POSITION PAPER

ESBG Response to: Second Part of CEBS' Technical Advice to the European Commission on Liquidity Risk Management

1 August 2008

ESBG

General remarks

The ESBG welcomes the opportunity to comment on the second part of CEBS' Technical Advice to the European Commission on Liquidity Risk Management. The ESBG also expresses its content as regards the possibility to participate in the ad-hoc Industry Expert Group on Liquidity, which has largely contributed to the discussions underpinning the drafting of the CEBS paper.

The ESBG appreciates the concomitant publishing of the CEBS paper on liquidity risk and the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision and welcomes the substantial synchronization between the two papers.

The ESBG very much welcomes the principles-based approach adopted by CEBS. We believe that the 30 Recommendations address the most important aspects of liquidity risk management and supervision. Only by resorting to high-level principles can regulation possibly consider properly the multitude of business models and the specificities of risk management, as well as allow for the flexibility required by changing market conditions. In this respect, the ESBG would like to point to the fact that the sometimes very detailed clarifications to the Recommendations should be seen merely as examples. In view of the diversity of existing best practices in liquidity risk management, such examples represent only some among many options.

The ESBG supports as well the explicit designation of proportionality as an overarching principle, guiding the application of all proposed recommendations.

With a view to supporting the principles-based and proportional approach promoted by CEBS, the ESBG would also encourage the explicit inclusion in the text of materiality as an additional overarching principle. In our view, overregulation can be avoided by making it explicit that the proposed recommendations and their explanations are relevant in the case of material risks and material circumstances.

Specific remarks:

Overall the ESBG would like to commend CEBS for its accurate analysis of liquidity risk management and supervision.

In the following we would like to make comments on some specific aspects of the paper, which in our view could be further improved.

1. The liquidity buffer (page 12, paragraph 4)

A liquidity buffer is defined in the introductory part of the CEBS paper as consisting of "unencumbered highly liquid assets". The ESBG considers that such wording is too strict as it would exclude undrawn committed credit facilities on the liabilities side. Furthermore, the term "highly liquid" would need more clarification or should be deleted, as the liquidity of an asset depends on a large variety of factors changing over time. For instance, based on different scenarios set in the Liquidity Management process, assets which might not be readily available during a very

short period of time could still be used on a medium or long-term horizon. Additionally, assets which might be used at the very moment for refinancing operations (e.g. collateral) could be freed after a certain period of time and – in a given scenario (addressed under the Contingency Funding Plan) - therefore become unencumbered.

Furthermore, for the calculation of a survival period not only highly liquid unencumbered assets should be taken into account. Also, it would not be appropriate to consider the survival period as a benchmark for the soundness of the liquidity risk management process of a bank if only highly liquid assets are allowed for consideration.

In relation to the proposed requirement concerning the active management of the liquidity buffer, we would like to point out that a simple increase of the liquidity buffer by e.g. issuing long-term funding and buying highly liquid AAA-rated government bonds against it, would not improve the overall liquidity situation on the current level. As those assets could be only used in an emergency case, the liquidity raised on the liability side would be neutralized by the purchase. Additionally, due to the rating situation of most banks (which are not AAA rated) this transaction would imply a loss in the portfolio due to the negative credit spread between banks and AAA-governments. Building up or increasing the available liquidity buffer will need long-term changes in the Asset/Liability Management process and supervisors should take this into consideration when assessing the importance of the liquidity buffer and/or survival period figures.

2. Reference to central bank refinancing when defining liquid assets (page 15, paragraph 21, last sentence)

When explaining its understanding of what is a liquid asset, CEBS refers also to the important role of central banks as potential funding providers. However, CEBS concludes that because of reputation risk (stigma) *"banks should not rely too heavily on obtaining funding from central banks"*:

The ESBG believes that such a recommendation should not be included in the paper, as it is misleading. Firstly, the business strategies of banks in the Eurosystem are based on low holdings of cash (Mandatory Reserve Requirement), which are balanced out through the ECB open market operations. Consequently, banks have to participate and retrieve funding from the ECB. Furthermore, banks with access to the European Central Bank liquidity are the intermediates for small banks (e.g. in decentralized networks) to receive funding. We are of the opinion that it would be very counterproductive should the liquidity management process of the ECB be interfering with a recommendation of the supervisor.

Also, we do not agree that the word "stigma" should be potentially associated with the usage of the standing facilities of the ECB. The ESBG Members using the Eurosystem’s refinancing facilities have not perceived anything like a stigma related to the two standing facilities of the ECB. The standing facilities are regular tools to fine-tune the mandatory reserve account held with the Eurosystem as markets might not be as efficient in certain periods of time, e.g. the last day of the maintenance period. As the crisis has shown, this is now also true for the facilities of the Federal Reserve System in the United States.

3. Recommendation 11 (Intraday Liquidity)

Recommendation 11 proposes that irrespective of whether institutions use net or gross payment and settlement systems, "they should manage intraday liquidity on a gross basis". This does not correspond to the current practice of many institutions and would therefore impose additional burden and costs that do not necessarily correspond to a commensurate improvement of the quality of liquidity risk management. The separate monitoring of incoming and outgoing payments on a gross-basis may be meaningful. On the contrary, when determining the necessary liquidity coverage inflows should be considered on a net basis, so as to avoid exaggerated collateral requirements.

4. Recommendation 14 (Liquidity Stress Tests)

The ESBG agrees with CEBS that liquidity stress tests are a useful tool, which can help to adjust internal policies and contingency plans. It is important that such stress tests rely on an adequate scenario analysis and are conducted in line with the proportionality principle.

5. Recommendation 15 (Contingency plans)

The ESBG understands that the testing of contingency plans does not imply that a credit institution should undertake operations (such as, for instance, tentatively selling parts of its portfolio), which could trigger rumours in the markets (implying reputational risks). It should be sufficient for a credit institution to check internally if the envisaged measures would function as planned.

6. Recommendation 16 (Liquidity buffers)

According to CEBS' proposal the liquidity buffer should be construed in a way that would allow the institution "to weather liquidity stress during its defined 'survival period' without requiring adjustments to its business model". The reference to 'liquidity stress' is equivocal. There should be a distinction between short-term and long-term stress. Short-term stress refers to an interval when the adaptation of the business model is not possible or required. Long-term stress implies that banks will primarily react by adapting their business model. Recommendation 16 should refer to short-term stress. It would be completely disproportionate to require banks to measure their liquidity buffer in a way that would ensure overcoming long-term stress without a change in the business model.

Overall, we agree that a liquidity buffer (understood as a certain amount of available collateral especially for Central Bank facilities plus undrawn committed credit lines) is a key element in managing a short-term name crisis or systemic event. However, it should be straightforward that the absolute figure of the liquidity buffer cannot be the only criterion on which supervisors can evaluate the liquidity situation of a bank.

7. Recommendation 18 (Transparency to the market)

The ESBG would like to draw attention to the risks that may be implied by such disclosures. Extensive disclosure of sensitive data on liquidity risk management does not necessarily contribute

to the stability of the financial system, but is rather prone to trigger overreactions and misinterpretations. This might have devastating consequences on the integrity and stability of the market and might jeopardize the liquidity position of an institution. Inappropriate disclosures could therefore be at odds with the objective of mastering liquidity risk. Moreover, if IFRS 7 only applies to consolidated accounts, there is no use for extending these disclosures to individual or sub-consolidated levels.

For this reason, we are in favor of a more complete dialogue with supervisors but we are against increasing the volume of quantitative information disclosed to the markets. The ESBG considers that disclosures should be focused on qualitative information.

8. Recommendation 25 (Internal Methodologies)

The ESBG welcomes the explicit mentioning of the possibility of supervisory recognition of the institutions' internal liquidity risk management methodologies for prudential purposes. This approach goes beyond the more reluctant Basel Committee's proposals. We appreciate that the recommendations of CEBS remain principles-based, which would thus allow every bank to use its own methodology.

9. Recommendation 29 (Cross-Border Groups)

The ESBG welcomes in principle the proposed recommendation regarding the coordination of the work of supervisors of cross-border groups. However, the ESBG underlines that such coordination should not, as spelled out in the current wording, have as an objective only the better understanding of the groups' liquidity risk profiles.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

European Savings Banks Group - aisbl
Rue Marie-Thérèse, 11 ▫ B-1000 Brussels ▫ Tel: +32 2 211 11 11 ▫ Fax : +32 2 211 11 99
Info@savings-banks.eu ▫ www.esbg.eu

Published by ESBG. August 2008