EUROPEAN COMMISSION
Internal Market and Services DG

Director-General

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Mme Danièle Nouy
Chairman
CEBS
Tower 42
25 Old Broad Street
UK-London EC2N 1HQ

Dear Danièle,

Subject: Call for Technical Advice (No.8) to CEBS on Liquidity Risk Management

I am very pleased to send you the Commission's eighth official call for technical advice from the Committee of European Banking Supervisors (CEBS).

As you are aware liquidity risk is a very important topic, since sound liquidity risk management can reduce the probability of serious problems with the institution's solvency. On the other hand, banks' capital positions can also have an impact on their ability to obtain liquidity, especially under stressed market conditions.

In spite of this, no specific EU prudential regulation in relation to liquidity risk has been adopted over the years. The Capital Requirements Directive (CRD), in Annex V, emphasises the need for EU credit institutions and investment firms to have an internal process in place to adequately monitor liquidity risk. (policies and procedures, use of alternative quantitative scenarios, mandatory contingency plans). The CRD, however, does not specify how this should be done.

Our interest in this topic is also linked to the longer-term debate on EU future supervisory arrangements. In particular, we have identified five issues (liquidity, crisis management, emergency liquidity assistance, deposit insurance schemes, reorganisation and winding-up of credit institutions) which deserve further consideration in order to ensure that financial stability arrangements and their interaction with prudential supervision in the EU are as efficient as possible. The Economic and Financial Committee ("EFC") and the European Banking Committee has welcomed our work being carried out so far.

The Commission services would like to, consistent with the better regulation agenda, identify those issues which may require changes in the regulatory framework and promote regulatory and supervisory convergence at EU level.

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Therefore, I would be grateful if CEBS could carry out a number of pieces of work to inform the Commission on this topic. Specifically, I would like you to update the stocktaking exercise on regulatory frameworks which was carried out by the Group de Contact (GDC) in 2000. I would like you to expand this to encompass the newer Member States.

In addition, I would like CEBS to deepen the analysis in the survey by looking at issues such as collateral, liquidity market risk, the impact of payment and settlements system design on liquidity management and the use of internal methodologies by sophisticated firms.

In this call for advice I would like you to focus on the identification of issues and not to provide solutions to them.

I am attaching to this letter a copy of our call for advice.

Yours sincerely,

Jörgen HOLMQUIST

Thierry Stoll
Deputy Director General

EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL INSTITUTIONS
Banking and financial conglomerates

CALL FOR TECHNICAL ADVICE (No.8) FROM THE COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)

Subject: Liquidity Risk Management

1. Background

The issue of liquidity risk management is a very complex one, since it can be analysed with respect to both normal and stressed market conditions. Liquidity, or the ability to fund increases in assets and meet obligations as they come due, is crucial to the ongoing viability of any banking organisation. Therefore, managing liquidity is among the most important activities conducted by banks.

Sound liquidity management can also reduce the probability of serious problems with the institution's solvency. On the other hand, banks' capital positions can also have an impact on their ability to obtain liquidity, especially under stressed market conditions.

The importance of liquidity transcends the individual bank, since a liquidity shortfall at a single institution can have system-wide repercussions. For this reason, the analysis of liquidity requires firms' management not only to measure the liquidity position on an ongoing basis but also to examine how future funding requirements are likely to evolve under various scenarios, including adverse conditions.

In the EU, no specific prudential EU regulation in relation to liquidity risk has been adopted over the years. The Capital Requirements Directive (CRD) emphasises the need for EU credit institutions and investment firms to properly address liquidity risk through policies and procedures for management of their net funding position on an ongoing and forward-looking basis (Annex V, point 11-12, Directive 2006/48/EC). It also introduces a requirement for mandatory contingency plans to deal with liquidity crises. The CRD however, does not specify how this should be done. Moreover, according to existing EU legislation, the host supervisor is in charge of monitoring liquidity risk for branches. This allocation of responsibility for liquidity to the host supervisor dates back to 1989 (2nd Banking Directive).

The European Banking Committee ("EBC") started a long-term discussion on the future of EU supervisory arrangements in November 2005, which has focused on the challenges – regulatory and non regulatory - facing the current framework and the work that needs to

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be carried out. In particular, the Commission services have identified five issues (liquidity, crisis management, emergency liquidity assistance, deposit insurance schemes, reorganisation and winding-up of credit institutions) which deserve further consideration in order to ensure that financial stability arrangements and their interaction with prudential supervision in the EU are as efficient as possible.

The Economic and Financial Committee ("EFC") has welcomed the work being carried out in this respect by the Commission services and the EBC and has asked the Commission services to report progress on the issue of liquidity risk management in September 2007.

Work on liquidity risk management has also been undertaken in different international fora, which serves to highlight its importance in the financial stability of international financial markets.

The European Central Bank ("ECB") has started work on an analytical project aiming at assessing whether the current liquidity risk management practices in financial institutions may affect financial stability and the smooth functioning of financial institutions and markets in Europe. The ECB expects to finalise its project by February 2007.

The Basel Committee on Banking Supervision (BCBS) has recently started its own project which will be based on an analytical survey of existing national approaches, taking into account changes in financial markets as well as supervisory experience with existing regimes.

2. Specific call for technical advice

The interest of the Commission services in this topic is twofold:

(i) to promote regulatory and supervisory convergence at EU level.

(ii) consistent with the better regulation agenda, to identify those issues which may require changes in the regulatory framework, as well as further convergence of supervisory practices, and which might be discussed in the broader context of the EU financial stability and supervisory arrangements.

To feed into the above work, the Commission services are seeking the technical advice of CEBS on the issues listed below.

(a) The Groupe de Contact (GdC) conducted a stocktaking exercise in 2000 on regulatory frameworks adopted by fifteen members and three EEA countries. Nine out of eighteen countries indicated that it was their intention to change their regulatory frameworks within a relatively short period of time following the stocktaking exercise. No survey has yet been carried out on the regulatory provisions of the newer Member States, including Bulgaria and Romania.

CEBS is asked to update the GdC survey in light of market developments and to include the twelve newer Member States in this update as well as specific information regarding any different treatment provided for specific types of credit institutions and/or investment firms.

Based on the updated survey, CEBS is also asked to identify regulatory and supervisory approaches adopted in respect of branches and subsidiaries. CEBS is in particular invited to clarify the underlying reasons and objectives that drive different supervisory approaches adopted in the EU, in relation to allocation of tasks and responsibilities for branches and subsidiaries.

(b) CEBS is asked to deepen the updated analysis set out in (a) by looking at the following issues:

- the GdC survey showed that some important variables that may significantly affect liquidity risk management have not received due consideration by supervisors. In particular collateral management, use of different types of collateral, the impact of covenants on net liquidity positions, netting agreements, the distinction between banking and trading books and the analysis of concentration of liquidity sources may be further considered in order to better align supervisory review approaches with market practices. Overall consistency with relevant existing CRD provisions (e.g. types of eligible collateral, recognition of netting arrangements) will also deserve due consideration;
- the blurring distinction between liquidity funding risk and liquidity market risk. This is, for example, due to the increased use of secured funding and, more generally, of complex products as additional sources of funding by firms (e.g. securitisation, covered bonds and structured transactions). Furthermore, assets that have been warehoused by firms to cope with stressed market conditions may not show the expected adequate liquidity profile under those same crisis scenarios;
- the increased use of internal methodologies by sophisticated firms and by credit rating agencies in order to assess and monitor firms' liquidity risk profiles;
- the impact of payment and settlements system design and relevant increased interdependencies (e.g. shorter time horizons, sound internal processes and procedures for clearing and settling outstanding transactions, quicker spillover effects of specific firm's liquidity problems).

In line with the bottom-up approach endorsed by the EBC, CEBS is asked to identify any other areas and problems that have not been included in the above and that appear not to be adequately addressed by the current regulatory framework at EU level.

This analysis will enable the European Commission to have a better understanding of the outcome delivered by a range of current liquidity regimes across the EU. It will also allow the Commission services to use this work in the broader context of the current debate on EU supervisory arrangements.

In this call for technical advice, CEBS is asked to focus on the identification of issues and not to provide technical advice on possible solutions to them. On receipt of this initial technical advice from CEBS, further calls of advice on this topic may or may not be forthcoming.

CEBS is also asked to ensure parallel work with the BCBS as much as possible, due to the global nature of the topic of liquidity risk management.

3 Timetable

CEBS is invited to provide the above advice as set out in (a) by July 2007. The analytical contribution explained in (b) above should be sent to the Commission services by January 2008.