whole, especially if the restrictions are established in already stressed conditions.

While we see government bonds as essential components of liquid asset buffers, we encourage regulators to recognise a wider range of assets, e.g. G20 government bonds, supranational paper and highly rated firm paper with appropriate hair cuts. This will ensure the buffer operates across different liquidity scenarios and avoids concentrations in government instruments. Indeed by limiting the assets that can be contained in the liquid assets buffer as proposed there is a risk that there is an excess exposure to government debt. In this respect it is also prudent for firms to diversify their portfolio of government bonds to avoid concentration risk.

An additional point that may be worth making here is that the more restricted the list of eligible issuers is for the buffer, the more systemic risk will be magnified if one of these issuers should be removed from the list due to its deteriorating credit quality. Or put another way, for issuers that qualify at the outset, what will be the process to disqualify them if their credit quality deteriorates? How many notches before they are disqualified? How much time will be allowed before they are disqualified to avoid a rapid forced sale of their bonds? The question is particularly important at a time where there is increased risk of sovereign credit rating downgrades.
1.2 Would you expect any potential pressure points due to possible inconsistencies in the definition of the liquidity value of eligible collateral and the liquidity value of assets/collateral taking into account in the computation of the net cash outflow?

As we tried to express at the CEBS hearing, this question cannot be answered without further clarification.

1.3 What conditions, if any, should be fulfilled in your view before a narrow definition could be applied, without undue side effects? (for example: availability of collateral, transition arrangements including its length, etc)

Depending on the intensity and duration of a crisis it is apparent that in some circumstances only government securities, central bank deposits and cash are likely to fulfil the definition required to count as core liquidity. Thus, we encourage the requirement of government securities and cash as a core liquidity buffer complimented by a second buffer of other assets subject to appropriate haircuts.

But the size and exact composition of any narrowly defined buffer should be determined and continuously reviewed based on macroeconomic considerations. Supervisors need to closely monitor the demand and supply of government bonds and ensure that their policy does not unduly restrict economic growth. While currently sufficient government bonds are available for a narrow definition of a liquidity buffer, there are long term concerns should governments recover their debts and thus restrict the availability of government paper.

As stated above we encourage a wider range of assets, e.g. G20 government, bonds, supranational paper and highly rated firm paper with appropriate haircuts. Further there needs to also be an emphasis on diversification so that firms do not look for the cheapest liquid asset for funding and concentrate their risk on certain government bonds. This will ensure the buffer operates across different liquidity scenarios and avoids concentrations in government instruments and also does not risk creating incentives for the behavioural patterns that might intensify a liquidity squeeze.

But over a longer survival period a wider pool of marketable assets would become saleable. We think firms themselves are best placed for this assessment subject to supervisory approval. Other assets then should include:

- Central bank eligible collateral accepted in firms’ business-as-usual open market operations
- A wider spectrum of assets, with an appropriate haircut, to avoid concentration and flexibility across different liquidity scenarios
- Unencumbered cash held by banks
- Central Bank reserve accounts
- Same-day-access money market funds
- Call accounts with highly rated financial institutions

The key to this approach is the setting of realistic haircuts and a sufficient level of diversification in marketable assets.
2) Would you consider that a too narrow definition of assets eligible to the buffers could entail a possible sub-optimal allocation of means from a macro-economic perspective? Would you see a risk of wrong incentives? Please specify, if observations/expectations refer to particular markets.

This does depend on what the required percentage is and how narrow the definition is, but ultimately if 10% of assets are held in high quality government paper that is likely to seriously reduce banks’ profitability and their capacity to lend. It should be stressed given the multiplier effect that any reduction in availability of liquid assets will manifest itself in considerably reduced lending.

We recognise that there is a risk of overloading the buffer with instruments that may not be suited across different liquidity scenarios. Also, there is the concentration risk to be considered for which there may also be a macroeconomic impact if these are government bonds. Thus, we believe there needs to be an appropriate level of diversified highly liquid assets to limit an excess exposure to government debt, as we indicated above.

3) How would you assess the reference to central bank eligibility for the purpose of specifying which assets should be eligible to the liquidity buffers?

Members indicated that this is a useful indicator along with the marketability of an asset. There also needs to be awareness of how broad the range of central bank eligibility is for any central bank and the incentives it provides to banks, e.g. to hold the highest yielding CB eligible bonds.

a. How does the return on liquid assets compare to the return on less liquid assets? Do you anticipate a (significant) impact on ROE?

We note that the answer will vary over time and be firm specific depending on the final calibration of the liquidity buffer. To give one example historic swap spreads (which were indicative of government vs. bank levels) over 5 years (2 year tenor USD and GBP) are 40basis points (bp). At the moment issuing longer term debt would generally be significantly above the swap rate, e.g. 100bp above 5 year swap rates for a AA rated bank. This would lead to a 140bp drop in yield for the amount of marketable securities that are switched out of bank debt into US / UK governments.

Further, a member’s equity research report on European Banks suggests that:

...in broad terms we expect holdings of cash and Government bonds to rise relatively sharply from here. For illustrative purposes only, every additional 5% holding of cash and Government bonds represents around €1trn of incremental liquid assets and if we assume an average negative carry of 50–100bps we estimate this would reduce the sector’s net interest income by around €5–10bn or 2–5% of pre-provision profits.

Combined with the impact of extending wholesale duration, we believe these secular issues could reduce pre-provision profits by 20–25% over time, everything else equal. Consequently, we believe net interest margin could be reduced by up to 40bps.1

Note that the cost to smaller firms, which have a higher cost of funding, will be higher than any median estimate that arises out of this consultation.

1 Credit Suisse Europe, Equity Research - Regional Banks (Banks) / Market Weight, “European Banks,” 11 June 2009, P. 9-10.
There is further work being undertaken by various firms and consultants. But a conclusive answer to this question will very much depend on the cumulative effects of the liquidity buffer calibration and further capital requirements.

b. Do you believe that CEBS’s proposals could lead you to restrict your lending capacity or increase the cost of financing for borrowers?

In trying to analyse what effect there will be on lending, further definitions of liquid assets and their quantification over e.g. total assets will be needed. The answer will lie in the eventual stringency of the requirements, but it is clear that there will be increases in the cost of banking and that these costs will no doubt be passed on to customers.

The impact will vary considerably from firm to firm, depending on their existing liquidity strategy. Firms that have a conservative strategy may not see any change in their portfolio of liquid assets or their business models. Firms with greater liquidity risk appetite will see more significant cost and business model changes.

c. Do you foresee any impact of these proposals on your business models or activities? Do they present any level playing field issues with competitors other than credit institutions?

Please refer to the answer above under point b.

There is a risk that inconsistency in approaches between jurisdictions will lead to unfortunate distortions and effects both with respect to the soundness of liquidity risk management which may suffer from a degree of fragmentation, or from competitive effects. Although regulators will clearly be guided first and foremost by prudential concerns, the level playing field within the banking market and with non-bank players is an important consideration.

Again it needs to be borne in mind, that the proposed changes are additional to CRD modifications that have already been enacted or proposed by the Commission and that will significantly increase capital charges - such as the 5% retention clause on securitisation, increased risk, increased charges for market risk exposures, potential leverage constraints, forthcoming new (stricter) definition of the concept of “Own Funds”, etc.

Thus, there is a need for some form of high level coordination to ensure that the cumulative impact of all these measures be proportionate to the risks involved and that their aggregate impact and effect on the European economy be carefully assessed and fully understood.

d. Do you consider that these Guidelines can help to restore confidence in the interbank market? To improve funding costs?

The guidelines are likely to reduce the risk of bank failure, but will also reduce the flows in the interbank market as banks themselves will have little or no incentive to invest in such bonds and banks will have to offer higher yields. In essence bank paper will fall outside the liquidity buffer so the yield offered by it will have to increase, thus adding to bank funding costs. The re-allocation of assets to (lower-yielding) government bonds will

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2 For example, see: Accenture, Banking 2012 Operational Excellence Research: “Time for bold moves” and “Operating Models for the New Normal.”
reduce the volume of risk-weighted lending, thus reducing overall return-on-capital as well as contributing to a lower leverage ratio at corporate and retail level.

On a final note, liquidity buffers are merely one of many new tools that are likely to be applied to banks within the relatively near term future. As with the possible macro prudential tools (whether counter cyclical capital buffers, dynamic provisioning, or leverage ratio), the revised definitions of capital, raised tier 1 ratios, and the direct increases to Pillar 1 risk weighted capital charges, the liquid asset buffers will have implications for firms’ capital planning and their need to raise capital funding. A comprehensive assessment of the cumulative effect and the interaction between these many important possible regulatory measures is essential.
Appendix B: Specific Drafting Comments

Paragraph 13

Here as indicated in our key messages we urge CEBS to expand on the implications for small, medium and large firms in terms of the principle of proportionality. It is essential that there is an open dialogue with supervisors when examining the specific situation of each firm. In this context we suggest that CEBS highlight the parameters where firms and supervisors can vary liquidity requirements commensurate with the level of systemic risk. The following three principle areas where proportionality can be exercised were mentioned in the 22 September open hearing at CEBS:

- Granularity of data
- Frequency of model calculation
- Sophistication of model

We believe that a reference to these three parameters would be a useful guide for the industry. With regard to the recent implementation of the BCBS “Principles for Sound Liquidity Risk Management and Supervision” in the UK, we note that funding diversification; liquidity risk pricing and contingency funding plans present areas of particular difficulty for smaller firms. In particular smaller banks were concerned about not having repo capabilities for government bonds. In the UK these concerns have been somewhat alleviated as the Bank of England will now allow smaller banks access to its reserve accounts, while the FSA have also agreed to permit the use of money market funds for liquidity purposes if they invest in government bonds – a move we very much welcome. This issue will no doubt reappear at the European level where small firms will need access to European repo markets in order to stay competitive.

Paragraph 25

The wording with regard to “most appropriate” and “most Conservative” does not appear tenable. We suggest removing “most conservative”, leaving “choose the type that is most appropriate in line with local regulations.”

Paragraph 26

This paragraph would technically disallow maturity mismatch if taken literally. CEBS describes “counterbalancing capacity under paragraph 30. The last sentence of paragraph 26 could be replaced by “the liquidity buffer and other liquid reserves and facilities booked at sight, or carried over....”

Or the paragraph could be amended to refer to the first maturity bucket only (or first few, with sufficient maturity to extend over the survivability period of one month). Longer buckets can have a net outflow, providing those within the survivability period have a net inflow.

Paragraph 34

Members support this paragraph but “systemically significant” is hard to define over time and across borders. We note that further work is currently being undertaken by G20 and the Financial Stability Board (FSB). Also, the FSA in its follow-up to the Turner Review have
published another Discussion Paper (DP) 09/4 and plan further work to address the issue of systemically important banks.³

**Paragraph 52**

We agree with CEBS excluding cash in ATMs, but note that there is no reference to excluding collateral for settlement requirements.

**Paragraph 59**

There is a danger in testing CFPs with central banks, perhaps this can be rephrased to involve central banks in the CFP testing process.

Also there should be a proportional approach for small firms as testing the markets is costly and resource intensive. As noted in our key messages above, smaller banks in the UK were concerned about not having repo capabilities for government bonds to test their CFP. Thus we urge that some allowances be made for smaller firms to test their CFPs without executing costly transactions.