

27 October 2010

**Feedback to the public consultation on
“Consultation Paper on CEBS’s Guidelines on Liquidity Cost Benefit
Allocation” (CP36)**

1. In March 2010, CEBS published a consultation paper (CP36), Guidelines on Liquidity Cost Benefit Allocation. The consultation period ended on 10 June 2010. Twelve responses were received, all, but one (where the respondent requested confidentiality), are published on the CEBS website. CEBS also discussed the proposed guidelines with market participants in a public hearing held 1 June 2010.
2. This paper presents a summary of the major points arising from the consultation and the changes made to address them. It includes a section presenting CEBS’ detailed views on the public comments.
3. In many cases several industry bodies made similar comments or the same body repeated its comments in the response to different questions. In such cases, the comments, and CEBS’ analysis of them are included in the section of the detailed part of this paper where CEBS considers them most appropriate.
4. The responses were generally positive and supportive of CEBS’ work and required only some clarifications and minor changes in the text of the guidelines.

General remarks

5. Respondents recognize that the guidelines proposed in this consultation paper outline a framework for accounting for liquidity costs and benefits in a holistic manner. Several answers express the view that this framework is a key component in the overall liquidity risk management systems employed by financial institutions. Further, they support the notion of incorporating the liquidity cost/benefit allocation mechanism as a natural extension to an institution’s transfer pricing system, as suggested in the guidelines.
6. Several answers appreciate the efforts taken by CEBS to provide guidance on this topic which, in their view, is very important to institutions. Making sure the costs of liquidity risk are understood and allocated internally is important for conducting business, as liquidity characteristics of products

significantly influence the funding- and buffer requirements. Views were expressed that the proposed guidelines will support prudent liquidity management and are likely to improve the understanding of liquidity mechanisms as a whole.

Proportionality

7. A majority of the answers welcome the reference to the proportionality principle. However, some state that in the application of this principle, it should not only refer to the business model and the size of the institution which play a role. The funding structure in particular could also be decisive.
8. Some answers point to a lack of specifics in the consultation paper on how the proportionality principle should be applied. Other respondents believe the main components of the allocation mechanism as detailed in the paper, to be appropriate. It was appreciated that CEBS issue broad guidelines rather than producing a detailed and prescriptive paper. They welcome, therefore each individual bank being required to enter into a dialogue with its supervisor on the soundness and completeness of the methodology which it has established to measure its internal liquidity costs.

Specific remarks

9. According to paragraph 4, an institution must define its risk tolerance. Some of the respondents ask for clarification of the fact that this requirement refers explicitly to liquidity risks. The purpose of the allocation mechanism based on the established risk tolerance, alongside other management tools, is to provide a tool for effective planning of the balance-sheet structure. In this respect, some of the answers point out that the management of the balance-sheet structure and the off-balance structure is not only based on liquidity control, but also includes further control parameters (including capital or risk assets allocation). It is interpreted that what was probably meant in paragraph 9 was that the allocation mechanism is to be used to plan the liquidity structure of the balance and off-balance sheet rather than the broader concept of balance sheet management.
10. Several comments agree that the function in charge of the fund transfer pricing system (including liquidity cost benefit allocation) should not be profit oriented, and that the people working there should not be measured by profit targets. Some comments however focus on institutions where organisation structure or size make it practical to establish this function (here called treasury function) in a larger unit measured by profit targets.
11. Some answers express difficulties in interpreting the meaning of paragraph 7 about controlling and monitoring the internal prices and ask for better definitions and explanations.
12. Several comments welcome the call for consistent framework conditions for transfer pricing within a group (paragraph 11). However, some respondents comment that the implicit assignment of the liquidity management function to a central treasury unit would not be appropriate for every group of

institutions. In general, the functions of the units possibly involved in the liquidity management of a group of institutions (business strategy decision-making, control or monitoring) are not presented exhaustively in the consultation paper. Therefore it is suggested to generalise the description of the function.

13. Several respondents agree that adequate granularity of the liquidity allocation mechanism is important and appreciate the reference to proportionality as regards size and sophistication of the institution (paragraph 12). Other comments point out that the funding charge process may be applied to individual transactions or in some cases to pools of transactions.
14. Some comments reject the explicit mention in paragraph 15 of deposits and a generalised requirement to anticipate sight deposit draw-downs and for pricing in the risk of such withdrawal of deposits. In their view it should be left to the institution to price in the indirect liquidity costs appropriately in accordance with its business model or its funding situation. Some of the respondents also find it difficult to agree to the contents of paragraph 16 about internal pricing of trading book assets. A majority of the comments do not agree that for uncommitted credit lines and implicit support the business units should be charged in a "similar" manner to that applied to committed lines (paragraph 17).
15. One respondent asks for clarification when paragraph 21 refers to behavioral models. It is not clear whether this model should be the regulatory requirements suggested by BCBS. Another comment supports the use of internal models, which is considered to be more tailored to the specific business activities and risk profile of individual institutions. It is stated however that such models do not necessarily need to be aligned with the assumptions in the (forthcoming) liquidity rules and should rather be based on the actual institutions experience and behavioral assumptions.
16. Comments differ regarding the usefulness of giving examples as in paragraph 23 on price curves to be used. One comment welcomes examples of possible adjustments, but notes that they are not limitative, while others respond that the examples in the text were rather arbitrary.
17. One comment to paragraph 24 states that since liabilities (funding) are the material from which institutions make their commodity, it is obvious that the cost of the material (funding) must be taken fairly into account when the price of a product is being determined. The comment supported the initiative to align internal pricing systems with product pricing, in a manner that ensures that products are fairly priced to include the economic cost of funding. Other respondents however express concern and suggest that the impact of added liquidity costs on borrowing and lending should be studied in more detail.
18. Several comments express the need for clarification and better definitions of some of the expression used in paragraph 25 such as "marginal costs", "average marginal costs", "current costs" and "dynamic price setting". In

addition there are comments saying that the calculating the cost of liquidity buffer is much less precise and more difficult than Annex 2 describes.

CEBS response to the comments received

19. CEBS agrees, that in the context of these guidelines, we are talking about liquidity risk tolerance; even if CEBS considers that liquidity risk tolerance is a part of the overall risk tolerance (paragraph 4), and that the allocation mechanisms should be used among others to plan the liquidity structure of the balance sheet and off-balance sheet items (paragraph 9, new paragraph 5). This has been clarified in the text of the guidelines.
20. In writing the guidelines CEBS has taken into account that organisation of the area responsible for the day to day running of the fund transfer pricing system (including liquidity cost benefit allocation) can be organised in different ways in the institutions. We do however see it as a necessary condition that this area does not have a profit target for this specific role. This is recognised by the comment saying that the result from the funding operations should be measured and made transparent within the organization. Related text in the guidelines will be rephrased.
21. The liquidity cost benefit allocation mechanism should be controlled and monitored by an independent control unit, e.g. risk control or financial control. The control unit should be independent from the business units and independent from the treasury function or other similar functions which have the responsibility for running the internal pricing mechanism on a daily basis. These independent controls and monitoring are important because the internal prices have effects on the measurement of product margins and business unit results e.g. for lending operations, trading and investment units etc. In this respect it is important that the internal prices used and the result effects of the liquidity cost benefit mechanism can be controlled and monitored in a transparent way, linked to funding prices observed in the market. This will be a way to justify and legitimate the mechanism and solve potential internal disputes. The text in paragraph 7 (new paragraph 8) has been made more precise on this point.
22. CEBS does not agree with the suggestion that paragraph 11 about a comprehensive approach to the liquidity cost in a group to be made more general. It is however recognise that in the last sentence, the text should be adjusted. The central management body e.g. treasury should have visibility over the entire organisation's balance sheet and off-balance sheet positions.
23. CEBS finds it important that the internal price mechanisms should have sufficient granularity not only to give information and measure performance at business unit level, but also if appropriate, to give information to transaction makers with influence on the units risk level and economic results. It is though recognised that the funding charge process in some cases could be applied to a pool of transactions (paragraph 12).

24. Paragraphs 15 and 16 have been slightly changed to clarify the terms "sight deposits" and "market liquidity cost". CEBS recognises that there are differences both legally and behavioural between committed and uncommitted lines. The text has been changed in paragraph 17.
25. When it comes to behavioural models (see paragraph 21) used in the liquidity management and internal pricing of assets and liabilities, it is CEBS view that internal models should be institutional specific.
26. The reference made to specific yield curves in the guidelines paragraph 23, should be looked upon as examples. Institutions practices of using price curves can be more diverse. CEBS also recognises that the description of the various risk factors which impact on the liquidity profile of an exposure could include more details than described. This should however be balanced against the aim of the guidelines which are to be principle based and not too prescriptive and detailed.
27. As an answer to comments made to paragraph 24, CEBS will point to the work on new liquidity standards by BCBS which include different types of impact studies related to holding certain levels of liquidity buffers and net stable funding. In the context of pricing liquidity risk as a part of internal fund transfer mechanisms, we would point to paragraph 1 under Guideline 1, where one fundamental basis for the guidance is expressed: "Liquidity is a scarce resource and accordingly a proper measurement of costs and benefits is essential to support sustainable business models and promote efficiency in individual institutions as well as in the whole banking sector. " CEBS is of the belief that as a result of the lessons learned during the recent crises, institutions across markets have become more aware of the cost of liquidity and that this element will be included in the measurement of product margins. It should however be made clear that product pricing versus customers is the institutions responsibility based on the institutions business- and risk strategy. As stated in paragraph 24 product approval and internal pricing processes should be integrated. This means that when the institution is undertaking a risk and profitability analysis of a potential new product, the implication of the institutions liquidity risk position, as well as the potential liquidity cost or benefit of the product, should be taken into account.
28. The description in paragraph 25 is not to be seen as an arbitrary example. The aim is to describe the main elements of the internal price. Some rephrasing has been made in the text.

Implementation date

29. Some of the respondents see the given timeframe for the implementation into national framework of the guidelines on liquidity cost benefit allocation as ambitious and too tight. They expect that most institutions will have a look at their loan and debt programs in order to fulfil the requirements technically. Similar IT projects in the past have taken at least 12-24 months to implement, not counting the budgeting and preparation time. Implementation date of 1 January 2012 was suggested, while another

suggestion was an implementation schedule in line with the requirements for the “Liquidity Coverage & Net Stable Funding Ratio” until end of 2012.

30. CEBS acknowledges that more time should be given to implement the guidelines. CEBS expects its members to transpose the guidelines into their national frameworks with due concern to the proportionality principle and apply them by 30 June 2011 at the latest with an expectation for implementation by the institutions before 1 January 2012. An implementation study will be carried out by CEBS during the second half of 2012.

Transition from CEBS to EBA and technical binding standards

31. The transition of CEBS to the EBA may necessitate the revision of existing guidelines in areas where the CRD will refer to technical standards. For those guidelines that will be translated into technical standards, institutions and other stakeholders will have the possibility to provide their input as per the usual consultation practices of CEBS, which are expected to be similar under the aegis of the EBA.

Analysis of responses to CP 36
Guidelines on Liquidity Cost Benefit Allocation

Draft Text CP36	Received Comments	CEBS analyses	New text (proposal) No response (n. r.)
	General remarks to chapter 1 - 3		
General remarks	<p>Several responses recognize that the guidelines proposed in this consultation paper outline a framework for accounting for liquidity costs and benefits in a holistic manner. Several answers express the view that this framework is a key component in the overall liquidity risk management systems employed by financial institutions. Further, they support the notion of incorporating the liquidity cost/benefit allocation mechanism within an institution's transfer pricing system, as suggested in the guidelines, as it is a natural extension to the internal pricing frameworks utilized by many institutions.</p> <p>Several answers appreciate the efforts taken by CEBS to provide guidance on this topic which, in their view, is very important to banks. Making sure the costs of liquidity risk are understood and allocated internally is important for conducting business, as liquidity characteristics of products significantly influence the funding- and buffer requirements.</p> <p>Views are expressed that the proposed guidelines will support prudent liquidity management and are likely to improve the understanding of liquidity mechanisms as a whole.</p> <p>Answers also mention that as a driver of the economic decision-making process, the cost at which funds are lent from central treasury to the bank's businesses needs to be set at a rate that reflects the true liquidity risk position of each business line. Where this policy is not followed, transactions which produce an unrealistic profit can be carried out. This profit could reflect an artificial</p>		

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	funding gain, rather than the true economic value added of the business line		
	One respondent asks whether the guidelines as currently drafted could be misinterpreted by local supervisors to dictate internal practice. For example, the consultation paper is unclear on what the guidelines are seeking to address. It is suggested that the guidelines need to be introduced with a clear statement that they aim to reflect the variety of methods of attaching a realistic cost of liquidity to those assets on the balance sheet and to any off-balance sheet exposures with a liquidity implication.	CEBS issues broad – rather than detailed and prescriptive guidelines. The guidelines are primarily meant for institutions, but should also become a tool for supervisors in the dialogue with the institutions when assessing the liquidity risk management framework. This is stated in the introduction to the guidelines on page 2. (See also response on page 9)	The following changes have been inserted in the text: “Recalling the CEBS Guidelines on the application of the Supervisory Review Process (January 2006), especially those guidelines on internal governance, the presence of an effective mechanism should become part of the dialogue between supervisors and institutions <i>when assessing the liquidity risk management framework</i> . The assessment of liquidity allocation mechanisms is important within an overall approach to liquidity risk.”
	Some of the responses give comments to the fund transfer price concept including liquidity cost benefit allocation described on page 4 in chapter 3 Contents. These responses are commented under paragraph 25 below.		see para 25
Proportionality	A majority of the answers welcome the reference to the proportionality principle. However, some state that in the application of this principle, it should not only be the business model and the size of the institution which play a role. The funding situation in particular could also be	CEBS agrees	In Chapter 3 Contents; the second sentence is changed to: “Respecting the proportionality principle, they are

Draft Text CP36	Received Comments	CEBS analyses	New text (proposal) No response (n. r.)
	<p>decisive. Accordingly, the wording of sentence 2 of point 3 (page 3) could read: "Respecting the proportionality principle, they are intended to apply to a wide range of institutions in terms of size, business model <u>and funding structure</u>"</p> <p>Some answers point to a lack of concretisation in the consultation paper on how the proportionality principle should be applied. The present approach resembles the establishment of "best practices", while some believe that a focus on less ambitious "minimum standards" would be more suitable and also more in line with the proportionality principle. It was seen as important that the present draft guidelines should not be stricter than previous CEBS recommendations in its Technical Advice on Liquidity Risk Management (CEBS 2008 147). In this context some respondents would welcome it, if in relevant sections of the guidelines, indications were given on the applicability of the proportionality principle and especially on the expectations concerning the sophistication and extent of cost measurement for smaller non-complex credit institutions. Otherwise, the guidelines could create unrealistic expectations pressuring smaller institutions to invest in complex measurement mechanisms, which go hand in hand with significant and disproportionate costs.</p> <p>Other comments believe the main components of the allocation mechanism as detailed in the paper, to be appropriate. It was appreciated that CEBS issues broad guidelines rather than producing a detailed and prescriptive paper. They welcome, therefore each individual bank being required to enter into a dialogue with its supervisor on the soundness and completeness of the methodology which it has established to measure its internal liquidity costs.</p>	<p>CEBS notices that there are different views among the respondents regarding how prescriptive and detailed the guidelines should be.</p> <p>The guidelines do not aim at giving a detailed prescription of liquidity cost benefit allocation methods. Systems and methods will vary accordingly to the institutions business models, sizes and complexity. Regarding smaller institutions we find it important that they are aware of different liquidity cost components and are able to take these into account in their business decisions as far as relevant for their type of institution. When it comes to technical solution for fund transfer pricing systems, this will be for the institutions to decide. In the dialogue between the supervisors and the institutions this will be discussed and assessed as a part of the liquidity risk management framework of the institution.</p> <p>Additional reference to the proportionality principle is made in paragraph 23 and 19.</p>	<p>intended to apply to a wide range of institutions in terms of size, business model <u>and funding structure</u>"</p> <p>New last sentence in the first section in chapter 3 on page 3;" <u>CEBS issues broad guidance rather than detailed and prescriptive guidelines. The soundness and the completeness of the methodologies developed by the institutions will be assessed within the SREP process.</u></p>
Implementation	Some of the respondents see the given timeframe for the	CEBS acknowledges that more time should	Chapter 1 Introduction

Draft Text CP36	Received Comments	CEBS analyses	New text (proposal) No response (n. r.)
<p>date and implementation study</p>	<p>implementation of the guidelines into national regulations as ambitious and rather tight. They expect that most institutions would have a look at their loan and debt programs in order to fulfil the requirements technically. Similar IT projects in the past have taken at least 12-24 months to implement, not counting the budgeting and preparation time. One suggestion for an implementation date is therefore 1 January 2012.</p> <p>Another suggestion is an implementation schedule in line with the requirements for the "Liquidity Coverage & Net Stable Funding Ratio" e.g. most probably at the end of 2012.</p> <p>One respondent suggests undertaking a study on how the guidelines were implemented by EU supervisory community one year after the implementation date. This is seen as an appropriate way forward to pave the ground for further harmonisation.</p>	<p>be given to implement the guidelines. CEBS will however refer to the CRD II, annex V (Directive 2009/111/EC of the European parliament and of the Council of 16 September 2009), see page 2 in the guideline document.</p>	<p>, sixth section page 2 will be changed: " CEBS expects its Members to <u>implement</u> the guidelines into their national <u>frameworks</u> with due concern to the proportionality principle and apply them by <u>30 June 2011 at the latest with an expectation for implementation by the institutions before 1 January 2012</u>. National supervisors <u>should</u> monitor the implementation progress, as necessary.</p> <p>To ensure harmonisation of practices across Member States, CEBS is considering conducting an implementation study <u>within</u> one year after the recommended implementation date.</p> <p>.."</p>
<p>Future EBA and technical binding standards</p>	<p>One comment questions the timing given simultaneous development of prudential rules (for instance in CRD4) and the changes in the supervisory architecture of the EU. These latter changes will entail: (i) CEBS being replaced with the European Banking Authority (EBA) which will have the authority to develop technical standards which will be legally binding as opposed to CEBS guidelines that are not; and (ii) further supervisory</p>	<p>The transition of CEBS to the EBA may necessitate the revision of existing guidelines in areas where the CRD will refer to technical standards. For those guidelines that will be translated into technical standards, institutions and other stakeholders will have the possibility to provide their input as per the usual</p>	

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	powers for the EBA (the extent of which are uncertain). CP 36 was commented on the basis that they are guidelines and not technical standards. If the EBA decides to develop binding standards addressing liquidity cost benefit allocation confirmation should be given that the EBA will give firms (and other stakeholders) the opportunity for further review and comment.	consultation practices of CEBS, which are expected to be similar under the aegis of the EBA.	
Guideline 1 (An important part of the whole liquidity management framework)			
Para 1	One comment endorsing the principle of consistency across the different parts of the liquidity management framework, further comments that in keeping with the proportionality principle, the methodologies for liquidity risk management and pricing adopted by financial institutions should be aligned with the risk management practices of the institution and the complexity of the balance sheet. In particular, the respondent advocates the use of economic models which provide a unified framework for measuring and managing liquidity risk, as well as for pricing and cost/benefit allocation.	CEBS agrees that this comment will be appropriate for larger institutions, but will not specifically elaborate on use of economic models in the guidelines since the guidelines should be aimed at most types of institutions regardless of size and complexity.	n.r.
Para 2	One answer requests the deletion of the reference made in point 2, according to which especially large institutions have a "transfer pricing system" that is used for product calculation or to assess net interest income. It could give rise to the impression that only big banks deploy or have to deploy such a mechanism.	CEBS agrees	Suggest change in para 2: "Institutions, generally have some sort of transfer pricing <i>mechanisms</i> that they use at the minimum to price lending or to calculate the correct net interest income component of profitability for business units, products, and customers."
Para 4	According to point 4, an institution must define its risk tolerance. Some of the respondents ask for clarification of	CEBS agrees that in this context it is talking about liquidity risk tolerance; even if	New text in para 4, first sentence: "Institutions

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	<p>the fact that this requirement in this connection relates only to liquidity risks. The wording should accordingly read: "Institutions must have a clear definition of <u>liquidity</u> risk tolerance."</p>	<p>CEBS considers that liquidity risk tolerance is a part of the overall risk tolerance.</p>	<p>must have a clear definition of <u>liquidity</u> risk tolerance.</p>
Guideline 2 (Supported by a proper governance structure)			
<p>Para 7 (new para 8)</p>	<p>Some answers express difficulties in interpreting the meaning of paragraph 7 and ask for better definitions and explanations of some of the expressions used, such as:</p> <ul style="list-style-type: none"> • Control and monitoring – what is the purpose • Who is undertaking the "control and monitoring" • Legitimation and justification <p>CEBS was asked to formulate the requirement more clearly and unambiguously.</p> <p>The term "end-user business area" is suggested to be replaced by the concept "liquidity users" (in contrast to "liquidity providers").</p>	<p>The liquidity cost benefit allocation mechanism should be controlled and monitored by an independent control unit, e.g. risk control or financial control. The control unit should be independent from the business units and independent from the treasury function or other similar functions which have the responsibility for running the internal pricing mechanism on a daily basis. This independent control and monitoring are important because the internal prices have important effects on the result measurement of business units, e.g. lending operations, trading and investment units etc. In this respect it is important that the internal prices used and the result effects of the liquidity cost benefit mechanism can be controlled and monitored in a transparent way, linked to funding prices observed in the market. This will be a way to justify and legitimate the mechanism and solve potential internal discussions.</p>	<p>New text in para 7 (new para 8): The liquidity cost benefit allocation mechanism should be controlled and monitored <u>by an independent control unit e.g. risk control or financial control in a transparent way. These independent controls and monitoring are important because the internal prices effect the measurement of product margins as well as results for the business units.</u></p>

Draft Text CP36	Received Comments	CEBS analyses	New text (proposal) No response (n. r.)
Para 8 (new para 9)	One respondent stresses that firms have an internal pricing policy and that deviations from this policy are possible for business strategy reasons. Consequently they suggest the two last sentences in Paragraph 8 to be deleted	CEBS does not agree to delete the two last sentences.	n.r.
Para 9	The allocation mechanism based on the established risk tolerance, alongside other management tools, is to provide a tool for effective planning of the balance-sheet structure. In this respect, some of the answers point out that the management of the balance-sheet structure and <i>the off-balance structure</i> is not only based on liquidity control, but also includes further control parameters (including capital or risk assets allocation). It is interpreted that what was probably meant in paragraph 9 was that the allocation mechanism is to be <i>used to plan the liquidity structure of the balance and off balance sheet</i> . This should be clarified accordingly. Based on the thematic link, it is suggested that point 9 should be joined to point 4 in Guideline 1.	CEBS agrees to the suggested changes in the text.	New text in para 9: Based on an agreed risk tolerance for liquidity, and alongside other risk management features such as gap limits, concentration limits, liquidity buffer and other quantitative measures, the allocation mechanism should provide a tool for management effectively to plan <u><i>the liquidity structure of the balance sheet and the off-balance sheet items</i></u> . Para 9 moved to new para 5 at the end of Guideline 1.
para 10	Several comments agree that the function in charge of the fund transfer pricing system (including liquidity cost benefit allocation) should not be profit oriented and that the people working there should not be measured by profit targets. Some comments however focus on institutions where organisation structure or size make it practical to integrate this function (here called the treasury function) in a larger unit measured by profit targets:	In writing the guidelines CEBS has taken into account that organisation of the area responsible for the day to day running of the fund transfer pricing system (including liquidity cost benefit allocation) can be organised in different ways in the institutions. We do however see it as a necessary condition that this area does not	New text para 10: The area or responsible function ultimately charged with implementing and <u><i>running</i></u> the internal price <u><i>mechanism</i></u> should be service oriented and not have a profit target

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	<ul style="list-style-type: none"> • Especially for smaller banks or non – complex entities, this requirement should not give raise to the need for substantially change to their organisation structure • Remaining in a profit centre will enable banks to continue to keep and hire the most qualified persons for one of the most important business functions within the refinancing department • It is unclear how extensively this provision is to be interpreted. If the “implementing” of the internal prices is to be equated with pricing, the requirement would not necessarily lead to the desired results. As a rule, transfer prices are set by treasury units. These units often also have profit-centre or cost-centre guidelines and operate close to the market. This closeness to the market is also absolutely essential for the setting of market prices or prices which can be derived from the market. The transfer prices are instruments to pass on risks – in this case liquidity risks – within the institution so that these can be (centrally) controlled. These risks are controlled on the basis of a limit system and monitored independently of the market. Furthermore, a restriction, as called for in the guidelines, is not appropriate and restricts the institution in their organisational freedom • It is a straightforward accounting mechanism to strip out the return generated from lending to internal business lines from the Treasury recorded return, thus ensuring that no artificial profit is created and providing comfort to business lines that the correct mechanism is being followed. <p>One general remark suggests the following addition to Guideline 2: The results from funding costs should be measured, monitored and reported with other funding risk metrics (see above).</p>	<p>have a profit target for this specific role.</p> <p>We recognise the comment saying that the result from the funding operations should be measured and monitored.</p>	<p>for this specific and <u>independent role</u>. Equally, for larger institutions, personnel working within the area should not be set profit targets for this activity. Appropriate technical systems and databases should, taking the proportionality principle into consideration, be available to the <u>independent</u> area or function_responsible for the internal pricing.”</p> <p>Addition to para 10: <u>“Any profit or loss from the internal pricing area or responsible function should be measured and made transparent within the organisation.</u>”</p>

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	<p>One respondent suggests the following modification to the paragraph: <i>"The area or responsible function ultimately charged with implementing and monitoring the internal prices should be service oriented and not have a profit target for this specific independent role. Equally, for larger institutions, personnel working within the area should not be set profit targets for this activity. Appropriate technical systems and databases should, taking the proportionality principle into consideration, be available to the independent unit or governing body responsible for the internal pricing function."</i></p>		
Para 11	<p>Several comments welcome the call for consistent framework conditions for transfer pricing within a group. However, some respondents comment that the implicit assignment of the liquidity management function to a central treasury unit would not be appropriate for every group of institutions. In general, the functions of the units involved in the liquidity management of a group of institutions (business strategy decision-making, control or monitoring) are not presented selectively in the consultation paper. Therefore it is suggested to generalise the description of the function.</p> <p>One comment suggests using the expression "liquidity management function".</p> <p>Comments also note that transparency is necessary with regard not only to the balance sheet items, but also the off-balance-sheet items.</p>	<p>CEBS does not agree with the suggestion of making this paragraph more general, but recognises that in the last sentence, the text should be adjusted. The central treasury should have visibility over the entire organisation's balance – and off-balance sheet.</p>	<p>New text in para 11, last sentence: <i>"The central management function e.g. treasury should have visibility over the entire organisation's <u>balance sheet and off-balance sheet items.</u>"</i></p>
Guideline 3 (Actively and proper use of the output in line with business profile)			
Para 12	<p>Several comments highlight that the funding charge process may be applied to individual transactions or to pools of transactions. As an example, demand deposit accounts are usually considered as a pool and fund transfer priced as such. As another example, trading portfolios may be considered as a pool rather than at</p>	CEBS agrees	<p>New text in second sentence para 12: The internal prices should percolate down to decision makers at transaction level <i>or if</i></p>

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	transaction level.		<u>appropriate, to a pool of transactions with homogenous liquidity risk</u> to ensure maximum impact.
	One respondent says that the reference to “the impact of the financial situation of an institution” seems ambiguous, as it suggests that the design of the allocation mechanism and the decision-making process is only to relate to such decisions. A deletion of this reference is asked for.	CEBS does not agree with the comment.	n. r.
	One respondent asks for the following reformulation of the second sentence: “The internal prices should percolate down to business <u>line decision makers</u> to ensure maximum impact.” In their view, allocation of the internal prices at business area level is sufficient to ensure that the business manager forwards the relevant cost components at transaction level to the decision-makers.	CEBS finds it important that the internal price mechanisms should have sufficient granularity to not only give information and measure performance at business unit level, but also if appropriate for transaction makers with significant influence on the units risk level and economic results.	n.r.
Para 14	<p>Several comments agree that sufficient granularity of the liquidity allocation mechanism is important and appreciate the reference to proportionality as regards size and sophistication of the institution.</p> <p>Some comments stress that aiming at granularity should not culminate in the expectation that individual internal transaction prices be derived for each individual funding operation, irrespective of its nature and context. It is stated that for some funding operations there are no suitable market transaction prices to which internal prices could be aligned.</p> <p>CEBS is invited to define “market transaction price” and clarify that there are areas where funding operations with similar liquidity profiles can be pooled, and that in such</p>	Based on the different views expressed, CEBS does not find it necessary to make major changes in the paragraph.	New text in last sentence in para 14: “Internal prices should be aligned with <u>wholesale</u> market transaction prices <i>where available</i> .”

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	<p>cases there can be one 'collective' internal price. CEBS is asked by one respondent to mention that, depending on the funding operation, as well as on the institution's funding structure and funding sources, it cannot be expected that a comprehensive measurement of liquidity costs is possible in all cases, and hence that internal prices may sometimes not go substantially beyond what is implied by the 'direct cost' component.</p>		
Guideline 4 (The scope of application of internal prices)			
Para 15	<p>Some comments reject the explicit mention of deposits and a generalised requirement to anticipate sight deposit drawdowns and for pricing in the risk of such withdrawal of deposits. It should be left to the institution to price in the indirect liquidity costs appropriately in accordance with its business model or its funding situation. In this respect, a more general formulation for point 15 was requested.</p> <p>One comment states that the behaviour of sight deposits can be extrapolated from past behaviour, to gauge an idea of stickiness. However, it is noted that a conservative approach should be applied. A stable deposit base during a period of market confidence is not necessarily a guide to behaviour in market correction.</p>	Based on the different views expressed, CEBS does not find it necessary to make major changes in the paragraph	Change in para 15 "... on demand withdrawable deposits even if they carry a low interest rate should be...."
Para 16	<p>Some of the respondents find it difficult to agree to the contents of para 16. The following issues were mentioned:</p> <ul style="list-style-type: none"> The market liquidity risk of a trading portfolio should only be reflected within the expected holding period. This period, which should be back tested, determines the funding costs of this particular strategy or portfolio. The inherent liquidity risk of a loss due to price changes should in this case not be covered by haircuts since it is already covered by the addressed 	Re bullet point one: We are not talking about risk due to price volatility (market risk), but market liquidity risk (risk that markets may become less liquid/illiquid).	Changes in the second and third sentence in para 16: The funding price charged should reflect both the expected holding period and the liquidity risk (change in <i>liquidity of the asset</i>). This can be achieved by calculating prudent <i>liquidity</i> charges

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	<p>capital for market or credit risk.</p> <ul style="list-style-type: none"> Both the expected holding period and the market liquidity risk should be components of the transfer pricing model, but both should not necessarily have to be included in parallel in determining individual prices. Sentence 2 should therefore be reformulated as follows: "The funding price charged should reflect <u>either</u> the expected holding period <u>or</u> the market liquidity risk (change in marketability)." Results of stress testing are not an appropriate starting point for the assessment of liquidity costs. This would not lead to prices in line with the market in normal market phases. Furthermore, the prices determined according to these specifications would lead to a double charge for the institutions, since the volume of the liquidity buffer to be held already takes this stress scenario into account. The last sentence should therefore be deleted. <p>One respondent comments that appropriate funding prices should also be charged for holding a position to hedge market risk</p>	<p>Re bullet point two: CEBS does not agree.</p> <p>Re bullet point three: CEBS does not agree</p> <p>CEBS agrees</p>	<p>(e.g. haircuts) for marketable assets which reflect possible abrupt adverse changes in <u>the liquidity of the asset</u>.</p>
Para 17	<p>A majority of the comments do not agree that for uncommitted credit lines and implicit support the business units should be charged in a "similar" manner to that applied to committed lines. The legal and behavioral differences between committed and uncommitted credit lines should be taken into account. Comments points out that the consultation paper does not match with the proposals that have been put forward by the Basel Committee in 'International framework for liquidity risk measurement, standards and monitoring', where exclusion of uncommitted lines is proposed. It is acknowledge that there may be potential moral</p>	<p>CEBS recognises that there are differences both legally and behavioural between committed and uncommitted lines. Incorporating as a standard that all uncommitted lines will be rolled over can be strict.</p>	<p>New text in last sentence para 17: "For <u>uncommitted lines</u>, the business units granting the facilities should be charged in a <u>similar manner, albeit reflecting the higher discretion that the institution has over final payout</u>."</p>

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	<p>hazard associated with not granting roll-overs of uncommitted lines, as this might have an impact on the reputation of the institution. However, incorporating these roll-overs into the liquidity transfer price based on a treatment that is similar to the approach of committed lines is seen as overly strict and does not reflect the uncommitted nature of these lines.</p> <p>One respondent comments that during the crisis it was observed that uncommitted and unsecured credit lines among financial institutions often were cancelled, while uncommitted credit lines to non-banks were maintained. On this basis a reformulation of the third sentence is proposed: "For credit lines with an evident implicit support, the business units granting the facilities..."</p> <p>Some also make a remark that at present most institutions do not charge internal prices for committed credit lines. Therefore they see a danger of distortions to competition, if not all institutions comply with this Guideline. Furthermore they anticipate that prices for clients will increase.</p>		
Para 19 and para 20	<p>Some of the comments are of the opinion that §20 appears to mainly repeat in more concrete terms the content of §19. They therefore believe §20 to be unnecessary and recommend that it be dropped. In addition, a reference to the proportionality principle is suggested. §19 are suggested to be amended as follows: "Respecting the proportionality principle, the transfer prices should reflect current market and stressed funding conditions as well as the actual institution-specific circumstances, and should reflect both direct and indirect costs, including the cost of a liquidity buffer (see the example in Annex 2)."</p> <p>Another respondent suggests the following changes : The transfer prices should reflect market conditions <i>observed</i></p>	CEBS does not agree to the suggestion of deleting paragraph 20.	<p>New text in first sentence para 19: "<u>Respecting the proportionality principle transfer prices should reflect....</u>"</p> <p>New text at the end of para 19: "<u>At a minimum depending of the updating frequency the transfer prices should reflect market conditions observed over a recent period and expected over the near</u></p>

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	<p><i>over a recent period (no longer than a few months) and expected over the near future (no longer than a few months) as well as the actual institution-specific circumstances, and should reflect both direct and indirect funding costs, including the cost of a liquidity buffer. To the extent that the institution would depart from match funding cost, within its funding risk tolerance, the residual risk could be priced in at inception for its expected funding cost, or could be charge its actual costs over the time, or a combination of those two possibilities.</i></p>		<p><u>future.</u>"</p>
Guideline 5 (The internal prices taking into account various factors involved in liquidity risk)			
<p>Para 21</p>	<p>One comment asks for clarification when para 21 refer to behavior model. It is not clear whether this model should be the regulatory requirements suggested by BCBS.</p> <p>Another comment supports the use of internal models, which are considered to be more tailored to the specific business activities and risk profile of individual institutions. It is however stated that such models do not necessarily need to be aligned with the assumptions in the (forthcoming) liquidity rules and rather be based on the actual banks experience and behavioral assumptions.</p>	<p>The second comment referred is in line with CEBS view. Internal models should be institutional specific.</p>	<p>n.r.</p>
<p>Para 23</p>	<p>Comments differ regarding the usefulness of giving examples on price curves to be used.</p> <p>One comment welcomes examples of possible adjustments, but notes that they are not limitative. Furthermore, there is need for some clarification. Specifically, some examples appear to be overlapping (e.g. letters a and c); the reference to the interest rate term structure model when discussing the liquidity cost may create confusion; the mentioning of "CDS spreads quoted in the secondary market" would benefit from being completed also with a reference to bond spreads quoted in the secondary market. In addition, the view is taken that the use of not common adjustments listed under letter e, (especially of the country risk premia)</p>	<p>The reference made to specific yield curves in the guidelines paragraph 23, should be looked upon as examples and that institutions practices of using price curves can be more diverse.</p> <p>CEBS also recognises that the description of the various risk factors with impact on the liquidity profile of an exposure could include more details than those provided. This should however be balanced against the aim of the guidelines which are to be principle based and not too prescriptive and detailed.</p>	<p>New text in the two last sentences of para 23: Furthermore, institutions' methodologies may make use of CDS levels <u>or bond spreads</u> quoted in the secondary markets to establish the pricing curve. <u>These are examples. Practices using yield curves in institutions can be more diverse.</u> For maturities exceeding that of an</p>

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	<p>should be strongly encouraged.</p> <p>Some other respondents recommend that for the establishment of internal prices and yield curves institutions should use benchmarks observed in the market. Examples of EURIBOR and LIBOR curves, as well as of swap curves and CDS levels, are regarded as rather arbitrary. It is a preference for a more general example and explicit references should be deleted, since in praxis the use of yield-curves is much more diverse.</p> <p>One comment finds it important to mention that funding cost curves should be broken down by currencies.</p> <p>A comment is made that in considering the various risk factors that might impact the liquidity profile of an exposure, it is viewed to be important to utilize an analysis framework that considers the different risks in an integrated fashion. This is in contrast to a "siloe" approach which treats each risk dimension separately. As an example, one could consider the transfer pricing of a callable corporate (fixed-rate) bond. As suggested in recommendation 23, the internal charge for the instrument should include, among other things, the funding cost, the credit risk charge, as well as the option premium. The value of the call option, in turn, is driven by credit quality dynamics of the bond issuer, as well as by interest rate dynamics. Further, early repayment of debt would impact the liquidity profile of the exposure, and should thus be taken into consideration when estimating the liquidity cost attributed to the instrument. In order to arrive at a price which accurately reflects this set of financial risks, a holistic framework that jointly accounts for the different risk dimensions and the interactions between them should be utilized.</p>		<p>institution's securities having the longest maturity, the curve may be calculated using an interest rate term structure model. <u>When appropriate and with respect to the proportionality principle, institutions should use internal funding cost curves broken down by currencies.</u></p> <p>Change in sentence above the examples starting with a.: <u>"Some examples are":</u></p> <p>New last sentence at the end of para 23: <u>"Ideally a framework that jointly account for the different risk dimensions and the interactions between them should be utilised."</u></p> <p>New illustration is inserted at the end of para 23.</p>
Para 24	One comment states that since liabilities (funding) are the material from which institutions make their	The work on new liquidity standards by	New text after the second sentence in para

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	<p>commodity, it is obvious that the cost of the material (funding) must be fairly taken into account when the price of a product is being determined." The comment supports the initiative to align internal pricing systems with product pricing, in a manner that ensures that products are fairly priced to include the economic cost of funding.</p> <p>Other respondents however express concern and suggest that the impact of added liquidity costs on borrowing and lending should be studied in more detail. While there is general agreement in the industry regarding the need for firmer liquidity standards, the potential impact of the proposed liquidity measures is a subject of much debate.</p> <p>One answer underlines that attention will need to be paid to make sure that European banks are not at competitive disadvantage vis a vis non European banks. Should requirements be made to non European subsidiaries of European banks, there would most probably be an uneven playing field.</p> <p>One comment says that in periods of elevated funding costs, the increase in loan fees needed to offset the cost of funds can be dramatic, particularly when loans feature an embedded prepayment option. This has implications for banks' competitiveness in credit markets, as well as for the overall cost of credit. While financial institutions can utilize different techniques to reduce the magnitude of such effects, the broad impact on credit markets is likely to remain a concern. In addition, the analysis highlights the importance of using a holistic risk framework in internal pricing systems employed in banks. Such an economic framework would allow banks to consistently integrate liquidity pricing with other risk management functions such as stress testing and scenario analysis.</p>	<p>BCBS will include different types of impact studies.</p> <p>In the context of pricing liquidity risk as a part of internal fund transfer mechanisms we will point to paragraph 1 under Guideline 1, where one fundamental basis for the guidance is expressed: "Liquidity is a scarce resource and accordingly a proper measurement of costs and benefits is essential to support sustainable business models and promote efficiency in individual institutions as well as in the whole banking sector. "</p> <p>CEBS is of the belief that as a result of the lessons learned during the recent crises, institutions a cross markets have become more aware of the cost of liquidity and that this element will be included the measurement of product margins. It should however be made clear that product pricing versus customers is the institutions responsibility, based on the institutions business- and risk strategy.</p> <p>As stated in paragraph 24 product approval and internal pricing processes should be integrated. This means that when the institution is making a risk and profitability analysis of a potential new product, the implication for the institutions liquidity risk position as well as the potential liquidity cost or benefit allocated to the funding price of the product should be taken into account.</p>	<p>24; <u>"This means that when the institution is making a risk and profitability analyses of a potential new product, the implication for the institutions liquidity risk position as well as the potential liquidity cost or benefit of the product should be taken into account."</u></p>

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	<p>Some comments invite CEBS to express more clearly the view that the derived internal price of funding primarily serves for the institution to better understand its own liquidity situation (and to anticipate future liquidity related problems). It should be stated more strongly that this internal price is not to automatically determine the price and amounts at which banks are to lend or offer funding on the markets. The understanding is that the guidelines leave room for separate decisions by the management, as long as these decisions are made in full awareness of the internal 'neutral' price of liquidity. There may be sound commercial strategy considerations explaining why banks may prefer to deviate from this basic principle (e.g. the comprehensive client relationship; competitive reasons)</p> <p>CEBS is also asked to specify whether the product approval process and the internal pricing process should be integrated.</p>		
Para 25	<p>One general remark makes the point that this paragraph describes how transfer prices should be calculated in detailed terms, while there are also other options available to banks. CEBS is requested to either make clear that the proposed approach is an example, or to state that other methods that are fit for purpose for an individual institution are also regarded as eligible approaches under these guidelines.</p>	<p>The description in paragraph 25 is not to be seen as an arbitrary example. The aim is to describe the main elements of the internal price. Some rephrasing will be made</p>	
	<p>Several comments express a need for clarification and better definitions of some of the expression used in this paragraph (see the following):</p> <p>Several answers found the additional concepts of "marginal costs", "average marginal costs" and "current costs" not very clear. CEBS is requested to either clarify these notions or to drop them since at present they may create considerable confusion.</p>	<p>CEBS acknowledges that some of the expressions used could have been explained. Marginal cost of funding: cost of making new funding transactions in the market. Average marginal cost of funding: The daily marginal costs calculated as a moving average over e.g. the last 30/60days. Current cost: (the same as marginal cost</p>	<p>New para 25: " <i><u>The internal prices used should reflect the marginal cost of funding. The price should reflect the marginal cost over a homogenous product</u></i></p>

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	<p>One comment finds it important to define the meaning of "average". It is welcomed, for example, if it were made explicit that it means that the daily marginal costs may be compounded as a moving average over the last 30/60days.</p> <p>Another comment is that expressions such as "dynamic price setting" should not be used as if they were self-explanatory: there is no common understanding of this concept in the industry.</p> <p>One respondent comments that the definition of "marginal" is unclear in the context of the guidelines, since the average rate does not always represent the marginal costs of the liquidity. For positions which are to be held to maturity, the current costs can be determined via a liabilities position with matching maturity. The current costs of funding the liabilities position should be reflected in the internal pricing of this position. On the other hand, for positions which are not to be held to maturity, a pricing model should be developed which measures the market liquidity risk. In this case, the costs of funding correspond to an average value of the currently existing costs of funding over various maturities. Although the homogeneous and the current costs of financing are to be considered in the transfer pricing mechanism, it does not lead to the desired results in our view to include both simultaneously in the determination of individual prices, since they represent different liquidity risks. The following new formulation of sentences 1 to 4 is proposed: "The internal prices used should reflect <u>the external cost of funding. The transfer pricing model should capture the cost of existing funding as well as the current funding costs. To achieve a reliable internal funding price, an institution's transfer pricing model must have the flexibility to adjust pricing variables to capture changes in costs for new funding, mainly,</u></p>	<p>of funding)</p> <p>"Dynamic price setting" is explained in the text as "an institution should ideally be able to recalculate the transfer price according to its expected balance sheet term structure"</p> <p>CEBS does not agree to calculate the internal fund transfer prices based on average cost of existing funding.</p>	<p><u>group. As the required size of the liquidity buffer (and its cost) changes with any new product sold, as well as any new funding tapped, an institution should ideally be able to recalculate the contingent liquidity cost element of the transfer price."</u></p> <p>In addition the last sentence on page 4 is deleted.</p>

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	<p><u>when calculating the contingent liquidity cost price.</u>"</p> <p>The call for a recalculation of the transfer prices after each new assets-side or liabilities-side transaction proves to be neither meaningful nor in line with practice. To control new credit business and funding (deposits, securities issues), the institutions need a reliable basis for calculation. Customers expect a certain consistency of pricing over time. Control impetuses resulting from changed transfer prices therefore as a rule occur at longer intervals, with changes from one day to the next constituting the exception. From a technical point of view, the call for real-time adjustment of the transfer price would give rise to considerable expense. Accordingly, the last sentence should be deleted.</p> <p>Some of the responses also have comments to the general framework for the liquidity cost benefit allocation mechanism described in chapter 3 Contents on page 4. These comments are posted below:</p> <p>Some of the answers ask for a more clear definition of "roll-over" risk. Some express the view that banks should only be required to allocate the liquidity cost to the current instrument and should not have to assume any additional costs for potential roll-overs that could occur. These costs should be taken into account separately at maturity in case the instrument is rolled over.</p> <p>Commenting on Footnote 1 to this paragraph, actually if the 3-year loan is fixed rate then the appropriate funding cost is the 3-year funding cost, but if the loan is floating then there is a case for saying the cost is the 3-mo CP cost PLUS the appropriate FTP liquidity spread.</p>	<p>Roll over risk: Risk that a loan or a commitment can not be cancelled at the expiring date, but must be rolled over due to customer relationships or reputation damage if not renewed.</p> <p>CEBS agrees to this clarification</p>	<p>New text in foot note 1 on page 4: For example, if a 3 year <u>fixed rate</u> loan is granted and is funded by 3 month commercial paper that will be rolled over each quarter, the appropriate liquidity cost is the 3 year funding cost and not the initial 3 month cost of CP issued.</p>

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	Annex 1 Examples of observed practices in European banks		
	<p>One respondent notes that Annex 1 describes the status of the implementation of transfer pricing in selected banks. However, no pronouncement is made on the extent to which the procedures discovered are in accordance with the new requirements or even possibly meet these in full. A “benchmark implementation” cannot therefore be inferred from this. From the scope of the paper, it can be concluded, however, that the new requirements are currently met in full by only a very few banks. It is therefore to be expected that in future banks will have to produce as a rule considerable one-off and continuous efforts in IT and human resources in order to implement the requirements. It is possible that transfer pricing justifies a new function of its own in the organisation of the bank.</p> <p>CEBS is asked to pronounce on the general expectation of the Committee concerning the implementation efforts in banks. These should be graduated roughly according to the degree of complexity of banks. Such expectations could make it easier for the banks to estimate the scale of the necessary work and to plan their own implementation. Besides, it is suggested dispensing with the entire annex.</p> <p>One respondent suggests that a wider sample of firms should be consulted to fully reflect the wide spectrum of firms’ business models and transfer pricing practices</p>	See comment to the implementation date above.	n.
	Annex 2 Calculating Contingency liquidity costs		

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	<p>One respondent says that annex 2 of the consultation paper proposes an approach for calculating the contingency liquidity costs corresponding to different exposures. The approach associates contingency liquidity costs with the cost of maintaining a liquidity buffer, which, in turn, is decomposed into the funding cost of the liquidity buffer, and the opportunity cost of holding low-yielding assets in the buffer. These two components should be considered when calculating the cost of maintaining a liquidity buffer. In addition to the cost of the buffer, it would be useful to compute the marginal contribution of exposures on the balance sheet to the liquidity buffer. In particular, it is advocated a definition of an economic measure that accounts for cross sectional variation in exposures' contribution to the required liquidity buffer. In order to quantify the marginal contribution of an exposure to the liquidity risk on the balance sheet, the measure should utilize information beyond statistics such as the size of exposure, and include instrument-specific characteristics such as cash flow structure, optionality, etc. Such a measure of marginal risk contribution would facilitate accurate pricing of liquidity risk at the individual exposure level</p> <p>One respondent makes comments that calculating the cost of a liquidity buffer is much less "precise" and a more difficult exercise than the annex suggests. For instance, in the current market environment it would make a great difference, in terms of carrying costs and price risks, whether a buffer is composed of core eurozone government bonds or, alternatively, (still highly rated) peripheral eurozone government bonds.</p>	<p>CEBS acknowledges that the topic of fund transfer pricing and a liquidity cost benefit allocation mechanism are complicated and technical matter. CEBS has tried to work out guidelines that will give some advice to the institutions, both to large and complex institutions, as well as smaller institutions with less complicated balance structure. To achieve this goal the guidelines have to be broad with the possibility of omitting some aspects and details which by some respondents could be regarded as important.</p>	<p>n.r.</p>