30th October 09

BNP PARIBAS ANSWER TO CEBS
CONSULTATION PAPER 28 ON LIQUIDITY BUFFERS AND SURVIVAL PERIODS
(Dated July 2009)

BNP Paribas welcomes the opportunity to respond to the Committee of European Banking Supervisors' (CEBS) Consultation Paper 28 on its proposed implementation guidelines for Liquidity Buffers and Survival Periods, dated July 2009. BNP Paribas fully supports CEBS's objective of promoting a common understanding and harmonised approach to liquidity issues by European supervisors and efficient allocation of liquidity as a response to Recommendation 16 of the 2008 Recommendations prepared by IIF with the contribution of industry. We believe that there is an interest to work out adjustments where need be to improve the system by learning from the lessons of the recent liquidity crisis.

BNP Paribas would like to highlight the fact that liquidity is a key constituent of risk management, especially as liquidity has proven to be of critical importance in the exceptional circumstances of the liquidity crisis in 2008. We approve Liquidity Buffers to be in place to ensure the survival of firms during both idiosyncratic and systemic crises. To survive to a liquidity shock, a firm needs to demonstrate to the markets that it is a well-run solvent viable institution. Liquidity Buffers are therefore essential to show that the institution holds high quality liquid assets in liquidity crisis and can access easily to market funding and to central banks facilities.

BNP Paribas understands that the objective of CEBS is to provide guidelines for sustaining systemic stability, and maintain the safety and soundness of financial institutions in their monitoring of liquidity risk. The proposed liquidity risk qualitative standards are guidance and not new regulation, and comprise overarching high level, principles-based guidelines avoiding the one-size-fits-all approach which proved to be problematic in the liquidity field. We also welcome the risk-base approach endorsed by CEBS that industry calls for long.

Therefore we note with appreciation that CEBS has recognized that liquidity is largely institution-specific. Principles-based regulation requires more dialogue and interaction between supervisors and firms, which results in a more detailed, comprehensive understanding of a firm's activities. We agree that the determination and implementation of the Liquidity Buffer needs to be a dialogue between the supervisor and the individual firm and that the guidelines should not be construed to constrain adaptations from time to time within each bank's dialogue with its regulators.

We strongly support the view that there is no single model for managing liquidity. Every firm has a unique exposure to different markets and businesses. A robust group risk management scaled to the needs and exposure of a financial institution, together with industry's experience and practices adapted to manage efficiently the liquidity risk of one individual firm, does not preclude strong supervision as equally essential. To the same extent the reform should be consistent with market efficiency.

We note that the guidelines purpose is not to achieve convergence in the liquidity matter, failing a common banking supervisory framework to bring convergence in Member States policy and enforce measures. We therefore plead for an urgent need for a supervisory framework to prevail over defining fragmented rules in the area of liquidity management in an isolated and diverging way. Setting up rules without consideration of supervisory harmonisation at European level can be counterproductive of all laudable efforts, although we reckon the merits of the regulators' initiative to enhance coordination of regulators and supervisors in the direction of harmonisation of practices and to contribute to a more efficient treatment of cross border firms, and finally improve communication amongst supervisory colleges. Lastly the reform should be consistent with market efficiency, the framework should take into account in as much as possible market practices and provide enough flexibility to financial institutions to monitor their liquidity risks.

We take the opportunity to emphasise that the proposed changes are additional to CRD modifications that have already been enacted and that will significantly increase capital charges. It is of the utmost importance that, before moving forward, not only the cumulative impact of all those changes are addressed and where need be, quantified, but also a thorough comprehensive analysis of the magnitude of those effects is conducted by the Basel Committee for Banking Supervision so that all these cumulative measures are proportionate to the risks involved and not piecemeal measures, and that their aggregate impact and effect on the European economy does not harm bank lending and funding.

An impact assessment is thereby requested for all capital requirements measures. We expect that the new requirements are construed at macro-prudential and that level impact assessment takes into account the interactions of all the regulatory and accounting changes now being rolled out.

As a preliminary view and generally speaking, BNP Paribas as an international cross border banking group is concerned about any limitation which may impair free flow of liquidity, as a factor to increase systemic risk. The initiative from the CEBS in examining how to overcome rules and legislation which may currently prevent an optimal flow of liquidity within a group in an unduly way is welcome. We appreciate that effects of the Guidelines on the overall economy are considered by CEBS.

From our standpoint as an international banking group we search to optimise our ability to direct liquidity to where it is needed as well as minimise excess costs, and reduce systemic risks which results from inhibit access to liquidity in one jurisdiction to support liquidity needs in another. Any stringent regulation that prohibits intra-group free flows would deter an efficient global risk management policy for liquidity and hamper groups to develop ambitious financing policies across its network, not to speak about its own funding policy and overall liquidity needs. Diversification of asset composition of the Liquidity Buffer must be assessed given the specificities of cross border groups, in as much as transferability of flows and assets in collateral must be possible across the group, without any impediment, such as legal obstacles to transfer assets eligible as collateral which may create competitive imbalance.

If on the principles there should be no reliance of a branch on other parts of the group for instance, the specificity of a cross-border group and its global liquidity risk management and appetite cannot be discarded, and our institution oversees group-wide liquidity management from major financial places throughout a thorough organisation with a centralised decision making process. It should be avoided to require self sufficient rules specified at host countries supervising level.

We would like to take the opportunity of this overview to mention expected outcome in harmonising regulation at international coordination level: reporting issues must be proportionate, consistent across the EU and of effective use. Also they should generate no double burden and should set up highly comparable standards for which benefits would not be overweight by the costs to develop and implement them. The idea of course is to avoid multiplication of work and chance of error for groups, and maximise the chances to identify the potential sources of vulnerabilities in providing supervisors safe standards of comparisons. However, standardization of templates does not imply standardization of the metrics used to manage risk, which will vary substantially from group to group. A phase-in period will be necessary as the development in systems will require full compliance with many jurisdictions that should replace divergent requirements. It is expected a "common language" of liquidity and liquidity reporting, to facilitate both process and understanding for both firms and supervisors (and colleges).

CEBS has made admirable progress towards an internationally consistent pattern of reasonable and useful reporting to supervisors with their "Liquidity ID" initiative. We welcome any steps that can help integrate the same reporting across supervisors into internal processes, which should facilitate a better result for all parties.

Q1. With regard to the definition of assets that should be eligible to a liquidity Buffer for a one month period of stress in a combined idiosyncratic and market-wide scenario, market participants' answers to the following questions would be most appreciated. If the composition of liquidity Buffers was to be restricted to assets that are both highly liquid in private markets (including in stressed time) and central bank eligible…

The Liquidity Buffer is viewed as a plan in an on-going business perspective that does not require additional sources of liquidity at the time the crisis occurs since they have been forecasted. The Liquidity Buffer represents available liquidity covering the additional need for liquidity that may arise over a defined short period under stressed conditions, without changing the business model.

Our understanding further to the London hearing is that the definition of the Liquidity Buffer proposed by CEBS for a one month period of stress in a combined idiosyncratic and market-wide scenario is as follows:

(a) for the very short end of the Liquidity Buffer (for example one or two weeks), the amount of assets both highly liquid in private markets and eligible to Central Banks; as a result, it excludes loans, ABS and self securitizations eligible to Central Banks ;
(b) for the longer end of the buffer (from the short end to anther period covering in total a month till the end of the month for example), the amount of other liquid assets on the market under stress with a predictable value based on objective criterium.

We also understand that the stress scenarii should be calculated on a longer period (6 months to 1 year). On medium term maturities beyond the term of the Liquidity Buffer (short term only) an in order to mitigate the consequences of the stress:

(a) loans, ABS and self securitizations eligible to Central Banks and excluded from the Liquidity Buffer should be part of the contingency plan;
(b) the Business model of the institution could be adapted.

As a preliminary remark we would like to underscore that whereas CEBS at the Public hearing recommends a strong diversification of the assets in the buffer by currency, by Central banks, by jurisdiction and legal entity, <u>still the definition of eligible assets is definitely too narrow as only cash and assets that are both central bank eligible assets and highly liquid assets in private markets are part of the very short part of the Liquidity Buffer.</u>

Requiring assets to be highly liquid will result very likely in an overgrowing concentration affecting the markets, since institutions will need to hold large amounts of such assets increasing their scarcity. In the event all banks start to liquidate the same range of assets (even if relatively diversified at the institution level) in the event a crisis occurs there would become illiquid as well, therefore, concentration may occur both at a single-institution level and at the system level, bringing adverse effects and undermining the very purposes of the Liquidity Buffer requirement. We therefore plead for a wider variety of assets to complete the Buffer to avoid less risk of unintended market effects, and to use Central Banks facilities right from the start of the crisis if any problem occurs in selling "liquid" assets in the market.

We would like to stress out that a system based on too strict definitions of which securities are eligible to the liquidity Buffer because of Central Bank's eligibility could end up in creating a "tiering" of the securities market. Segments of the market considered outside the scope of the Buffer would trade at a wide discount, or even freeze up in times of tension while securities eligible to the Buffer would trade normally or at a premium. This phenomenon occurred during the turmoil and would clearly produce adverse effects.

The break up of the continuum between asset markets is less likely to occur in a system based on a less rigid definition of Buffer eligibility. Indeed, it is by widening the eligibility criteria that central banks tried (not that successfully) to revive trading in those securities most affected. Market participants would then know that most financial assets are eligible to the central banks but with a different liquidity value, central banks would decide haircuts applicable upon submission by participants, the later to gain the confidence of accessing liquidity with the uncertainty as to the liquidity value of the collateral they own.

Finally, and although it is outside of CEBS scope in the present Consultation, we also plead for consistency in collateral eligibility and collateral transferability between central banks, at least at euro zone level. Interoperability of collateral is a key driver for sound liquidity policy on the EU. In particular efforts must be made towards harmonisation at EU level in respect of collateral and its enforceability. The realisation of collateral assets may face operational and legal impediments that cause imbalance or valuation anomalies across jurisdictions and that must be taken into account in liquidity planning.

A competitive imbalance could result in the current lack of consistency in collateral eligibility and transferability of collateral between central banks in different countries inhibits the free cross border flow of liquidity within international banking groups. This would as a consequence increase risk and adding costs as part of trapped pools of liquidity maintained in several jurisdictions such pools reducing rather than increase global liquidity, and impede rather than facilitate recovery.

1.1 …Would you foresee any shortage of eligible assets, such as government bonds, or any increase in the concentration or cost of holding such assets? Any impact on less liquid assets?

As a matter of fact, growth of public deficits further to the crisis provides for a large base of eligible government bond, bringing enough liquidity on the short term but may be upheavaled with concentration risk in the long term. Eligibility of assets is a tricky issue: There is no incentive to hold assets that cannot be eligible for the Buffer which as a consequence will deteriorate in price and value and will be illiquid whereas opposite effect will occur on liquid eligible assets in the so called survival period.

In times of stress, rating of government debt issues may also imply a risk for banks domiciled in lower rated EU Member States since banks will have to exchange local government debt into foreign better rated government debt. Therefore a squeeze in available highly liquid assets may increase in consideration of this factor.

Additional funding required to meet Liquidity Buffer requirements will compete directly with other activities such as hedging of illiquid assets or lending the economy in a time where issuers, which do not have access to such markets, will request more bank loans. Lending capacity will conflict with the Liquidity Buffer, the former will increase while impairing long term economic growth as bank lending will decrease. Another effect will be a competition for capital funding between other capital requirements such as leverage ratio and dynamic provisioning.

1.2 Would you expect any potential pressure points due to possible inconsistencies in the definition of the liquidity value of eligible collateral and the liquidity value of assets/collateral taking into account in the computation of the net cash outflow?

The answer given during the hearing in London has satisfied the CEBS.

1.3 What conditions, if any, should be fulfilled in your view before a narrow definition could be applied, without undue side effects? (for example: availability of collateral, transition arrangements including its length, etc)

The mere consequences of a narrow definition is banks reallocating their assets and make a cherry picking of the eligible assets being a quite limited number of products and tiering instruments into eligible and non eligible categories to Central Banks. As it is major change in the present functioning of the liquidity market, it is important that a sufficiently long transition period of implementation allows non eligible assets existing in the market to mature and be replaced by qualifying securities, doing so will keep in diversity. Even in the transition period to the new proposals there would be a two tier market, in favour of highly liquid central bank eligible assets. There would be an adverse impact on the overall banking system as the price of funds to customers would increase and / or the banks' P&L would be negatively affected.

Q2. Would you consider that a too narrow definition of assets eligible to the Buffers could entail a possible sub-optimal allocation of means from a macro-economic perspective? Would you see a risk of wrong incentives? Please specify, if observations/expectations refer to particular markets.

As expressed above, a prescriptive approach linked to a narrow definition will favour holding of government debt parallel to a reduction in availability of highly liquid assets, with adverse effect of lending capacity to decrease significantly while exposure on government bonds may have a macro economic impact. There is indeed a substantial risk of negative impact on the real economy of overly restrictive Liquidity Buffer requirements.

A side effect in as much detrimental as to the market than for cross-border firms' activity are the constitution of liquidity "trapped pools" by banks, a growing concern which may compromise the single market in Europe. Liquidity can also be trapped due to operational limits to timely pledge collateral to the appropriate Central Bank. Operational issues need to be brought to the forefront when discussing cross border pledge-ability. Settlements systems must be upgraded to enable a seamless access to cash and secure delivery. Therefore, if such pools are a management issue that financial institutions must deal with, we believe that there CEBS has a key role to play to undertake to minimise the fragmentation of regulation across the EU and smooth rules that may regulate liquidity in a more efficient way, and push for regulation that maximises the surety of settlements together with CESR.

Q3 How would you assess the reference to central bank eligibility for the purpose of specifying which assets should be eligible to the Liquidity Buffers?

Central Bank eligibility is not necessarily synonymous with liquidity in the market, under stressed conditions, for example for loans, ABS and self securitizations which Central Banks accepted as eligible assets in the past during the turmoil.

Nevertheless, for the other type of assets, as it is very difficult to forecast the market liquidity under a range of stressed conditions, banks will not have any other choice than using the "Central Bank eligibility" criteria as a benchmark for "Market liquidity" criteria. These eligible instruments should include bonds issued by central governments, Central Banks, Local and regional governments, Jumbo covered bonds, Agencies, Supranational counterparties, Traditionnal covered bonds, corporate and credit institutions.

The difficulty is to determine the objective criteria (counterparty rating, depth and breath of each specific market...) to forecast the market value under different stressed conditions and different horizons. CEBS is well aware of this problem to assess predictable values and relies upon the industry to move forward.

One lesson of the recent systemic crisis was that major European government bonds became illiquid on the market. Banks should improve their skills to better anticipate market value evolutions for their assets. In this respect BNP Paribas agrees with CEBS on diversification in Liquidity Buffer.

Central Banks play a key role for creating liquidity, but over reliance on such authorities may block the system. Therefore an alternative to a narrow definition would be to bring more flexibility and subjectivity on a case by case basis to consider other sources of assets that are not tagged as highly liquid assets, subject to CEBS definition.

A common definition of eligible collateral to the inter-bank lending market, in general and at least at euro zone level, would avoid severe competitive imbalance between firms by specifying also what facilities are permanent and what are not before to determine whether the universe of eligible securities is suitable. This means that Central Banks must clearly communicate on their policy in normal times and for periods of systemic stress as part of the liquidity support business plan, including specific asset features such as types of additional collateral that could be pledged, haircuts that could be applied, limits by asset type (if any), and the delivery form of such assets in stressed periods.

We are of the opinion that such procedures should be applied during stress periods but as part of the plans to liquidity market resilience such exceptional measures and conditions should not remain past the crisis is over. Then it is highly recommended that plans towards new market situation are operational and disclosed to the banking community. In that context, CEBS, as part of this new liquidity Buffer regime, should work towards these goals with relevant Central Banks. Banks need to have a clear understanding of central bank policies for normal operations and operations for systemic situations, but not only at local level but at global level, which pleads for an integrated global liquidity strategy at EU level to avoid fragmentation of regulation.

In addition, feedback on the general economic impact of the proposed Guidelines would be most appreciated.

Question A - How does the return on liquid assets compare to the return on less liquid assets? Do you anticipate a (significant) impact on ROE?

We anticipate that there will be no offset of yield between governments bonds (yield decreases) and other bonds in a bank's portfolio (yield increases), having a negative impact on the ROE. The size of Buffer and spread between funding costs and asset yield, which will increase the longer the liquidity Buffer needs to be funded for, will determine ROE as well. ROE decline will adversely affect the cost of capital much more expensive, with all the more acute impact occurring in the most difficult market situations. The pressure put on financial institutions with the leverage ratio will more likely exacerbate these effects, as firms will at the same time have to raise much more regulatory capital and be solicited by the market.

Bank margins will suffer at the same that their costs increase, retail and corporate (especially SMEs) customers will bear higher prices with higher costs for liquid assets (cash). As said before, demand for less liquid assets will decline with a little opportunity cost for non-eligible assets that will yield more if fewer assets are allowed.

Question B - Do you believe that CEBS proposals could lead you to restrict your lending capacity or increase the cost of financing for borrowers?

As each institution develops its own liquidity strategy the impact will result in different situation across firms, large cross border financial institutions will face a larger diversity of situations across jurisdictions. Liquidity Buffer requirements will probably generate three types of adjustments: an increase in the amount of the liquidity Buffer, an increase in medium term debt and a decrease in credit capacities, likely to trigger a credit crunch.

At the end user's level it will reduce the lending base in tightening conditions and impact the cost of doing business with clients as a result of increase in funding costs, as banks will pass on liquidity costs to their clients in the pricing. From a bank's perspective and in order to comply with regulatory levels of liquidity Buffers in larger portfolios for long terms it will reduce the customers' lending base thus impacting the real economy.

Question C - Do you foresee any impact of these proposals on your business models or activities? Do they present any level playing field issues with competitors other than credit institutions?

It is hard to analyze the full impact of these proposals on business activities because of the uncertainties about specifics of numerous other new supervisory and accounting requirements and guidelines currently being debated, but the direction of the impact is quite certain. Thus, it cannot be said whether the effects of combining the numerous different business restrictions will magnify the effect of just one. Business models may be influenced to some degree and first of all as a consequence of increased costs that are directed onto the structure.

Large cross-border firms will have to manage liquidity effectively at the group level but with the fragmentation of regulation must manage liquidity to local requirements and needs, and firms may organize their liquidity management on more centralized or more decentralised models depending on, amongst other, its business strategy.

Very likely any business that deals in illiquid assets (as defined by their eligibility for the Buffer) will need to alter its business plan and risk appetite to take into account the new requirements to hold more liquid securities, but the extent and the dimensions of that impact depend in part on interaction with capital, leverage, accounting and other requirements. There may also be knock-on effects on collateral policies and the like, which will needed to be added in.

These proposals will also affect loan business strategy if mitigation costs are appreciably higher than current liquidity risk management practices.

Time horizon for planning and managing survival periods depend on facts and circumstances, extending or not survival periods beyond the proposed timing should remain a management option at the hand of the institution in line with its overall liquidity policy and risk appetite for longer term survival.

Question D -Do you consider that these Guidelines can help to restore confidence in the interbank market, to improve funding costs?

As long as implementation is done in incremental steps and based on realistic analysis of the impact of these guidelines on the markets for all securities and the firms themselves, then confidence can be restored. However, if the proposals are implemented immediately without regard to banks' individual business models and funding profiles, and without a cumulative impact study with other regulatory and accounting changes, recovery will take more time. CEBS guidelines may likely contribute to jeopardize interbank markets : since interbank loans are not a "strategic" activity, they are likely to be arbitraged in favour of government bond portfolios and of loans to customers. In other words, confidence may come back, liquidity costs may improve, but interbank markets will be downsized again.

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