

**Italian banking system Position  
Paper in response to CEBS  
consultation paper CP19 on  
Liquidity Risk management and  
in response to Basel Committee  
consultation document  
“Principles for Sound Liquidity  
Risk Management and  
Supervision”**

July 2008

## Introduction

The Italian banking industry appreciates both the CEBS initiative in setting out its preliminary views on the issues raised in the European Commission's call for advice on liquidity risk management and the Basel Committee initiative in setting out the consultation paper "Principles for Sound Liquidity Risk Management and Supervision"

The Italian Banking Association (ABI), in order to produce a banking industry position on the CEBS and the Basel Committee consultation papers has collected the various points of view of its member banks and gathered a series of proposals concerning the aspects treated.

Based on the comments received and on the activity of interbank working groups, ABI has drafted the attached position paper, transmitted to the Basel Committee, to the CEBS and to the Italian Supervisory Authority.

## General remarks

In general, we agree with the content of the consultation documents and, at the same time, hope that they will lead to a greater convergence of the various national frameworks adopted by regulators concerning liquidity risk management.

Both documents are quite similar in content and recognize the principle of flexibility when applying the recommendations, which may be assessed according to the dimensions and nature of the specific business, e.g. the complexities of the activities of the individual banks.

There are no specific objections to the wording of the various principles. Certain recommendations concerning developing dynamic analysis and stress may need further development as well as technical arrangements.

We are in favour of adopting a principle-based approach with the possibility of using internal methodologies, but it is essential that in the future, the application of the principles may be underpinned by an open dialogue between banks and regulators.

The quantity and the complexity of the recommendations issued by the Basel Committee and CEBS, even though presented as non-binding suggestions tempered with the principle of proportionality, are overwhelming. They are a true and real set of rules. They do not address whether they are necessary but rather underline that they should be gradually implemented.

In implementing them, the regime concerning liquidity risk should not be integrated in the supervisory regulations on capital adequacy, but they should be contained in a specific regulation. In this way, the limited connection between a bank's net financial position and net worth, should be more obvious.

## Comments on single Principles

This paragraph has been structured in such a manner as to comment on both the Basel Committee document as well as that of the CEBS.

**The following comments refer to the Basel Committee document.**

**Principle 4.** We generally agree with the invitation to banks to incorporate internal processes to measure implications, in terms of cost/benefit, arising from liquidity risks: the correct allocation of such cost, which should be considered part of company strategy, should be sought by providing the possible use of individual and personalized solutions - in terms of implementable timeframes and conditions- based on the situation of each bank.

We note that incorporating liquidity risk costs in pricing could exaggerate financial market volatility in business dynamics. This innovation of using liquidity costs entails - keeping in mind that appropriate regulations and necessary implementable interventions need to be carried out- a timeframe which is not short.

**Principle 5.** This principle is tinged with the recommendation to try to match incoming flows with outgoing resources. This is acceptable if it refers to only the short term while for an extended timeframe these rules should not translate into an excessive limitation to the transformation of maturity

**Principle 10.** We believe that banks, analogous to what is required by the capital framework, should be in a position to cope with situations of expected and unexpected financial conditions, the latter with solid forecasts. Banks should also assess the potential impact on their liquidity profile that could lead to conditions of severe stress ("severe stress", paras. 25 and 97), or prolonged ("prolonged period of stress", para. 10), but without this potential impact having to translate automatically into additional reserves of liquidity. This is due to the difficulty associated with forecasting the probability of outside events, for the numerous management levers aimed at combating these stress events, as well as for the elevated costs associated with locking up corresponding reserves. However, the principles issued by the Basel Committee do not distinguish between unexpected liquidity conditions and conditions of severe stress, therefore resulting in ambiguity of the principles themselves. Rather it should be recognized that the techniques for measuring liquidity risk are at such a level that, in the absence of solid quantitative models to measure unexpected liquidity to assess cash flows linked to defined techniques, it would be advisable to use "judgmental" stress tests, but not necessarily for severe stress. We hereby propose that the frequent references to stress tests (eg. paras. nos. 9, 10, 11, 17, 23, 25, 39, 45, 50, 83, Principle 10 etc.) should be further specified. Specifically, we suggest that the statement "A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies and

positions and to develop effective contingency plans" (Principle 10) should be tempered by at least one principal of self-assessment by banks of the significance of these results.

**Principle 13.** Public disclosure of information on a bank's liquidity position and current limits could be counter-productive, exposing the bank to instability and speculation.

**Principle 16.** Even confirming our general consent for the introduction of the use of internal models for the management and measurement of liquidity risk, we point out that the lack of an objective criteria to carry out the stress tests could create disparity and could make it difficult to assess the ratio of any intervention by a regulator with respect to risky/deficit situations.

**The following comments refer to the CEBS document.**

**Principle 11: Intraday Liquidity.** This recommendation by the CEBS refers to the possibility of managing intraday liquidity on a gross basis even for payment flows with net settlement. Although we agree with the underlying logic of this principle, (aimed at urging banks to have a full understanding of all possible risks associated with managing intraday liquidity flows), more clarification is needed on the problems connected to managing collateral in relation to net payment systems (paragraph 130, page 40).

**Principle 15: Contingency Funding Plan (CFP).** In relation to CFP, recommendation no.15 of the CEBS appears to invite financial institutions to carry out periodic tests, even by involving outside counterparts included on a "contact list". We believe that involving outside counterparts vis-à-vis the test on CFP may cause reputation problems with respect to funding. Therefore, we believe it would be better to strengthen the role of central banks, possibly including them when defining contingency plans and tests.

**Principle 18: Disclosure.** Without prejudice to what is set out in the comment to Principle 13 of the Basel Committee document, we highlight that, as in the CEBS document, the issue of what information must be disclosed remain essentially open.

With respect to this, we agree that there needs to be more openness in qualitative information, which must in the future be as detailed and clear as possible. At the same time, more information of a quantitative nature could instead result in interpretation problems and may be the object of mistaken comparisons; we believe that the issue needs to be further analyzed and developed.

**Principle 28: Supervisory reporting framework.** As previously mentioned in the general remarks, we firmly agree with the use of internal models for the management and measurement of liquidity risk.

Specifically, with reference to recommendation no. 28 of CEBS (referring to the need for supervisors to prepare precise and up-to-date quantitative/qualitative information to assess the liquidity risk of the various financial institutions), we note that it may be more acceptable to use sets of reports individually produced from internal models, rather than using standard and general reporting outlines.

**Principle 29: Home/ Host Supervisors.** The existence of inconsistencies in the various legal frameworks, as for example, the current distinction between the competences of domestic and foreign supervision, makes cross-border liquidity more complex for banking groups with an international presence. As mentioned above, we hope that further harmonization will be achieved of the standards imposed at the international level.