avantage
CAPITA

30 July 2008

Committee of European Banking Supervisors
Tower 42 (Level 18)
25 Old Broad Street
London
EC2N 1HQ

Dear Sir/Madam,

Response to Recommendation 2 of "Second part of CEBS'S Technical Advice to the European Commission on Liquidity Risk Management" issued for comment by Committee of Banking Supervisors' on 17th June 2008

The original recommendation reads as follows:

> *"Institutions should have in place an adequate internal cost/benefit allocation mechanism – supported where appropriate by a transfer pricing mechanism – which provides incentives regarding the contribution of liquidity risk of the different business activities. This mechanism should incorporate all costs of liquidity (from short to long term, including contingent risk)."*

We believe that the wording in the recommendation is potentially confusing because it combines two different objectives by introducing two very different and not always complementary mechanisms: cost/benefit allocation and transfer pricing. The implication of the wording in this recommendation is that a transfer pricing mechanism can effectively achieve both the allocation of all liquidity costs and can incentivise appropriate liquidity risk behaviours.

Suggested Changes

To improve clarity and recognise the often contradictory objectives of full cost allocation and encouraging appropriate behaviours towards liquidity risk, in our opinion the recommendation should be split into two separate recommendations or two paragraphs within the single recommendation as follows:

> *"A transfer pricing mechanism should be established that provides incentives for the generation and use of liquidity, consistent with an institution's risk appetite.*
> *An adequate internal cost/benefit allocation mechanism should be created that adjusts the costs provided by the transfer pricing mechanism to capture all costs of liquidity (from short to long term, including contingent risk)."*

Justification

The appropriate allocation of all costs of liquidity to the businesses serves the purpose of evaluating performance and represents a strategic objective of any institution. The implementation/operation of an adequate transfer pricing mechanism serves a very different purpose of ensuring that liquidity implications are factored into business decisions and is tactical in nature. As many institutions can testify there is no evidence that both objectives can be achieved by deploying a transfer pricing mechanism. The reasons are outlined in more detail below.

Yield Curve Framework

The objective of an accurate allocation of funding costs to the businesses/transactions/positions can be achieved by applying one price/rate for all maturities. However, such an approach does not incentivise the creation of short term assets over long-term assets and the latter contribute most to liquidity risk.

In order to avoid price gaps for a particular tenor and to reflect the environment in which businesses operate, institutions adopt a yield curve approach consistent with normal market conventions (e.g. overnight/next day/spot/week/month etc.) and interpolate rates for those time periods/tenors in which a weighted cost cannot be derived due to the absence of existing funding in a specific tenor. This approach provides clear incentives to minimise liquidity risk but does not accurately reflect liquidity costs.

Two-Way Pricing

Any transfer pricing mechanism should recognise liquidity generating capability of certain business activities (e.g. repo desk activities) and discourage undesired behaviours (i.e. generation of excess liquidity when market rates are lower than internal price based on historic cost of funds). This can only be achieved with the application of two-way pricing, where liquidity generation can be regulated by varying the internal liquidity bid-offer spread: the wider is the spread the less incentive there is to generate excess liquidity.
However, this approach distorts the accuracy of allocating liquidity costs as a result of internal profit created by Treasury and the true cost of liquidity not being reflected in the offer price of liquidity.

External and Internal Liquidity Pricing Conflict

For banks operating in the external inter-bank market it is not possible to create a differential between the externally quoted prices and the internal liquidity pricing given the arbitrage opportunities available to those businesses capable of generating liquidity. The transfer pricing mechanism in this case reflects the marginal cost of short term funding which is far removed from the total costs of liquidity, i.e. current market liquidity pricing versus internal historical cost.

Conclusions

When the transfer pricing mechanism is most transparent and effective in ensuring that each tactical liquidity decision is undertaken and priced in line with the institutions corporate liquidity risk appetite, it is also least effective in reflecting the total costs of liquidity.
Conversely, the application of a single rate (based upon the daily interest expense divided by the total funds outstanding) for charging positions achieves an accurate allocation of funding costs even though it does not reflect current market rates, lacks transparency and has the following drawbacks:

- applies one rate to assets regardless of their maturity / quality;
- rewards liquidity generation and consumption equally leading to generation of excess liquidity during periods of falling market interest rates;
- represents a hindsight view since determination can be achieved at best a day in arrears;
- ignores maturity profile of funding/liabilities.

In short, (and without discussing the various approaches that can be used to incorporate the costs of long-term financing, model the maturity profiles of non-term deposits and estimate the proportion of contingent funding

obligations to be hedged and thus priced) the creation of a transfer pricing mechanism that accurately captures and thus allocates actual funding costs is difficult to attain and the more effective it is in encouraging desired behaviours the less accurate it becomes as a tool for allocating all liquidity costs.

Yours faithfully,

Nigel Walker
Managing Consultant