BUILDING SOCIETIES ASSOCIATION

31 July 2008

Response to the second part of CEBS'S technical advice to the European Commission on liquidity risk management

Background

The Building Societies Association represents all 59 building societies in the United Kingdom. Building societies have total assets of just under £350 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, more than 20% of the total outstanding in the UK. Societies hold about £215 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies employ over 51,000 full and part-time staff and operate through more than 2,000 branches.

Introduction

The Building Societies Association welcomes the opportunity to comment on this consultation paper. The paper sets out CEBS' preliminary views on the issues raised in the European Commission's call for advice on liquidity risk management (second part). It builds on an earlier Groupe de Contact survey of regulatory regimes, and on discussions in the light of the 2007-2008 liquidity crisis held with an industry expert group on liquidity.

The paper says that the current market turbulence challenges traditional assumptions concerning liquidity and liquidity risk, and call for a review of the common understanding of their nature and definitions. CEBS points out that while there is currently no single regime for the supervision of liquidity, there is a considerable degree of commonality in terms of qualitative expectations. We agree with this thinking.

Summary

We believe the consultation paper sets out good practice for liquidity risk management. Much of its recommendations are already incorporated in building societies' policy and operational frameworks. It is possible that while certain practices outlined in the paper are followed by the vast majority of societies, they may not always be fully documented, or put on a formal footing.

We welcome the recommendation of a proportionate approach to liquidity risk supervision. We are, however, concerned at the impact of proposed changes to the large exposures regime on the ability of smaller credit institutions to follow certain recommendations in this liquidity risk paper.

Proportionality

Building societies that responded to this paper welcome the recommendation that supervisors – in the UK, the Financial Services Authority - should apply a proportionate approach to the supervision of liquidity risk management, assessing each institution's intrinsic liquidity risk and its systemic risk against the robustness of its liquidity risk management. Proportionality is crucial

The Building Societies Association 6th Floor York House 23 Kingsway London WC2B 6UJ
Telephone 020 7520 5900 - Fax 020 7240 5290 - Web www.bsa.org.uk - *Director-General* Adrian Coles

if non-high-impact firms are not to be burdened with a regulatory framework that is aimed at the biggest institutions, which pose the greatest systemic risk.

They also agree that supervisors should not rely unduly on an institution's capital base or capital ratio. Supervisors should verify that all liquidity risks are covered in both normal and stressed times.

Asset quality

Some societies have expressed concern at the apparently changing definition of "high quality" asset, and the higher costs associated with these changes. In the UK - at least currently - such an asset is now synonymous with UK government securities. The impact of this change of definition on building societies is varied. One society – and it is not alone - acknowledges the reasons why it has had to increase its holding of government stock but reports an accompanying adverse impact on the yield of its liquidity book. Other societies appear to have found liquidity management in the current conditions less challenging.

Consistency with other regulatory objectives

Any new framework must take into account other regulatory objectives. For example, of current concern to building societies (and other European credit institutions) are the European Commission's plans for the large exposures regime. A major issue here is the proposed blanket limit of 25% of own funds to be applied on all interbank exposures with no mechanism to mitigate the effects of this limit on smaller credit institutions such as building societies. These plans differ to the advice given by CEBS earlier in the year, which had proposed a €150 million threshold for smaller credit institutions. (When the liquidity risk consultation was published, the Commission's decision to perform a U-turn on the threshold was not, of course, known).

Should these changes to the LE regime be adopted and no robust mitigating mechanism re-introduced, certain recommendations in the liquidity risk consultation paper would be difficult for smaller credit institutions to follow. One example is Recommendation 16. This states that an institution must have adequate liquidity buffers to enable it to weather liquidity stress during its defined "survival period" without requiring adjustments to its business model. CEBS recognises that interbank exposures limits, depending on how they are calibrated, can affect banks' day-to-day liquidity management and their preparations for periods of liquidity stress.

CEBS argues that in normal circumstances, banks that are structurally or temporarily long of liquidity may have to diversify and/or secure their interbank exposures to a greater extent than they would otherwise. "Provided that banks have access to a sufficiently diverse range of high quality counterparties, this should not reduce the aggregate amount of liquidity available to banks in need of it. **Smaller domestic banks may not have such access, and it is partly for this reason that CEBS proposed to exempt interbank exposures below a certain absolute size from the limits regime.**" As stated above, recommendations in the CP, for example no 16, may now be difficult for smaller credit institutions to follow unless the European Commission changes its plans for the LE regime.