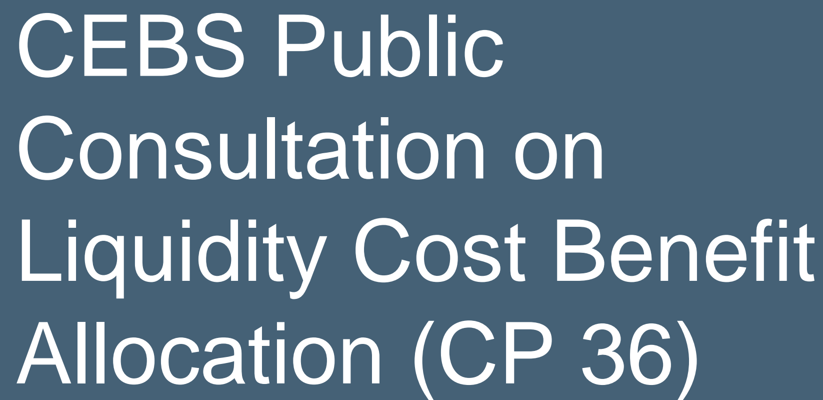

Presentation at Public Hearing

1 June 2010, London

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CEBS

Committee *of* European
Banking Supervisors

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The role of CEBS (1)

- Established in Nov 2003; first meeting in Jan 2004
- High level representatives from the banking supervisory authorities and central banks of the EU
- 27 Member States, 3 observers from EEA countries, the EU Commission, the ECB and the Banking Supervision Committee of ESCB
- From 2011 transformed to European Banking Authority (EBA)
- Chair : Giovanni Carosio, Deputy Director General of the Bank of Italy

The role of CEBS (2)

Objectives:

Promote efficient and effective supervision and the safety and soundness of the EU financial system through:

- good supervisory practices
- efficient and cost-effective approaches to supervision of cross-border groups
- effective regulation
- level playing field and proportionality

Main tasks:

- Give advice to the Commission
- Promote consistent implementation/application of the EU legislation and enhance convergence of supervisory practices
- Exchange information and enhance supervisory cooperation
- Alerting on financial stability

The role of CEBS (3)

CEBS’ Task Force on Liquidity Risk Management

- 27 members from 21 countries
- referring to the *Groupe de Contact* (Chair: Jukka Vesala) and then CEBS
- Chaired by Dominique Laboureix
- In September 2008, published 30 Recommendations for institutions and supervisors on Liquidity Risk Management

The Consultation Paper (1)

The guidelines in this Consultation Paper (CP36) have been prepared by the CEBS Task Force on Liquidity Risk Management after dialogue with CEBS's Industry Expert Group on Liquidity (IEGL), some institutions (on a bilateral basis) and 2 ALM associations.

They are a follow-up to CEBS's Recommendations on liquidity risk management (September 2008), in particular to Recommendation 2 and to the CRD (point 14 in Annex V of the amendments to the CRD 2).

The Consultation Paper (2)

The CP 36 gives guidelines on elements to be considered when creating or reviewing adequate liquidity cost benefit allocation mechanisms.

The guidelines target a liquidity cost concept that includes not only direct funding cost, but also associated indirect costs such as liquidity contingency support.

The resulting mechanism should allow management to give appropriate incentives to ensure prudent management of liquidity risk.

The guidelines are aimed primarily at banks' internal risk management processes, although they may be helpful for supervisory review purposes as well.

The Public hearing: Questions and suggestions?

Participants are invited to

1. Focus on the main issues on which redrafting might be needed,
2. Elaborate on the materiality of their possible concerns,
3. Put forward proposals, to be possibly further specified in written comments.

Written comments should be sent to cp36@c-ebs.org by

<u>10 June 2010</u>. Early responses will be greatly appreciated

Mandate –CEBS Recommendations

CEBS Recommendations on Liquidity Risk, Sept. 2008

Recommendation 2 -“Institutions should have in place an adequate internal mechanism – supported where appropriate by a transfer pricing mechanism – which provides appropriate incentives regarding the contribution to liquidity risk of the different business activities. This mechanism should incorporate all costs of liquidity (from short to long-term, including contingent risk)”.

Mandate-CRD 2

Point 14 in Annex V of the amendments to the CRD :

“Robust strategies, policies, processes and systems shall exist for the identification, measurement, management and monitoring of liquidity risk over an appropriate set of time horizons, including intra-day, so as to ensure that credit institutions maintain adequate levels of liquidity buffers. Those strategies, policies, processes and systems shall be tailored to business lines, currencies and entities and **shall include adequate allocation mechanisms of liquidity cost, benefits and risks**.”

Mandate

The guidelines are principles-based and aimed at internal risk management in institutions.

Respecting the proportionality principle, they are intended to apply to a wide range of institutions in terms of size and business models.

The Liquidity Cost concept

The funding transfer price concept in this paper consists of two components.

1.Direct costs of funding -the costs of raising funds from an asset and liability management perspective and the interest rate curve cost component.

2. Indirect liquidity costs.

Indirect liquidity Costs

Distinguish between:

(i) the mismatch liquidity cost, for which, the liquidity tenor (not the interest rate tenor) is relevant;

ii) the cost of contingent liquidity risk, including inter alia, the cost of holding stand-by liquidity available to cover unexpected liquidity needs (liquidity buffer) as well as the cost of roll-over risk; and

iii) other categories of liquidity risk exposure that an institution may have.

CP 36 - Contents

CP 36 is made of 5 guidelines, with 2 main purposes :

- Reinforce a risk culture around liquidity management
- Help to price products, measure performance and enhance the tools for ALM

3. Guideline 1

Guideline 1 **– The liquidity cost benefit allocation mechanism is an important part of the whole liquidity management framework. As such, the mechanism should be consistent with the framework of governance, risk tolerance and decision-making process.**

3. Guideline 1

In general, the starting point for developing an allocation mechanism is an institution’s fund transfer pricing system.

The prices derived from the proposed liquidity cost benefit allocation mechanism although market based are likely to have a wider information content than traditional management accounting figures.

Institutions must have a clear definition of risk tolerance. This tolerance along with the business model and chosen strategy of the institution sets the context for a functioning liquidity allocation mechanism.

3. Guideline 2

***Guideline 2-* The liquidity cost benefit allocation mechanism should have a proper governance structure supporting it.**

The overall methodology used within the global liquidity management and risk framework should be approved by the management body in its supervisory function.

The resulting internal prices should be generated in a transparent and consistent manner.

The management body in its management function(1) should explicitly approve the overall liquidity allocation mechanism and policies at least annually.

1) or a governing body to which the management body delegates its power (e.g. the Asset/Liability Committee (ALCO))

3. Guideline 2

Expectation that all relevant management levels use the information generated actively and properly.

The liquidity cost benefit allocation mechanism should be controlled and monitored in order to legitimise and justify the derived internal prices for end-user business areas.

The prices generated should be used for:

- the internal pricing of liquidity;
- performance measurement; and
- the appraisal of new products or businesses for all significant business activities, both on- and off-balance sheet.

3. Guideline 2

The area responsible should be service oriented and not have a profit target for this specific role.

There should be a consistent internal pricing framework and policies that apply across the organization and business units.

Central treasury should have visibility over the entire organization's balance sheet.

3. Guideline 3

***Guideline 3-* The output from the allocation mechanism should be actively and properly used and appropriate to the business profile of the institution.**

End users in the institution should understand the output and know how to use it to facilitate decisions .

The internal prices should filter down to decision makers at transaction level to ensure maximum impact.

The liquidity pricing methodology should compensate the providers of liquidity and charge the users.

3. Guideline 3

The business lines should understand the rationality of the internal prices.

The treasury function needs to be continuously updated about business and transactions and to understand the rationale and funding implications of the deals transacted.

The liquidity allocation mechanism should generate prices that can be used at an appropriate level of granularity, reflecting the size and sophistication of the institution.

3. Guideline 4

***Guideline 4-* The scope of application of internal prices should be sufficiently comprehensive to cover all significant parts of assets, liabilities and off-balance sheet items regarding liquidity.**

Sight deposits should be properly treated.

Appropriate internal funding prices should be charged for holding ***trading book assets*** or other marketable assets (AFS portfolio).

Committed credit lines should incur a charge to reflect the cost of liquid funds that must be available to meet the funding requirement of a client if the facility is drawn.

3. Guideline 4

For **uncommitted credit lines and implicit support**, the business units granting the facilities should be charged in a manner similar to that applied to committed lines.

The **holding of a buffer of liquid assets** is a direct response to contingent liquidity risk. This buffer has a cost and it is important that the ***contingent liquidity risk cost*** should be allocated to the business units and products responsible for generating the risk.

3. Guideline 5

Guideline 5 **– The internal prices should be determined by robust methodologies, taking into account the various factors involved in liquidity risk.**

Modelling the behaviour of assets and liabilities is a key step. This modelling framework should be accompanied by a robust governance framework.

Selecting **an internal pricing yield curve** is a critical aspect since it determines how profit contributions to net interest rate margins are measured. The internal prices used should reflect current marginal cost of funding.

3. Guideline 5

The benchmark is generally market determined. Many institutions make use of a Euribor/Libor curve for floating rate transactions and the swap curve for fixed rate transactions.

Most common examples of adjustments to a base price

curve are:

- adjustments for the institutions own credit risk (own creditworthiness)
- bid/ask spread adjustments
- adjustments for liquidity attributes of different instruments/products
- option component adjustments (prepayment)
- other adjustments

4. Next steps

- The public consultation will run until **10 June 2010**
- The document will be revised, taking comments from the market participants into account
- The final guidelines will be published after endorsement by the CEBS planetary meeting in **October 2010**
- CEBS expects its Members to take into account the guidelines with due concern to the proportionality principle and apply them by **30 March 2011** at the latest.

Written comments to the consultation paper should be sent to cp36@c-ebs.or by 10 June 2010.

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