

EBA's Discussion Paper on the methodology for the assessment of liquidity and funding risk under supervisory review (EBA/DP/2013/04)

Submission from the Banking Stakeholder Group

General comments

Risk management in financial institutions should follow generally accepted principles for Enterprise Risk Management (ERM) in corporations, reflecting the fact that financial institutions are subject to national and supranational regulatory frameworks that determine the overall targets and requirements for risk appetite.

The EBA Discussion Paper sets out (preliminary) common procedures and methodologies for the Supervisory Review and Evaluation Process around the risks that banks face in terms of liquidity and funding. The discussion paper should be considered by supervisors in respect of a bank's liquidity risk management as part of the SREP process.

The BSG welcomes this Discussion Paper that aims at the establishment of common procedures and methodologies as part of the single rulebook. The discussion paper is all the more important as this will be the first time that the European supervisory community considers this for liquidity and funding risks of credit institutions in a harmonised approach. In this process it is important to be specific on what the genuine risks and possible impacts of liquidity and funding shortfalls are for a financial institution, and how these could be effectively dealt with.

Furthermore, in the execution of its duties the BSG has enshrined in its mandate that particular regard must be given to the proportionality of regulation¹. It therefore welcomes the reference to the proportionality principle in paragraphs 14 and 34 of the Discussion Paper. The BSG also agrees that emphasis needs to be given in the supervisory process to the point made in paragraph 14 that "...not all the elements have the same relevance for all the institutions, and that it may be interpreted as applying with a lesser degree of granularity to non-systemically important institutions."

The resulting liquidity and funding risk guidelines, which are to be finalised - after further consultation - by end-2014, are in keeping with what would be expected in such a review and the requirements of the CRR. It is noteworthy that certain jurisdictions in the EU already have supervisory practices in place on these risks,

¹ As stated in the mandate of EBA under Article 107(3) of Directive No 2013/36/EU (CRD), BSG would give emphasis to the requirement for EBA's guidelines to be given "...in a manner that is appropriate to the size, the structure and the internal organisation of institutions and the nature, scope and complexity of their activities..."

and particular attention should be paid to the experience gained in those jurisdictions in the EBA single rulebook in terms of the operability and feasibility of the guidelines.

In some instances the Discussion Paper is not sufficiently clear, especially where new ratios (e.g. customer funding gap, loan/deposit ratio) are introduced. Their calculation and purpose would need a more detailed specification. In other instances it appears overly detailed for what in the end would amount to an informed judgment call as to the overall adequacy of the liquidity and risk management by each institution. It should be made clear which risk elements are to be dealt with through the financial institutions' own rules as part of their governance and internal working processes. BSG suggests that the regulatory element should be to oversee and ensure that such governance and processes are following the regulatory recommendations, and to assess the extent to which institutions live up to their own governance and procedures.

On a more general note, there is an increasing demand on data and reporting from supervised entities in multiple areas, which is starting to become difficult to process effectively and efficiently in a manner that would satisfy supervisors on all counts. The principle of proportionality – in terms of the frequency and intensity of the review having due regard to the size, systemic importance, nature, scale, and complexities of the activities - should be allowed to apply in this regard as much as possible.

Specific Observations

Supervisory evaluation of Liquidity Risk.

The development of supervisory liquidity stress testing is likely to result in an increased level of data requests from the supervisory authorities and this needs to be weighed against the value of such tests given the already increased reporting burden for institutions and the existence of banks' own internal liquidity stress testing. In addition, BSG stresses that the identification of 3-12 months as a stressed period (while a point for discussion between the institutions and the supervisory authority) should not automatically lead to an increased liquidity buffer requirement.

Supervisory activity in the field of liquidity and funding should therefore be more focused more on the existence and adherence to banks' internal governance and procedures, rather than on reporting requirements. The BSG wishes to underscore the need for a proper and full dialogue between bank and supervisor around the ILAAP as opposed to a hard reporting-based approach.

Lastly, the development of supervisory stresses to identify the "likelihood of falling below the minimum ratio" appears to be an unnecessary level of complication, as it would be expected that an institution's own stress tests would identify the level of buffer required to ensure compliance under stress or alternatively the stress that

would cause such a breach. The results of such stresses could be made available to the respective supervisors.

Some clarification is needed regarding the term “consistency” (page 11, indent 25): the definition of liquidity risk tolerance in the discussion paper implies already the use of a liquidity buffer / counterbalancing capacity. Under these circumstances it remains unclear how consistency should be reached. Or does “consistency” mean that liquidity risk tolerance must be always zero?

Intraday Liquidity Risk

This is a complex area exacerbated by the fact that, unlike many other aspects of liquidity, it is not entirely within the control of the reporting bank since there is a significant dependency on incoming funds from third parties. While reference is made to the Basel Committee Guidance of April 2013, it needs to be highlighted that there is a need for a thorough discussion within the EU on a harmonised approach for implementing the Basel Committee guidelines. It is considered highly desirable by the banking industry that payment systems use a similar reporting methodology to help banks to comply with regulatory intraday liquidity requirements.

Within the euro area, this could be achieved by use of the Eurosystem’s central reporting platform. The Eurosystem central banks have a centralised data warehouse in TARGET2 that has the potential to generate standard reports on, for example, payments, liquidity and intraday credit indicators.

The banking industry is in discussions with the European Central Bank, which is willing to explore the possibility of the use of the central reporting platform to facilitate compliance with the reporting requirements on intraday liquidity. To check the feasibility of the data delivery, it is necessary to provide the Eurosystem with a detailed set of data requirements.

However, given that the Basel Committee Guidance leaves considerable discretion to national supervisors (as well as room for interpretation) there is a need to commence a dialogue at the European level between all interested parties to ensure a coordinated approach. It should be avoided that given the absence of harmonisation at EU level, national supervisors would move in isolation causing multi-country banks operating on a global basis to face a set of diverging requirements and not being able to benefit from the infrastructure already in place at EU level.

The Discussion Paper remains silent on specific elements of intraday liquidity risk, such as delays in cash transfers or computer failures, which may represent an important risk to intraday liquidity management. Downtime, or the collapse of own or third party systems under the responsibility of local clearing houses, SWIFT or

correspondent banks may have serious detrimental effects on the intraday liquidity management of a financial institution.

Supervisory evaluation of Funding Profile.

The funding profile should be a reflection of the soundness of the balance sheet and earnings/cash flow, combined with governance and processes related to funding principles imposed and formalised (in writing) by the management of the institution. Again, the main supervisory focus must be on the existence of banks' internal governance and procedures, which are in line with supervisory recommendations.

While it sounds appropriate to require that long term funding be met via a well-diversified portfolio of funding instruments, it may also be important to evaluate the diversification across maturities. Supervisors may want to check that the redemption schedule of funding instruments follows a relatively smooth pattern, with no "cliff effects" associated with a large portion of funds being due within a short time span.

The terms "funding instruments", "funding markets" and "connected counterparties" should be specified in more detail.

Supervisory evaluation of Liquidity and Funding Risk Management

The reference to an Internal Liquidity Adequacy Assessment Process (ILAAP) in the Discussion Paper, raises the question as to whether all supervisors will require a formal document addressing this process to be prepared and submitted. Should this be the case, it would be useful if standard guidelines as to the format and content of such a document could be developed.

The development of guidelines on ILAAP should mirror the long established methodology and procedures for the Internal Capital Adequacy Assessment Process (ICAAP).

Alternatively, a compulsory section of the bank's ICAAP could be dedicated to liquidity risk and based on some pre-defined minimum content.

The predecessor of EBA (CEBS) and the EU supervisors engaged at length with the industry in the discussions that preceded the setup of the ICAAP guidelines. Drawing from that experience, it is worth noting that a common conclusion of banks and supervisors was that the ICAAP is, first and foremost, an internal process of every bank. Quoting from the CEBS Guidelines on the application of the supervisory review process under pillar 2:

- *Institutions should 'own', develop and manage their risk management processes; the ICAAP belongs to the institution and supervisors should not dictate how it is applied;*
- *The task of the supervisory authority is to review and evaluate the ICAAP and the soundness of the internal governance processes within which it is used.*

Likewise, it is to be encouraged that the ILAAP would be a bank internal process and, accordingly, BSG proposes that a 5-step process should be followed:

1. Understand (the bank's assessment);
2. Dialogue (between bank and supervisor);
3. Challenge (the bank's methods and assumptions);
4. Common ground (to be found);
5. Corrective measures (to be justified).

In other words, the process of assessing funding and liquidity risk is as much about monitoring and supervision of internal procedures as it is about formal regulatory requirements.

Measures which may be imposed

Financial institutions must themselves be the "owners" of their Enterprise Risk Management (ERM) functions; this is a prerequisite for establishing a prudent business operation and must be part of any company's governance and working processes. With this in mind, BSG emphasises that the existence of national and international regulatory bodies setting limitations should never become an obstacle for financial institutions in defining their own risk appetite, risk tolerance levels, and internal governance arrangements. By defining risk appetite and risk tolerance, financial institutions are at the same time forced to define their tolerance for liquidity and funding risks. These risks are the ultimate risks, including all other risk elements, determining a corporation's probability of not meeting commitments, i.e. not having sufficient cash.

The very existence of supervisory activity should encourage financial institutions to speed up the implementation of governance and working processes which at least satisfies regulatory bodies. Regulatory bodies should encourage such internal systematic risk assessments (ERM) and the organisation of the risk function. The regulatory bodies should have more focus on guidance, on establishing governance and working procedures, and to following up that these are actually in operation within each institution. This may reduce the focus on reporting and processing of numbers at local regulatory level.

Any measures to be imposed should be conceived as incentives to motivate banks towards better liquidity risk management. In this sense, such measures should as a rule be temporary and supervisors should always spell out the targets that banks are

expected to meet (in terms of, for example, greater diversification, increased timeliness/granularity of risk reports, completeness of contingency plans, etc.) that may over time lead to the corrective measures being lifted.

Further clarification is needed on the perceived conflict of interest of a profit-orientated treasury versus the company's interest (page 17, indent 37). Within the existing framework of liquidity risk limits and stringent liquidity transfer pricing systems a profit-orientated treasury enables the efficient use of liquidity and allocation of liquidity reserves which is in the outright interest of the institution.

Regarding the suggestion to integrate the outcome of stress testing into an institution's strategic planning process for liquidity and funding (page 20) it should be kept in mind that strategic planning is usually based on prudent assumptions under normal market conditions whereas stress testing refers to specific adverse scenarios.

In times of electronic payment and settlement systems the location of an asset does not have an impact on a timely payment transaction, unless different time zones or legal payment restrictions apply (page 22, indent 47).

With respect to the Annex 1 listed supervisory measures (non-exhaustive list) it should be added that the competent supervisor discusses the potential list of measures with the affected institutions to reach a consensus already beforehand. Such a procedure would be in compliance with Article 104 (1) lit. k CRD.

Submitted on behalf of the EBA Banking Stakeholder Group

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