

Necessary improvements for liquidity risk regulation



This document was drafted by Eurofi with input from its members. It does not engage in any case the EU Polish Presidency or the Polish financial authorities.

Executive summary

The challenge for the Basel Committee on Banking Supervision (BCBS) is to put in place a common global liquidity risk regulatory and supervisory framework that sufficiently strengthens liquidity management practices, hence the liquidity of financial institutions and avoid that those practices would be driven by the moral hazard. The challenge is also to impose no unnecessary cost to the economy or competition distortions that may result from regulations being ill-suited to certain financial activities, or from piling-up effects.

The banking industry has generally welcomed the Basel Committee's objectives to define a Liquidity Coverage Ratio (LCR) allowing enhanced liquidity independence for financial institutions and a Net Stable Funding Ratio (NSFR), which is designed to promote resilience over a longer timeframe.

Some banking groups are broadly comfortable with the current proposals. However, many institutions have found that certain aspects of the liquidity framework still need further consideration.

Both regulatory demands, which rely on a single unlikely stress scenario encompassing unprecedented idiosyncratic and market-wide shocks, combined with a narrow definition of high-quality liquid assets, are unnecessarily stringent. Moreover, the proposed liquidity regulation imposes similar demands on institutions regardless of their specific risk profiles.

As such, the ratios envisaged would sterilise liquidity, require overfunding and significantly penalise maturity transformation. It is detrimental to EU banks in particular, since the framework is built regardless their typically reduced-risk lending activities. Indeed in other geographic areas such reduced-risk activities are mostly directly funded in the financial markets, while the higher-risk ones remain within the banking system.

This is likely to trigger deep changes in liquidity markets and lending activities: significant increase in the cost of resources, reduction in the maturity of loans, increase in the price of banks' long-term financing, reduction in lending activities that do not "attract" deposits, re-intermediation of deposits, etc...

More specifically, these changes would be troublesome for households, SMEs, local public entities or infrastructure projects, which do not have easy direct access to the financial markets. In the

Eurozone, Monetary and Financial Institutions (MFI) actually provide around € 19,500 billion of long-term financing, based on only € 8,700 billion of long-term resources.¹

Furthermore, to meet the Net Stable Financing Ratio (NSFR) requirements, European Monetary and Financial Institutions are expected to at least double their yearly long-term borrowings. Taking into account the needs of public infrastructures and green growth, this means that net primary bond issues are expected to exceed € 850 billion per year, compared with the current average of € 400 billion². This simply cannot be absorbed in market terms, without sharp increases in yields, crowding-out and credit crunch effects.

At the same time, the list of high-quality liquid assets, which the banks would be asked to hold to comply with the LCR, is based predominantly on sovereign debt, while it neglects the assets currently eligible as Central Bank collateral³. Given the sovereign debt crisis, there can be doubts over the legitimacy of such a preference. In addition, a definition of high-quality liquid assets that is too narrow and static may lead to banks holding them solely for liquidity-buffer purposes and fire-selling them in times of liquidity stress, further increasing systemic illiquidity. This narrow definition, is particularly detrimental for retail finance activities, which will be required to park liquid assets in addition to the customers' loans although they are eligible to the Central Bank,

"The fates of Northern Rock, Bear Sterns and Lehman were clearly affected by the nature of their funding. But the ultimate concern was about the quality of their assets. The funding problems were symptomatic of concerns about asset quality", stated Guy Debelle, Assistant Governor of the Reserve Bank of Australia, recently.

Indeed, the crisis has revealed that, in the absence of global common liquidity regulation, the supervision of liquidity risks by supervisors and the liquidity management practices of banks sometimes proved to be unsatisfactory or risky. However, one can learn from the crisis that in the context of an excessive liquidity and therefore scarce attractive investment-opportunities, which increased the appetite for risk, the opacity and complexity of products, institutions and markets left room for an unprecedented moral hazard that in turn backfired, to the detriment of its primary beneficiaries. The backfire took the (usual) form of uncertainty and distrust, and therefore unprecedented illiquidity.

The financial crisis also underlines that Central Banks can provide liquidity with an acceptable level of risk and therefore without a significant increase of moral hazard in the financial system.

1. Q2 2010 ECB data computed by SG and BNP Paribas.

2. 1999 - 2010 average. ECB, IMF and BNPP data computed by SG and BNP Paribas.

3. Are eligible as collateral in Europe (ECB) - under the condition that the debtor/guarantor meets high credit standards: -> Marketable assets e. g. ECB debt certificates, central government debt instruments, debt instruments issued by central banks, local and regional government debt instruments, supranational debt instruments, covered bank bonds, credit institutions' debt instruments, debt instruments issued by corporate and other issuers, asset-backed securities - > Two types of non-marketable assets: credit claims and non-marketable retail mortgage-backed debt instruments (RMBDs).

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Lastly, the crisis emphasises the compelling need for a tougher supervisory framework, with common specific guidelines at international level. This is even more important for global banks. In addition, it would be desirable for the US and Europe to converge for the implementation of these ratios and the guidance and supervisory role on this issue.

In such a context, sound systemic liquidity requires above all continuous information to be provided concerning the resilience of the financial system, e.g. financial products, markets and institutions, while adapting risk assessment-tools, permanently reducing information asymmetries. Within this framework, Macro Supervisors should constantly test the actual transparency of financial products and markets. They should also identify emerging risks, paying particular attention to the most innovative financial practices to detect possible sources of risks implying potential loss of confidence and liquidity stresses.

Moreover, experience also suggests that liquidity regulations should not consider maturity transformation in particular as risky per se. This would be avoided if the regulation were risk-sensitive, i.e. adapted to institutions' risk profiles, which should be assessed based on the actual risk diversification, their exposure to financial innovation and emerging risks, their specific maturity transformation policies, their liquidity arrangements and the complexity and transparency of their organisation.

As a consequence, the liquidity requirements currently being proposed should just be considered as a by-default set of liquidity benchmarks. This leads to Micro Supervisors being relied on more intensively to adjust the liquidity requirements taking into account the dynamic nature of liquidity. This requires in addition the cautious surveillance from BCBS to achieve both appropriate adaptations and to avoid unlevel playing field.

A more granular and adaptable liquidity framework needs to be proposed urgently, encompassing better conceived benchmark ratios, an effective risk-sensitive liquidity framework and strong supervisor intervention under a Pillar 2 approach. But the observation period set out in the Basel III regulatory framework provides limited leeway⁴.

In this context, legislators, particularly in Europe during the legislative process to adopt the Capital Requirement Directive IV (CRD IV) should rapidly undertake to work alongside one another to:

► **Define the role of Central Banks as lender of last resort in the event of systemic liquidity stresses**

During the crisis Central Banks demonstrated their capability to provided amazing amounts of liquidity. Recently in August 2011 in a hearing in the EU parliament J. -C. Trichet reminded that there were no liquidity shortage for eurozone banks as the ECB refinancing of the financial system was amounting to €530 billion while the total amount of marketable eligible securities was around € 14,000 billion.

In this context a sufficient level of Central Bank intervention in the case of systemic liquidity stress should be allowed and be part of the general liquidity risk regulation framework.

With this in mind, liquidity provision arrangements should be harmonised among Central Banks, and the role of Central Banks within the liquidity framework should become explicit. As a result, Banks should be asked to diversify their liquid assets in keeping with the Central Banks' liquidity practices.

► **Adjust the calibration of the proposed ratios that should be considered as a by-default benchmark for liquidity requirements:**

Taking national and regional specificities into consideration and also experience-based hypothesis, the current proposed liquidity framework needs in particular to

- Take into account the operational management and contractual commitments between the entities within financial groups
- Significantly review the list of "high-quality liquid assets" in order to include eligible assets for Central Bank liquidity provision mechanisms in particular
- Reduce demand for stable funding relating to loans, especially to those retail customers maturing in less than one year,
- Increase the "availability factor" as a stable resource of stable deposits (the availability factor is currently 85%)
- Reduce the expected outflow rate of corporate deposits, currently set at 75%
- Reduce the run-off of 10% for committed credit facilities to non-financial institutions, sovereigns and central banks, public sector entities and multilateral banks, and the 5% for retail and small business customers in the NSFR. Empirical evidence during the crisis does not support these numbers: observed run-off are about half of those proposed in the regulation.
- Reduce the expected outflow rate of stable retail deposits, currently set at 5% or 10% etc...

► **Put in place the relevant working process to define an effective risk-sensitive liquidity framework and give the necessary room for manoeuvre to supervisors.**

The objective is to propose a set of

- Complementary "standard stress tests" adapted to diverse "standard business model" seeking more specifically an appropriate approach for maturity transformation,

4. The two liquidity ratios are expected to come into force on be enforced in 1 January 1, 2015 (LCR), and 1 January 1, 2018 (NSFR)

- Principles to adapt and combine such standard stress tests for a financial group, based on
 - Relevant domestic specificities;
 - Possible technical deficiencies of the risk weighting techniques and available data specific to each type of asset;
 - Risk diversification of institutions and their exposure to financial innovation, opaque products or markets, and more generally emerging risks (asset bubbles, deteriorating sovereign risk, etc.);
 - Complexity and transparency of a financial group's organisation and its liquidity risk mitigation arrangements (risk firewalls, diversification of available assets, diversity of sources of liquidity, liquidity management practices, etc.);

- Demonstrated reliability of internal risk assessments and the related disclosures provided to public banking authorities (Central Banks and Supervisors), and of those given to other banks or economic agents.

➤ **Propose an international and regional working process to:**

- Allow the international liquidity framework to be constantly adapted to local financial and economic conditions
- Ensure appropriate cooperation arrangements between supervisors at international level, fostering mutual trust through peer reviews and reinforcing the international level playing field.

Necessary improvements for liquidity risk regulation

Introduction

Basel III is intended to address the liquidity shortcomings revealed by the crisis. The internationally harmonised liquidity framework being considered consists of two minimum regulatory standards: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). Their objectives complement one another.

The LCR is designed to bolster the short-term resilience of a bank's liquidity risk profile by ensuring that it has high-quality liquid assets in sufficient quantity to survive a plausibly severe stress scenario lasting for 30 calendar days. The stress scenario, defined by the Basel Committee, incorporates many of the shocks experienced during the crisis and considers that they will all take place simultaneously. It includes a partial run-off of retail deposits, a partial or complete drying-up of wholesale funding sources, a need to post additional collateral due to a credit rating downgrade, and unscheduled drawdowns on unused credit and liquidity facilities. The NSFR is designed to promote resilience over a longer timeframe by creating additional incentives for banks to use more stable sources of funding on an ongoing basis.

These proposals could have severe unintended consequences:

The transformation mechanism, which fuels long-term productive investments and modern economies by compensating for the limits of long-term savings on the basis of short-term savings, would be jeopardised. This is particularly true in Europe, where three quarters of corporate financing comes from the banks, while this situation is reversed in the US, where the financial markets have a predominant role.

The race to de-intermediated long-term funding would be such that the markets would not be enough, with significant interest rate rises and crowding out phenomena therefore expected. In this way, price distortions for a broad range of assets represent one undesirable expected outcome. At the same time, the race to deposits will concentrate moral hazard within the banking sector and further increase the cost and volatility of their funding.

Excessive restrictions on admitted marketable instruments are extremely dangerous. Are we sure that focusing exclusively on Treasury bonds is the right option? When we look at current sovereign debt issues, there are grounds for some doubts.

The proposed liquidity regulation is underpinned by a systematic application of a common-sense observation which states that, all things being equal, a bank that perfectly matches asset and liability maturities, that is invested mainly in securities and that holds comfortable cushions of "high-quality liquid assets" faces a limited liquidity risk.

However, to avoid the numerous unintended consequences, the proposed framework should allow an effective adaptation to local financial and economic specificities and be up to the challenge, which is not to overestimate the liquidity risk of various time and field-proven business models, even though they come up with traditional non-marketable loans on the basis of citizen deposits. Indeed, these business models involve neither an unaffordable moral hazard nor an acute liquidity risk.

Overall, a simple set of "one size fits all" arithmetic rules (LCR and NSFR) is not the right answer. Banks present different liquidity risks depending on the countries where they operate, their business models, the proportion of deposits in their funding, the quality and diversity of their assets and funding sources, as well as their legal structure, the specificities of their arrangements to cover liquidity risks, the appropriateness and transparency of the information

concerning their solvency provided to the markets and funding counterparties, etc...

This paper therefore suggests an in-depth review of the key principles underpinning the proposed ratios, under proper international supervision and guidance (FSB, etc.), to rely more extensively on supervisors to determine the liquidity requirements of each specific bank. In this context, regulators should not consider LCR and NSFR as a minimum ratio, but rather a by-default benchmark.

In addition, experience over the past few years has shown that liquidity crises can arise because of sudden uncertainties, and that the supervisors have a duty to look through the assets and markets in order to foresee such a possible uncertainties, while the Central Bank should be prepared to lend against high-quality assets if necessary. Central Banks should be prepared and committed to perform their "lender of last resort" role and lend to solvent but temporarily illiquid banks.

I. Issues and negative consequences of the proposed liquidity risk regulatory framework, as anticipated by the financial industry

The challenge for the BCBS to put in place a common global liquidity risk regulatory and supervisory framework that sufficiently strengthens the liquidity of financial institutions and avoid that liquidity management practices would be subject to moral hazard. The challenge is also to impose no unnecessary costs for the economy and competition distortions that may result from regulations, ill suited to certain financial activities or piling-up effects.

The banking industry in general has welcomed the Basel III proposals to define a liquidity risk coverage allowing for a "liquidity autarky period" and providing structural liquidity resilience.

Some banking groups are broadly comfortable with the current proposals. However, many institutions have found that certain aspects of the liquidity framework still need further consideration.

The different issues or negative consequences as anticipated by the financial industry in relation to the proposed regulation are as follows:

► NSFR: a clear penalisation of maturity transformation and longer-term intermediated financing, to the detriment of the EU economy's financing mechanisms in particular.

The NSFR states that the funding maturing over one year must exceed the assets maturing over one year, and sets a list of Required Stable Funding Factors, defining the "long term weighting" for each item on the banks' balance sheets.

However currently, it is not possible to comply with the proposed **Net Stable Funding Ratio (NSFR)** even with asset and liability maturities that match perfectly. In fact, the envisaged long-term ratio destroys liquidity and requires over-funding. Moreover, the proposed ratio significantly penalises maturity transformation. Indeed, according to NSFR's definition of the long term weighting of stable deposits, these count as stable funding for only 85%.

As a result, the proposed ratio favours a reduction in the maturity of loans and increases lending costs. Moreover, this ratio, which gives preference to bonds and securities against loans, achieves a paradoxical outcome, jeopardising the banking sector's loan activity. More specifically, this is detrimental to the EU's mainly intermediated financial mechanisms, despite the typically reduced-risk lending activities of EU banks, especially in retail markets⁵. Such a limitation would be particularly troublesome for SMEs, which do not have easy direct access to the financial markets⁶. Moreover, Banks are going to be deterred from keeping on their books long-term assets that are indispensable for financing infrastructures, improving productivity and meeting the new challenges raised by green growth.

This would happen in a context such as the eurozone, where long-term financing needs exceed long-term resources by around €7,500 billion and where financial institutions currently provide around €19,500 billion of long-term financing, based on only €8,700 billion of long-term resources.⁷

► LCR: an increased importance of deposits as a source of short-term liquidity and a too restrictive list of "high-quality" liquid-assets may have unintended consequences.

The Liquidity Coverage Ratio evaluates the next 30-day net financial outflow of a financial institution, which is supposed to be covered by available "high-quality liquid assets", in the event of a stressed situation, which is expected to reduce or increase the actual expected inflows and outflows. For example, 5% to 10% of stable retail deposits are supposed to run away, while 75% of the deposits of corporates

5. As reported in the EBF letter to the Director General of the European Commission - May 16, 2011: "Business specificities must be taken into account. It needs to be taken into account that the impact which the implementation of Basel III will have on the European economy, because of the business models of EU banks, will increase the uneven level playing field with other jurisdictions, in which different banking business models dominate, such as investment banks in the USA".
6. This unlevel treatment is also illustrated by the calculation of NSFRs, where loans to companies and individuals with maturities exceeding one year are subject to a required stable funding factor (RSF) of 100%, while corporate bonds with the same maturity that are over the NSFR's measurement period as liquid as a loans, require only a 20% to 50% RSF.
7. Q2 2010 ECB data computed by SG and BNP Paribas.

expected to evaporate. At the same time, only 75% of expected inflows are accounted for.

The proposed list of high-quality liquid assets demanded in order to enhance the liquidity independence of financial institutions and provide structural resilience relies predominantly on sovereign debt, while it neglects the assets currently eligible as Central Bank collateral. Such a definition is objectionable: while Banks should mainly hold Treasury investments, equities or corporate bonds with good ratings are not eligible. Given the sovereign debt crisis, there can be doubts about the legitimacy of such a preference.

The restrictive definition – under the LCR - of high-quality liquid assets would reduce the availability – and increase the price – of credit for non-sovereign economic players, i.e. corporates and consumers. The too narrow and static definition of high-quality liquid assets may also lead to banks holding assets solely for liquidity-buffer purposes, actually reducing their current liquidity. Indeed, during a systemic crisis, such assets would eventually be fire-sold, as all banks would be trying to liquidate them, further increasing systemic illiquidity.

In addition, the LCR puts a particular emphasis on deposits. This is likely to trigger deep changes in liquidity markets: e.g. re-intermediation of deposits, to the detriment of money market funds, even though they diversify liquidity sources and stimulate market discipline and transparency from the banks. In this context, the proposed regulation also gives unintended incentives for Banks to reduce their financing for certain economic agents - e.g. local public authorities, corporates - when they do not bring⁸ them (stable) deposits.

► **LCR: the unrealistic and non risk-sensitive assumptions, which back the stress scenario, impose excessive and uniform liquidity demands.**

The scenario on which the LCR is currently based is considered to be highly unlikely. Indeed, it compounds a series of very severe idiosyncratic and systemic shocks, which did not materialise even at the height of the 2008 financial crisis.

There is no evidence that the various stress situations included in the scenario would take place simultaneously. Moreover, the proposed scenario rules out any possibility for financial institutions and Central Banks to react⁹ to the shock, which is simply unrealistic. Neither is there any evidence that the scenario would have a similar impact on the diverse financial institutions, whatever their business model, portfolio mix, legal structure, etc.

► **LCR: the asymmetric treatment of interbank debt could also lead to more fragmentation and less resilience for the international banking system in terms of local liquidity stress situations.**

With the stress scenario underpinning the LCR, 100% of the liquidity facilities granted by a bank to other financial institutions are supposed to be withdrawn, while only 75% of the liquidity facilities benefiting the bank are expected to be available.

Such a regulatory constraint does not take into account operational practices and contractual commitments between the various entities of a financial group and, more generally, immobilises liquidity pools, which normally should be involved in the money market.

► **LCR: the specificities of domestic markets also have material impacts on liquidity, which are not covered by a single ratio.**

Eligible liquid assets may be very scarce resources in certain countries, reflecting either the absence of highly rated debt or conversely the absence of a sufficient amount of available public debt (oil producing countries in the Gulf). The volatility of retail deposits can also vary significantly from market to market, depending on the level of maturity and the historical experience of local banking systems. This can make the Basel III retail deposit outflow assumption too lenient in certain cases (e.g. in a country like Russia for most banks). The 75% corporate deposit outflow assumption can also appear unmanageable in many emerging markets, where corporate deposits tend to account for the majority of funding sources. On top of that, “corporate” deposits may be stable. In regions like the Gulf, a significant proportion of bank deposits come from large corporates, which, like the banking systems, are often government-related and have proven stable throughout the past crisis. Another example of regional specificities concerns countries with foreign exchange controls, such as South Africa, where liquidity cannot suddenly leave the overall domestic banking system in a period of systemic stress.

► **NSFR and LCR are mainly designed for developed markets.**

The specificities of emerging markets are not properly addressed. Indeed, the Basel III ratios could lead many emerging market banks to increase their reliance on foreign financial markets. Indeed, without sufficiently large domestic financial markets to issue debt, many banks, which are currently entirely deposit and equity funded, would have to raise foreign long-term funding to meet the ratio requirements.

8. In particular, the proposed LCR stress scenario limits to 75% the positive contribution of corporate deposits, which are considered as significantly volatile.
9. As reported in Basel III: International framework for liquidity risk measurement, standards and monitoring. The Basel Committee on Banking Supervision – December 2010. For the LCR, the stress scenario specified incorporates many of the shocks experienced during the crisis that started in 2007 into one significant stress scenario for which a bank would need sufficient liquidity on hand to survive for up to 30 calendar days. For the NSFR, the standard aims to ensure stable funding on an ongoing and viable entity basis, over one year in an extended firm-specific stress scenario where a bank encounters, investors and customers become aware of: “a significant decline in profitability or solvency arising from heightened credit risk, market risk or operational risk and/or other risk exposures; a potential downgrade in a debt, counterparty credit or deposit rating by any nationally recognised credit rating organisation; and/or a material event that calls into question the reputation or credit quality of the institution.

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► Disclosure policy should prevent negative interplay with financial markets

Additional information should be reported to the market, particularly by enhancing the current bank Pillar 3 disclosures. However liquidity risk information must be accurate and well balanced otherwise it may negatively influence liquidity dynamics. Indeed, inappropriate information on liquidity risk could be miss leading and negatively interplay with financial markets, possibly creating additional volatility at some point in time and accelerating a liquidity crisis.

► The “observation period” within the timetable leading to the implementation of the framework is inappropriately considered as a transitional phase.

The observation period specified in the Basel III regulatory framework is limited and will be conducted during a too particular period (stressed liquidity conditions in Europe, excessive liquidity coming from Central Banks, particularly in the US, etc.). It would not allow the authorities and financial institutions to precisely monitor the actual impact¹⁰ of the regulations and adjust or fine-tune them before their introduction, which is expected for January 1, 2015, and the NSFR, expected for January 1, 2018¹¹.

Indeed, to meet the Net Stable Financing Ratio (NSFR) requirements, European Monetary and Financial Institutions (MFI) are expected to at least double their yearly long-term borrowings. Taking into account the needs of public infrastructures and green growth, this means that net primary bond issues are expected to exceed €850 billion each year, compared with the current average of €400 billion¹². This simply cannot be absorbed in market terms without sharp increases in yields, crowding-out and credit crunch effects. Regulators should carefully evaluate the monetary, financial and economic consequences of such measures.

Lastly, banks have insufficient time to implement the required IT work at a time when the entire industry is focused on the implementation of Basel III¹³ as a whole.

► Conclusion: combining common sense principles and relevant adaptability

The proposed liquidity regulation reveals a systematic application of a common-sense observation which states that, all things being equal, a bank that perfectly matches asset and liability maturities, that is invested mainly in securities and that holds comfortable cushions of “high-quality liquid assets” faces a limited liquidity risk.

However, to avoid numerous unintended consequences, the proposed framework should be up to the challenge, which is to appropriately depict and mitigate the liquidity risk of various time and field-proven business models, even though they come up with traditional non-marketable loans on the basis of citizen deposits. Indeed, these business models raise neither an unaffordable moral hazard nor an acute liquidity risk. The regulations should also allow for an effective adaptation to local financial and economic specificities.

II. Possible ways forward

In addition to a necessary short-term adjustment of the two proposed ratios, e.g. the list of liquid assets and a general reassessment of the stress scenarios, a sound liquidity framework needs to become risk-sensitive, i.e. adapted to institutions’ risk profiles, and closely involve micro supervisors. It should also be adjustable in line with local specificities.

As such, the liquidity requirements currently being proposed should be considered as a set of liquidity benchmarks. Moreover the proposed liquidity regulations should better factor in the role of the Central Banks.

Lastly, achieving sound systemic liquidity requires continuous information to be provided concerning the resilience of the financial system, e.g. financial products, markets and institutions.

10. As reported in the speech of M. Barnier, Internal Market Commissioner, on June 8, 2011: “The European Union is considering testing bank liquidity, but separately from a new round of stress tests. The EU’s new bank regulators are proposing that liquidity might be tested in parallel to EU-wide bank stress tests. The European Commission is considering this option, because the issue of including liquidity in the stress tests is sensitive”.

11. As reported in the EBF letter to the Director General of the European Commission - May 16, 2011: “It seems that supervisory authorities appear to consider the Liquidity Coverage Ratio (LCR) observation period as a mere transitory phase on the path to its adoption by the industry at the beginning of 2015. However such an attitude minimizes the relevance of the observation phase and is likely to trigger market expectations to abide by the LCR before its design is finalized. The observation period must be used to ensure that the design of the LCR is optimized by collecting further empirical evidence on the behavior of possible components of the liquidity buffer. The industry is keen to assist in the process of designing an effective and meaningful pan-European LCR reporting template to provide the information that supervisors will need in order to evaluate the need for changes to the calibration and design of the LCR. Reporting to regulators is due to start in January 2012”.

12. 1999 - 2010 average based on ECB, IMF and BNPP data computed by SG and BNP Paribas.

13. As reported in the EBF letter to the Director General of the European Commission - 16 May 2011: “Banks will need a minimum of one year to prepare for implementation after the text of the new rules has been published. Therefore if the legislative process is not, as initially scheduled, completed by the end of 2011, consideration should be given as to adjusting the ultimate implementation dates as it is imperative that banks are provided with sufficient time to adapt to and implement the adopted texts”.

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► Regulations mitigating liquidity risks should be risk-sensitive i.e. adapted to institutions' risk profile and organisation, adaptable to countries' specificities and closely involving micro supervisors. As such, the liquidity requirements currently proposed should be considered as a general by-default liquidity benchmark. This requires strong involvement of supervisors and cautious surveillance from BCBS to achieve both appropriate adaptations and to avoid unlevel playing field.

The single common liquidity ratios should not prevent financial institutions from adjusting liquidity requirements to their specific risk profiles. Moreover maturity transformation should not be considered as risky per se, since the maturity transformation practices performed by traditional banks have proven their resilience during the crisis and should not be discouraged as they optimise the financial-resources allocation to the economy.

Indeed, maturity mismatches expose financial institutions to possible refinancing dry-up and deposit runs, as far as the institution is actually faced with interest rate risks, counterparty risks and more generally any of the specific asset portfolio risks. Illiquidity results from risk becoming likely or material. During the financial crisis, liquidity did not disappear (consider the size of Central Bank liabilities), but has been withdrawn from financial and interbank markets (see the appendix I - **Lessons from the financial crisis**).

In this context, the various stress reductions or increases weighting the financial flows to set the LCR, and the contribution of the different sources and uses of stable funding to the valuation of the NSFR - including the expected stability of consumer or corporate deposits and the proportion of stable funding demanded for corporate and retail loans - should be modulated based on:

- a. Relevant specific domestic features;
- b. Possible technical deficiencies of the risk weighting techniques and available data specific to each type of asset;
- c. Risk diversification of institutions and their exposure to financial innovation, opaque products or markets, and emerging risks (asset bubbles, deteriorating sovereign risk, etc.);
- d. Complexity and transparency of a financial group's organisation and its liquidity arrangements (diversification of available assets, diversity of sources of liquidity, liquidity management practices, etc...);
- e. Demonstrated reliability of the internal liquidity risk assessments and related risk disclosures provided to public banking authorities (Central Banks and Supervisors), and of

those to other banks or economic agents, which minimise the possible negative effects of information-asymmetry. etc...

The difficulty involved in setting a relevant single general liquidity ratio on an ex nihilo basis in line with the specificities of each financial institution and the countries where it operates inevitably leads to more reliance on Micro Supervisors, coordinating their methodologies and demands for the liquidity risk more effectively and making them consistent.

The role of Supervisors in the area of liquidity risk should be similar to the one they already perform for validating internal ratings and risk assessment techniques with the Basel II framework. Indeed, Supervisors should validate and ensure timely adjustments to internal models linking the liquidity risk factors outlined above, and domestic financial system specificities, to the stress scenario adopted by the financial institution and on this basis determine related firm-specific liquidity requirements. Supervisors should also take into account financial institutions' disclosure practices, since their accuracy, completeness, reliability and transparency further strengthen their credibility. This supposes that a permanent attention (peer reviews) will be paid to avoid possible unlevel playing field resulting from inappropriate liquidity demands adaptations.

Lastly, it would be appropriate to incorporate the assessment of the liquidity risks a bank is exposed to and the appropriateness of the mitigation techniques that may help to lower regulatory requirements into the existing framework for the Internal Capital Adequacy Assessment Process (ICAAP), which ensures that the firm's material risks are understood by its board and that there is sufficient and appropriate risk management.

► The proposed liquidity regulation should better factor in the role of the Central Banks.

During the crisis Central Banks demonstrated their capability to provide amazing amounts of liquidity. Recently in August 2011 in a hearing in the EU parliament J. -C. Trichet reminded that even though the balance sheet of ECB had increased of 77% since the 2007, the refinancing of the financial system was amounting €530 billion while the total amount of eligible assets was around €14,000 billion.

The crisis also demonstrated that the so-called unconventional liquidity arrangements provided by Central Banks brought about limited moral hazard (see the appendix I - **Lessons from the financial crisis**). **As a result, a sufficient level of intervention by the Central Banks in the event of a systemic liquidity stress should be admitted**, and should be part of the general liquidity risk regulation framework¹⁴. In this context:

14. It seems crucial to align eligibility criteria with those of Central Banks. They have to be large enough to contain not only a few types of assets. It is without doubt that banks liquidity management should not excessively rely on Central Bank provision of liquidity, however the rule of disregarding extended borrowing from Central Bank facilities is too rigid. Some level of intervention in severe systemic stresses would be reasonable to expect.

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- **Liquidity provision arrangements should be sufficiently harmonised among Central Banks, and the role of Central Banks within the liquidity framework should become explicit.** More specifically, this level of intervention should be integrated into the regulatory stress scenario that determines the size of liquidity buffers;

- **Banks should be asked to diversify their liquid assets in keeping with the Central Bank's liquidity practices.** This may make it possible to avoid any undue concentration on a particular asset or market, which was one of the shortfalls outlined during the actual sovereign debt crisis. Instead, national regulators should have the flexibility to constantly reconsider the merits of each asset, which may change rapidly, on a dynamic and shared basis with the financial industry. More specifically, the possibility for a bank to obtain liquidity on the basis of high-quality customer (long-term) loan portfolios should be better reflected in the NSFR ratio, which mainly encourages securitising and penalises loans at present.

Lastly, the appropriate diversification of liquidity sources requires the role of Money Market Funds and Financial Institution liquidity facilities to be balanced in relation to the role of deposits.

► **Sound systemic liquidity requires the resilience of the financial system to be constantly enhanced and information provided, e.g. financial products, markets and institutions.**

This should be achieved firstly on the basis of:

Adaptive risk assessment-tools allowing for early adjustments of capital charges to actual assets and business risks;

Permanent reduction of information asymmetries alongside the financial value chain regarding the risks embedded in products, markets and institutions (e.g. sufficient transparency, appropriate consumer protection, reduced conflicts of interest in the financial value chain, etc.);

Regular information provided by institutions and markets to supervisors on their risk-profile (e.g. markets: resilience of market participants, soundness of practices, etc.; products: the quality and accessibility of the information required to assess risks and prices, etc.; institutions: risk profiles, risk diversification, exposure to innovative financial products, etc.).

Regular communication from supervisors on the resilience of financial institutions, markets and products. The information and communication policy should include general stress tests that verify ex ante the sensitivity of the financial sector's various components to emerging threats. At the same time, supervisors' disclosure policies regarding liquidity arrangements should seek effective comparability and clarity, which makes it necessary to take into account financial institutions' specificities (business models, asset portfolio, legal structure, etc.) and domestic specificities (soundness of sovereign debt markets, predictability of depositor behaviours in relation to their banking system, etc.)

In such a context, Macro Supervisors should constantly test the actual transparency of financial products and markets. They should also identify emerging risks, paying particular attention to the most innovative financial practices. They should have the possibility to trigger early relevant stress tests, enabling them to provide market participants and investors with adequate and timely information on institutions' solvency and liquidity.

III. Next steps

A more granular and adaptable liquidity framework needs to be proposed urgently, encompassing better conceived benchmark ratios, reliable internal liquidity models and strong supervisor intervention under a Pillar 2 approach.

In this context, legislators, particularly in Europe during the legislative process to adopt the Capital Requirement Directive IV (CRD IV), should rapidly undertake to work alongside one another:

► **Adjusting the calibration of the proposed ratios that should be considered as a by-default benchmark for liquidity requirements:**

Taking national and regional specificities into consideration and also experience-based hypothesis, the current proposed liquidity framework needs in particular to

- Take into account the operational management and contractual commitments between the entities within financial groups
- Significantly review the list of "high-quality liquid assets" in order to include eligible assets for Central Bank liquidity provision mechanisms in particular
- Reduce demand for stable funding relating to loans, especially to those retail customers maturing in less than one year,
- Increase the "availability factor" as a stable resource of stable deposits (the availability factor is currently 85%)
- Reduce the expected outflow rate of corporate deposits, currently set at 75%
- Reduce the run-off of 10% for committed credit facilities to non-financial institutions, sovereigns and central banks, public sector entities and multilateral banks, and the 5% for retail and small business customers in the NSFR. Empirical evidence during the crisis does not support these numbers: observed run-off are about half of those proposed in the regulation.
- Reduce the expected outflow rate of stable retail deposits, currently set at 5% or 10% etc...

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Taking into account national and regional specificities. Such a review should rapidly reduce any unnecessary penalisation of long-term financing and maturity transformation

➤ **Defining the Central Banks' lender of last resort role in the event of systemic liquidity stresses**

➤ **Putting in place an effective risk-sensitive liquidity framework, proposing a set of**

- Complementary “standard stress tests” adapted to diverse “standard business model” seeking more specifically an appropriate approach for maturity transformation,
- Principles to adapt and combine them for a financial group, based on
 - Relevant domestic specificities;
 - Possible technical deficiencies of the risk weighting techniques and data specific to each type of asset;
 - Risk diversification of institutions and their exposure to financial innovation, opaque products or markets, and more generally emerging risks (asset bubbles, deteriorating sovereign risk, etc.);
 - Complexity and transparency of a financial group’s organisation and its liquidity risk mitigation arrangements (risk firewalls, diversification of available assets, diversity of sources of liquidity, liquidity management practices, etc.);
 - Demonstrated reliability of internal risk assessments and the related disclosures provided to other banks, public banking authorities (Central Banks and Supervisors), and economic agents etc...

➤ **Proposing an international and regional working process to:**

- Allow the international liquidity framework to be constantly adapted to local financial and economic conditions
- Ensure appropriate cooperation arrangements between supervisors at international level, fostering mutual trust through peer reviews and reinforcing the international level playing field.

Appendix 1

Lessons from the financial crisis

Causes and consequences of an unprecedented liquidity dry-up

“The fates of Northern Rock, Bear Sterns and Lehman were clearly affected by the nature of their funding. But the ultimate concern was about the quality of their assets. The funding problems were symptomatic of concerns about asset quality”¹⁵.

► **Excessive complexity and opacity of financial products and markets led to a major confidence crisis.**

In early 2007 (as forecast by many economists and the FED), the real estate market bubble burst in the USA. It triggered a general depreciation of related securitised financial assets and in particular those based on subprime mortgages.

The general complexity and opacity of Asset Backed Securities (ABS) prevented investors and traders from clearly identifying which of them were holding distressed mortgages, triggering widespread distrust of these securities, which translated into a sharp drop in their prices and exchanges. Similarly, the opacity of the financial players originating, holding and trading these securities accentuated the contagion process as badly informed investors increasingly questioned their creditworthiness. Widespread lax risk-assessment practices within both banks and investors, accentuated this negative dynamic. Lastly, the opacity of OTC derivative markets contributed towards magnifying the exposure of financial institutions to the most distressed ones.

As a result, not only did all ABS - origination and trading - stop representing an important source of liquidity, but in the context of widespread uncertainty over the creditworthiness of banks and their positions on financial assets, the other liquidity sources for financial institutions (deposits, commercial paper and interbank markets) also dried up rapidly.

In turn, while certain banks with too limited liquidity sources required an early bailout by public authorities, in most European countries and in the United States, all the banks, irrespective of their actual creditworthiness, needed extended public deposit-guaranties, and “unconventional” liquidity provisions from the Central Banks.

Over time, the cash flows actually paid by the different asset-backed securities have stabilised their prices at an appropriate level, while repeated stress tests would eventually reassure investors and counterparties within money markets.

From this description of the crisis, one can learn that in a general context of lax risk-assessment practices, information asymmetries on products, institutions and markets, between financial intermediaries and investors or counterparties left room for an unprecedented moral hazard that in turn backfired, to the detriment to those primarily benefiting from it. The backfire took the (usual) form of uncertainty and distrust, and thus the unprecedented illiquidity that destabilised all financial institutions whatever the size of their pool of liquid assets. It required outstanding intervention by governments that set up wide guarantee schemes and by Central Banks that re-intermediated large parts of market exchanges.

► **Insufficient liquidity risk analysis, hence liquidity risks mitigation regulations and practices contributed to the crisis spreading.**

The crisis also revealed that, in the absence of global common liquidity regulation, the supervision of liquidity risks by Supervisors and the liquidity management practices of banks proved sometimes to be unsatisfactory or risky. This also contributed towards increasing financial system weaknesses; as demonstrated by some spectacular rescues, including the case of Northern Rock (see Box 3 The Northern Rock case and a comparison with the Hong Kong one).

This situation suggests that each financial institution should hold sufficient liquid assets to survive until extraordinary liquidity sources are set up and to provide public authorities with more “room to manoeuvre”.

► **Central Banks' privileged access to information on the quality of banks' financial assets allowed them to provide banks with liquidity without a significant moral hazard.**

The financial crisis also underlined the peculiar position of Central Banks. Indeed, they can positively take advantage of their privileged access to information, particularly during times of trouble regarding asset quality and financial institution exposure in the various financial markets.

This position made it possible for many Central Banks during the liquidity crisis to roll out “unconventional” policies encompassing “Special Liquidity Schemes” and “Asset Purchase Facilities”. Indeed, they were able to overcome the general mistrust concerning bank solvency and provide banks with liquidity on the basis of the high-quality assets that financial institutions were holding en masse, looking beyond any distressed assets, even though the corresponding financial markets were sometimes illiquid at the time since participants and investors were no longer behaving rationally.

This access to information allowed them to provide liquidity with an acceptable level of risk and therefore without a significant increase of moral hazard in the financial system.

15. Collateral, funding and liquidity, Guy Debelle, Assistant Governor, Reserve Bank of Australia, June 2011

Appendix 2

Solvency and liquidity interplay Northern Rock and Hong Kong case studies

In the wake of the unfolding subprime crisis, the UK bank Northern Rock experienced increasing funding problems in rolling over its short-term debt. This situation eventually created a run on its deposits that only ended when the UK authorities pledged a 100% deposit guarantee and the Bank of England extended unlimited liquidity facilities.

Why were such funding difficulties seen? Usually analysts – appropriately – point out that Northern Rock's funding policy was over-reliant on short-term financing sources (e.g. retail deposits but mainly wholesale) that dried up rapidly in 2007. But why did short-term investors suddenly become reluctant to finance the successful Northern Rock bank? Some¹⁶ assume that not only were investors increasingly reluctant to invest in mortgage-related financial papers, but also the actual solvency of Northern Rock was in question. Indeed, at that time, the rise in its refinancing spreads was expected to rapidly erode the bank's scarce capital. The business model based on short-term low-rate funding and limited capital, which allowed, in the favourable times of lax monetary policies, aggressive commercial practices (asset size expanded by 30% over one year) and high returns on equity, proved inappropriate to cope with a more restrictive monetary policy. Questionable assets and liabilities management practices have led Northern Rock to a dubious solvency. Unfortunately the size of the normal liquidity needs of financial institutions is so large that for any of them mistrust rapidly equals total paralysis.

Currently, the Hong Kong financial authorities are concerned that their domestic banks could face a similar situation. In a context when Chinese financial authorities were restricting access to credit, Hong Kong banks have been facing outstanding credit demand (+30%, including +54% in USD\$ during the first quarter of 2011¹⁷). Alongside this, the context of low interest rates channelled deposits towards Hong Kong banks. But more recently, the sudden rise in interest rates for the Renminbi and US\$ "made the HK\$640bn inflows into Hong Kong in late 2008 to 2009 gradually flow out"¹⁸. In this context, the Hong Kong Monetary Authority is forcing the city's banks to undergo stress tests in order to gauge not their access to liquidity, but rather the impact of the reversal of the interest-rate miss-match on their profitability.

16. Wall Street Journal - Robert A. Eisenbeis and Georges G. Kaufman, October 18th, 2007. "Why a run on Northern Rock but not Countrywide".

17. Agefi - Patrick Aussannaire, May 2011.

18. FT - Cardiff Garcia on Friday, May 27, 2011.