

31st July 2008

**UniCredit Group's reply
to the CEBS's consultation on the Recommendations for the
management and supervision of liquidity risk**

The Committee of European Banking Supervisors is consulting the public on liquidity risk regulation, in order to answer a European Commission' Call for Advice. The public consultation, ending on 1 August 2008, runs in parallel with the consultation of the Basel Committee on Banking Supervision (BCBS), which is on the same topic. CEBS' recommendations are consistent with the BCBS' "Principles for the management and supervision of liquidity risk".

UniCredit S.p.A. (UniCredit) is the holding company of UniCredit Group. Along with its subsidiaries, HypoVereinsbank and Bank Austria, it holds a leading position in one of the richest areas in Europe, UniCredit has a relevant presence in 23 countries, 40 million customers, 181 thousand employees and more than 10,000 branches..

GENERAL REMARKS

The considerations presented in this reply originate from the objectives of pursuing a sustainable business, enabled by 1) better regulation for liquidity risk, 2) an efficient and effective supervisory framework for liquidity risk, and 3) appropriate market discipline.

For cross-border banking groups, a group-wide and qualitative liquidity risk management approach is important for its efficiency and effectiveness. Host supervisors may put more uniform reliance on home supervisors and regulation to ensure adequacy of enterprise-wide management of liquidity. In the EU, this requires further enhanced centralisation and integration of group-wide supervision under the lead of the consolidating supervisor. The group liquidity risk management is not conceived as a profit center but as a

function establishing the necessary conditions for a sustainable business activity, thus promoting financial stability. At the same time, regulation and supervision directly impact on the group liquidity management. Specific supervisory requirements should not be prescriptive, provided the Group liquidity policy can allow for appropriate measures and a structured dialogue is in place with competent authorities.

The are no major reservations concerning the recommendations proposed by the CEBS. Currently there is pressure for competent authorities to take prompt actions to restore market confidence. These actions are primarily targeted at addressing potential deficiencies in the liquidity risk management practises of financial institutions. We understand that this is justified by the need to address the whole banking system where practises differ widely and best standards are not always well-defined and applied. However, the CEBS consultation indicates that there is a reflection among competent authorities on the effectiveness of the current institutional framework of micro/macro-prudential supervision. This is particularly relevant for the EU, where the debate has just started with the European Commission's consultation on the role of the three EU supervisory committees.

SPECIFIC REMARKS

a) **Accountability and Monitoring**, Recommendations 1, 4, 12: *Institutions should be aware of the strategic liquidity risk and liquidity risk management at the highest level of the group, and have adequate knowledge of the liquidity positions...*

Comment: the **Group considers itself to be aligned with such recommendations**. The Group liquidity policy, in fact, defines and limits the Group risk appetite through a complete set of short-term and medium/long-term limits which are adapted for each so-called *Regional Center*. In simple terms, the risk profile is defined according to three levels of control:

- 1) during normal market conditions and for the short-end of the maturity curve, by limits on maturity buckets up to a maturity of one month. These are coupled with warning levels at maturities of two and three months;

- 2) during normal market conditions and at the long-end of the maturity curve, by ratios which define the minimum percentages of long term assets that are financed by liabilities with matching maturity;
- 3) during market distress and only for the holding (acting as lender of last resort), there is another operational target expressed in terms of days of surviving.

b) Legal, regulatory and operational obstacles to group' effectiveness and financial stability, Recommendations 4 *requires also that "market, regulatory and other constraints are taken into account when managing liquidity in banking groups".*

Comment: **A more effective institutional framework could also foresee that all efforts are undertaken to ensure that those limitations are removed.** There are national legal impediments that may hamper the capability of the parent company from managing effectively the group liquidity risks, especially under stress conditions. For example, there are restrictions to intra-group transfer of assets or liquidity on a cross-border basis. Regarding assets, a possible initiative is to adapt EU legislation to ensure legal certainty in respect to collateralised credit provided by central banks in all circumstances to the group legal entities. More generally, the lack of a definition in EU legislation of the banking group concept is a primary source of concern.

It is therefore suggested **a new principle that entrusts supervisors, in cooperation with central banks** be added, **with the task of:**

- identifying legal, regulatory or operational impediments to the transferability of assets and liquidity by and within cross-border banking groups;
- identifying legal, regulatory and operational limitations that may constitute an impediment to an efficient and effective management of liquidity and related risks;
- set-up a common portal which is a single information point where the country features are easily accessible and compared across countries;
- suggesting to competent authorities how to address these impediments..

c) Regulatory/operational obstacles to efficient collateral management,

Recommendation 9: *In order to ensure sound collateral management institutions should...- understand and address the legal and operational constraints underpinning the use of collateral, including within control functions.*

Comment: **In today's market, collateral is an essential component of liquidity risk management.** Collateral deriving from different market segments should be treated with a high level of automation in a whole context of substitutions, margining and eligibility criteria, in order to reduce operational risk impacts and to obtain an easier access to credit operations (intraday or fixed maturities). A correct collateral mobilization could help intraday liquidity management.

First, the obstacles preventing banks from using a common pool of collateral that is held centrally in a single location (e.g. with one central bank) within the EU, while being used in open market operations with other central banks, have to be investigated.

Second, central banks' collateralisation procedures are not always harmonised across countries. This unlevel playing field across counterparties may also affect the smooth use of collateral. For instance, in a few countries the current earmarking technique is less favourable than the pooling technique because it does not allow the substitution right and makes collateral management much less efficient, especially when credit operations are of longer maturities, which is the present situation.

Third, collateral management would substantially benefit if the option to re-use collateral was effectively provided, especially within the operational framework of the central banks. Based on lessons learnt with the ongoing market turbulence, we would expect that the introduction of some innovations, which optimise the use of collateral to make liquidity available, is one of the main objectives of the central banks. This initiative could be implemented through cooperation between central banks and Central Securities Depositories (*triparty agents*) to define the integrated process of allocating, delivering and servicing collateral.

d) Analysis and Control, Recommendation 13 and 17: *Institutions should verify that their internal methodology captures all material foreseeable cash inflows and outflows, including those stemming from off-balance sheet commitments and liabilities... Institutions should actively monitor their funding sources to identify potential concentrations...*

Comment: The Group considers itself to be aligned concerning the liquidity risk arising from all future cash flows of assets and liabilities, with ladders computed on a daily basis.

A valuation process of contingent liquidity demand associated with off-balance sheet positions is in place.

The Group adheres to the principle concerning the diversification of funding sources. A yearly funding plan defines the allocation of funding to each regional liquidity centre according to respective specialisation.

UniCredit experience: In order to avoid negative economic consequences, banks have experience in how to manage possible higher liquidity costs, implementing all measures to balance funding maturities and to attenuate the liquidity impact on short term buckets. Besides, the gap between secured and unsecured markets is forcing banks to optimise their collateral utilisation. This optimisation inevitably considers the more favourable conditions to finance certain eligible assets at the single ECB rate rather than in the private repo market where asset categories are priced differently, if traded at all. Such a pricing situation is deemed positive during the current market conditions. However, this potential subsidy nature, embedded in the current operational framework, may not necessarily facilitate a smooth restoration of market conditions in the medium-term.

In addition, the wider economic impact of the sub-prime mortgage crisis has emphasized **the role of the parent company as the "lender of last resort" for the Group to provide additional liquidity in a possible local liquidity crisis**. The parent company, after establishing the correct perimeter for its role, should cover all local liquidity access thereby optimising foreign branches'/subsidiaries' intraday credit access towards central banks using eligible foreign collateral. International banks need to manage their collateral in different

currencies to avoid possible extraordinary local liquidity needs. For this reason central banks are encouraged to broaden the list of eligible assets, in emergency situations, to non-euro denominated assets and, especially for the Eurosystem, to provide credit in currencies other than the euro.

All aspects have to be considered by central banks in order to promote harmonised intraday credit access with foreign collateral. In a settlement system contest, the group parent company liquidity manager has to identify all measures to allow a global view of all Group payment flows and the intraday Group liquidity available. In the European Target2 system, the banks are able to use a liquidity pooling functionality to view and use their liquidity irrespective of which Real Time Gross Settlement (RTGS) account it is held in. For multinational banks this service avoids liquidity fragmentation and allows the liquidity manager to monitor available Group liquidity during the day.

Recent events have shown that central banks assume a crucial role when market liquidity decreases and the funding liquidity needs of financial institutions rise. Their interventions, typically, are intended to prevent the collapse of financial markets and to restore confidence in the system supporting interbank funds. Central banks have a double responsibility: to execute monetary policy and maintain financial stability, and at the same time promoting a smooth functioning of financial markets. The Eurosystem operational framework, and especially the collateral framework, has been able to step in effectively when intermediation in interbank markets deteriorated, without the need to make changes to its framework. This has contributed to financial stability in the euro area and to distinguish the instruments to pursue the different responsibilities.

In this regard, we think that a strict cooperation between all central banks is essential to allow all possible liquidity access. An efficient and effective collateralisation of central banks' liquidity may require some form of mutual recognition of the eligibility criteria and convergence of collateral procedures.

e) Stress conditions, Recommendations 14 and 15: *Institutions should conduct liquidity stress tests and have adequate contingency plans.*

- 4) *Comment:* **The Group considers itself to be aligned concerning the group-wide liquidity stress tests and the contingency plan of the**

Group. The liquidity management is based on the principle that each Regional Liquidity Centre is responsible for its own solvency by means of using its own liquid assets. Backtesting of the group-wide liquidity stress tests have given support to the assumptions of the stress test model. The holding company acts as lender of last resort, in the interest of the financial stability of the Group as stated in the Italian Banking Law. Nevertheless, recent events have contributed to a focus on the stress test methodology. In particular, there is scope for fine tuning for the treatment of committed lines, items with optional features, and collateral management, and behavioural models for items like sight and saving deposits under stress situations.

f) Disclosure: Recommendation 18 *requires institutions to have policies and procedures that provide for the disclosure of adequate and timely information on their liquidity risk management and their liquidity positions, both in normal times and stressed times. The nature, depth, and frequency of the information disclosed should be appropriate for their different stakeholders...*

Comment: When assessing which information is relevant for disclosure, one may also refer to Recommendation 4, which clarifies that both market liquidity (external factors) and funding liquidity (internal factors) should be taken into account. The recommendation to take into account market liquidity is understandable. In fact, the combination of low funding liquidity risk and the underpricing of market liquidity risk has been a major cause of the ongoing financial turmoil, probably triggered by an environment of excess liquidity and “hunt for yield”. A re-pricing of market liquidity risk including promoting market discipline is, therefore, crucial.

The President of the ECB recalled the importance of “More and improved data on net credit risk exposures and on the concentration of positions ... that could help to mitigate sizeable shortcomings in both counterparty and systemic liquidity risk management. Following the financial turmoil and official requests, an increasing number of banks are releasing more and better individual information. This information refers to micro-data requirements to which a subset of financial

institutions are subject. More disclosure is useful to price funding liquidity risk and counterparty risk.”¹

However, the information mentioned by Mr Trichet, as reiterated in June 2008², is of a macro-prudential nature and especially useful in measuring market liquidity risk. In fact, the banking supervisory architecture, which mainly focuses on micro aspects, proved to be simply inadequate in collecting appropriate information, to analyse the worldwide distribution of risks and to disclose relevant information that would enable market discipline to work and better price liquidity risks. EU and international institutions and fora (e.g. the ECB, IMF, BIS, FSF) should, in fact, play an increasing role in gathering information from national supervisors and assessing vulnerabilities stemming from a concentration of risks or homogeneous behaviour which could eventually result in a market liquidity dry-up.

In this regard, we consider it highly desirable that a structured dialogue be established between senior managers of financial institutions, major central banks and supervisors in order to identify information that may be:

- a) disclosed by individual institutions (Recommendation 18) or***
- b) aggregated by competent authorities and anonymously disclosed - relevant for assessing market liquidity risk (Recommendation 4)***

The Financial Stability Forum has provided some suggestions to individual institutions on point a). Concerning point b), the following information may be aggregated and disclosed by competent authorities:

- Systemically relevant data that may be used as input parameters for liquidity stress testing: e.g. aggregated, committed and used credit lines (also according to committed lines to SPVs and others); the distribution of the stress test parameters across banks; the percentage of withdrawals of sight and saving deposits in cases of bank runs (e.g. Northern Rock and others) and in cases of stress situations;

¹ Jean-Claude Trichet: “Some reflections on credit derivatives”, April 2007

² Jean-Claude Trichet: Reflections on the current financial markets correction: “Augmenting transparency is not only necessary to make the markets more efficient and to optimise the allocation of capital, but it is also the best insurance policy against irrational herd behaviour and unjustified contagion in times of stress”.

- Qualitative and quantitative information on aggregate exposures and risk concentration . Further investigation may identify appropriate breakdown by asset categories, type of debtors, type of market participants and type of risk;
- Where available, time series liquidity indicators, relevant to assess the evolution of market liquidity for certain pre-defined asset categories: turnover, anonymous distribution of activity among participants, depth etc.

g) Supervisory/central banking operational obstacles, Recommendation 23: *When assessing the quality of liquidity risk management, supervisors should pay particular attention to the adequacy of the institution's liquidity risk insurance, especially for stressed situations. Supervisors should pay particular attention to the marketability of assets and the time that the institution would actually need to sell or pledge assets (taking into account the potential role of central banks).*

Comment: **misalignments occur between assets eligible for supervisors and central banks.** In order to address an existing uneven playing field, supervisors and central banks should cooperate to increase consistency between the eligibility criteria of assets that may be used, on one hand, as a prudential liquidity buffer and, on the other, as underlying collateral for central banks' credit operations which, by definition, also make highly liquid non-marketable assets, such as credit claims.

In addition, a **currency can be a "regulatory" obstacle when related markets are disrupted:** A foreign currency liquidity facility in central banks, accepting as eligible, collateral denominated in other currencies, can become very important. This is especially important in enabling cross-border players to act as efficient allocators of capital and risk throughout the banking system in the event of market liquidity disruptions.

The emergency use of cross-border collateral has the potential to support financial stability during a local crisis³. The availability of central-banks' currency

³ The Committee on Payment and Settlement Systems' report on cross-border collateral arrangements published in January 2006 describes possible generic cross-border arrangements, each of which requires actions by central banks.

swap facilities⁴ are highly desirable. They allow banks to cope effectively with both currency market disruptions or liquidity difficulties. This should include systemically relevant branches/subsidiaries for currencies whose currency swap market is not developed or severely hampered. In addition, central banks should consider developing new techniques to facilitate intraday and overnight credit .

With the process of financial market integration, the flexibility to use collateral denominated in different currencies, in order to obtain liquidity in different currencies, is becoming essential to mitigate potential liquidity shocks in different markets and to strengthen financial stability. In general, accepting foreign collateral held abroad might increase the flexibility of banks when it comes to receiving credit and reducing its overall collateral cost.

h) Inefficient use of internal group-wide model: Recommendation 25: *Supervisors should consider whether their quantitative supervisory requirements, if any, could be supplemented or replaced by reliance on the outputs of institutions' internal methodologies, providing that such methodologies have been adequately assessed and provide sufficient insurance to supervisors.*

In some countries where the group is present, quantitative criteria are used by supervisors for subsidiaries, negatively affecting group's efficiency and effectiveness. We support the effort of CEBS that asks EU supervisors to consider the conditions for replacing those requirements with adequate internal methodologies, consistent across the group.

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⁴ For example those established by the FED, the ECB and the Bank of Japan or the tender procedures for provision of USD to Eurosystem counterparties, under the Term Auction Facility.