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Mr. Giovanni Carosio
Chair
Mr. Arnoud Vossen
Secretary General
Committee of European Banking Supervisors
Floor 18 Tower 42
25 Old Broad Street
EC2N 1HQ London United Kingdom

Re. CEBS Consultation Paper on Liquidity Buffers

Dear Sirs:

The IIF fully supports the concept that firms need to maintain adequate buffers of assets in order to handle stress periods. In the *Final Report of the Committee on Market Best Practices*[1], released in July 2008, the institute acknowledged the need to have "specifically earmarked and unencumbered liquid assets that they should maintain at all times to meet immediate liquidity needs when faced with adverse conditions." Any such reserve is critical for surviving both one-time stress events and prolonged periods of turbulence. At the height of the crisis it became readily apparent that having access to a reserve of liquid assets was instrumental to a firm's ability to endure market disruption. The Institute's position on buffers was, however, already clear before the crisis; in 2007 the *IIF Principles of Liquidity Risk Management* clearly stated that "Firms should develop methodologies and policies to determine the level of specifically earmarked liquid assets that they should maintain at all times to meet immediate liquidity needs when faced with adverse conditions."[2]

While a buffer requirement is clearly appropriate, especially in light of the last two years' experience, it must be carefully calibrated to achieve its purpose without overkill. The cost of holding a mandated amount of specific assets will have an effect on the recovery of the wider economy itself. Maturity transformation is the essence of banking. While a buffer requirement is clearly sensible to enable banks to weather the inevitable vagaries of the economy and the market, and to put some proportionate limits on maturity transformation, a requirement that goes substantially beyond reasonable safety-and-soundness levels would compromise the banks' ability to fulfill that essential social function.

For this reason, liquidity requirements may have as great, or greater, effect on the overall credit-generating capacity of the system as capital, and need to be designed with those credit needs in mind. This impact is all the more important as it becomes evident that some form of leverage ratio will be

[1] Available at http://www.iif.com/press/press+75.php
[2] See Recommendation 41; available at http://www.iif.com/press/press+25.php

imposed, assuming a leverage ratio will tend to penalize holding of the types of assets likely to be eligible for liquidity buffers.

We will detail some of the more specific potential effects of a miscalibrated requirement, such as the prospect of dumping ineligible assets on the market in order to finance the purchase of "safe" eligible securities, later in this letter.

Putting aside those specific risks, however, there is a general concern about the lack of an analysis thus far, at either the international or the European levels, of the combined impact of all new regulatory and accounting measures, from capital and leverage requirements to securitization restrictions to new accounting guidelines, including new liquidity requirements, and the cumulative effects of all these changes on the ability of the financial industry to provide the amount of credit needed for recovery and sustained prosperity. This is a serious issue when examining all the changes planned under the auspices of the G20 and the FSB, but the concern is compounded if the suite of new regulatory initiatives differs across jurisdictions. We realize that impact analysis is now planned for the coming months - this must be a truly comprehensive analysis, including all changes, especially, for purposes of this letter, the interaction between liquidity-buffer requirements and leverage ratios.

Concern about cumulative impacts, on the one hand, and about fragmentation across jurisdictions, on the other, does not in any way call into question the need for comprehensive regulatory reform. However, as stated in the Institute's July 2009 report, *Restoring Confidence, Creating* Resilience: "it is crucial that the cumulative effects of reform be consistent with market efficiency, avoiding rigidities that could stifle growth, job creation, and innovation, or increase the cost of financial services to customers."

Guideline 5

The IIF agrees with the general language of the guideline, but the usage of "maximum extent possible" is a cause for concern. The industry would need to know more about the specifics of the stress periods being used by CEBS in the scenarios. In our response to question 1.1 we will approach the issue of concentration in more detail, but it must be said that it may be hard for some firms to avoid holding large concentrations of particular assets if the definition of eligible assets is too narrow, limiting the possibility of diversification. There are already indications that some countries, even within Europe, would limit this to local state obligations, which is both at odds with the single market and inevitably going to cause concentrations of assets that may be vulnerable to the ratings and market standard of the sovereign or other eligible local issuers.

More generally, the concept of "maximum extent possible" must be understood practically and flexibly, as any crisis situation will require a nimble response and the use of good judgment. Application of this concept in a dogmatic way could lead to dumping assets on the market or other unintended effects that could compound rather than mitigate a crisis, and thereby lessen both the individual firm's and the system's resilience.

In addition, application of the "to the maximum extent possible" and "available in times of stress" aspects of Guideline 5 needs to be weighed against macroprudential concerns such as credit provision and maintaining liquidity in the market (and, on the other hand, avoiding underpricing of liquidity) and thus must be variable over time.

As discussed in some detail in our prior reports, we certainly agree that a careful examination of the "legal, regulatory, or operational impediments" to access to liquidity should go hand-in-hand with each firm's assessment of liquidity guidelines and restrictions.   This sort of due diligence is a normal and necessary part of any firm's liquidity-risk management.

Paragraph 13
We are heartened by CEBS's commitment to make these guidelines principles-based. In a market such as Europe, with a wide range of financial institutions carrying on numerous combinations of business lines, the principles-based approach (in a context of good supervision) is clearly correct and should avoid the one-size-fits-all approach that is particularly problematic in the liquidity field[3]. Principles-based regulation requires more dialogue and interaction between supervisors and firms, which results in a more detailed, comprehensive understanding of firms' activities. Firms welcome that approach and support the direction CEBS is taking.

Paragraph 18
The statement that "CEBS intends to give further consideration to the economic implications of its recommendations during the consultation period, before presenting its final recommendations," is highly congruent with the conclusions of the Institute in its *Restoring Confidence* report. A balance must be found between ensuring financial firms will be able to weather another shock and overshooting in the calibration of new requirements to the extent that they brake recovery and burden economic activity unduly. As stated above, it is important that this impact assessment take into account the interactions of all the regulatory and accounting changes now being introduced.

Paragraph 19
The use of the term "highly liquid" in this context can be problematic if not well defined and qualified by a practical sense of the market. Market liquidity is not an absolute concept, but very relative, as it is variable in time. Many assets that are highly liquid in "normal" circumstances may become illiquid in systemic crisis. During periods of market stress over the past year, there were very few assets that could be defined as highly liquid consistently. The guidelines need to recognize the practical limitations when there are systemic event conditions. As we have experienced, even AAA government bonds may be difficult to repo or sell under certain conditions.

It should be clear that "highly liquid" should be assessed in good faith by the bank in terms of conditions existing from time to time; the guidelines should not be so rigid as to create audit or examination problems for banks using best efforts to cope with difficult market conditions.

Moreover, for the avoidance of doubt, it should be made clear that the commercial concept of "highly liquid" would include the capability to sell or repo an asset (directly or via triparty repo arrangements), or to transact with the central bank in its normal open-market operations. There are market conditions in which it may be difficult to sell certain assets but it is still possible to use them via repos to raise liquidity.

Question 1.1
The committee notes with appreciation that CEBS's approach does not take the most restrictive route that has been considered.

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[3] See Consideration for the Official Sector C, Principles, and Consideration for the Official Sector III.J, in the *Final Report of the Committee on Market Best Practices* (2008)

A too-restrictive definition of eligible assets when there will be an expectation of maintaining large portfolios of such assets for liquidity-buffer purposes will necessarily affect the markets for both eligible and ineligible assets. Eligible assets, if defined too narrowly, may actually become significantly less liquid, as they will need to be held in large amounts for liquidity-buffer purposes, while demand for ineligible assets may diminish.

Currently there is a large supply of government debt that could be used for this purpose; however, when economies begin to recover and nations start to reduce their debt, a shortage of available assets that are considered eligible could develop. A too-narrow definition will inevitably increase concentration in certain assets, increasing the chance that they will become relatively less liquid or even substantially illiquid, in difficult market circumstances. This concentration may occur both at a single-institution level and at the system level. If most banks hold the same range of "highly liquid" assets (even if relatively diversified at the institution level), in the event of a systemic crisis it would imply all banks trying to liquidate the same range of assets, which would so become illiquid. Similarly, as discussed below, there would be the danger of simultaneous action by many institutions if an asset were downgraded or otherwise changed its liquidity characteristics. Thus being too restrictive in establishing the acceptable composition of the liquidity buffer would risk undermining the very purposes of the buffer requirement.

See the related discussion under Paragraphs 67-68, below.

We expect demand for shorter term instruments to be particularly strong on a relative basis to avoid incremental market risk. It is important to realize that any liquid assets that are not considered eligible for the buffer, i.e., part of the solution to a sudden need for funds, become automatically part of the problem and need to be considered as illiquid for the prescribed survival period.

Excluding any class of assets that is reasonably liquid from buffer eligibility will delay or permanently impair the recovery of the related funding markets, markets that may be important to long-term economic growth. Issuers that have reduced access to such markets will generate more demand for bank loans at a time when banks are trying to improve liquidity and capital cushions, and hence have reduced lending capacity.

Any cut-off point of eligibility will have secondary effects, including incremental costs, which banks will have to bear and pass on to customers, with the macroeconomic impact on the broader economy of these higher costs and greater unmet demands for loans.

Conversely, a somewhat broader definition will run less risk of unintended market effects because firms will be able to bid for a wider variety of assets to complete their buffers.

Question 1.2

As was discussed at the London hearing, this question requires some clarification. It is, however, factually true, that operational or legal impediments to use of collateral across jurisdictions may cause distortions or valuation anomalies that have to be taken into account in liquidity-risk planning.

We hope central banks will work to maximize the compatibility of their requirements and facilitate interoperability of collateral wherever possible. Any steps toward greater international consistency of central bank-acceptable collateral would facilitate building truly liquid, robust, and reliable buffers.

While this is outside of CEBS's scope, nonetheless, CEBS and its member bodies should work closely with the central banks to keep them in mind of the liquidity-risk implications of their policies.

Question 1.3
Until we know what assets are to be allowed it is difficult to answer this question. There needs to be greater clarity regarding how narrow this definition is, and under what circumstances it is implemented, before we can fully gauge any side effects.

One necessary condition is a reasonable transition time for firms to adapt to the new guidelines, which will need to be longer the narrower the list of eligible assets. While we understand that the consultative paper is proposing guidance and not new regulation, nonetheless it will clearly have regulatory implications and it should be made clear that phasing in the changes will take time.

To urge banks to change the asset makeup of their liquidity over a short period of time will force banks to sell assets simultaneously, depressing prices for affected assets, while at the same time driving up demand for whatever assets are eligible. Depending on the initial definition of what is allowed, it would be helpful if CEBS would commit to ongoing re-assessment of the impact of the measures and the ability to change rules if needed.

A similar necessity is the establishment of an allowance for periods of adjustment if an instrument is downgraded or suddenly becomes illiquid. If, for example, a major government loses its AAA rating or an asset becomes no longer central bank eligible, how fast will firms have to replace that component of their buffer?[4] We can see very serious systemic issues resulting from such an event because of the rush to buy eligible assets and sell ineligible assets as described above. Downgrades or restrictions in eligibility are more likely to come during times of economic and market stress, with the effect that any requirement rapidly to change the composition of banks' liquidity buffers could cause excess procyclicality in the concerned markets. This question is especially acute as state debt of certain European countries faces a very real risk of downgrade.

What these concerns reflect is the dynamic nature of markets: liquidity changes over time, and market conditions will cause fluctuations in the availability and cost of collateral. A narrower definition will put more pressure on the market, and hence change the dynamics, perhaps with unintended consequences to those assets sitting in the liquidity buffer. These effects must be effectively understood if we are to put in place such a regime – hence our request for an ongoing assessment of the program as it is implemented.

As well, the definition should differ for short and long buffers. For the short-term buffer a somewhat more narrow definition of "highly liquid" assets including central-bank eligible paper, covered bonds, etc., would generally be appropriate. However, for the longer end, even a "narrow" definition should take in a broader range of instruments.

In the short term, central bank eligibility may be the only functional source of liquidity, and thus the only available buffer, in a systemically bad market; hence central bank eligibility is more likely to be

[4] An important although in some ways difficult example would be the self-securitizations and bank loans currently allowed under ECB rules, These currently meet the criterion of central-bank eligibility but would not as of now meet the "highly liquid" test.

essential at the short end and for system-wide issues, and it may not, depending on circumstances, be realistic to expect "high liquidity" in other markets. For name-specific issues, however, there is likely to be more latitude and a range of assets may be disposable in private markets.

At the longer end, certain non-central-bank-eligible instruments may be "highly liquid' and entirely appropriate and prudent to count toward the buffer. This is recognized by CEBS, judging by the hearing in London and paragraph 50; however, it would be helpful if Guideline 4 were clarified to remove any implication that the requirement of "both" central-bank eligibility and market liquidity would necessarily apply at the longer horizon.

Provisions for liquidity buffers need to take into account the exercise of discretion by central banks depending on their mandates. In some systems, a firm can access central bank facilities without restrictions as long as it has the collateral required. In other jurisdictions, central banks can deny access to firms under certain circumstances, especially if believed to be insolvent. This discrepancy will cause ambiguity and uncertainty for firms operating under the umbrella of different central banks. There should be a clear delineation of conditions regarding access to central bank facilities.

In addition, it must be recognized that smaller institutions will often appropriately use bank paper, especially at the longer terms. Allowance for this should be made in order to recognize what is in fact prudent risk management on their part but also, and perhaps more importantly, because of the impacts that eligibility or non-eligibility of such paper will have on the large banks' funding, and hence on the liquidity structure of the entire market.

Question 2
We have detailed the effects of a too-narrow definition of eligible assets in responding to the previous questions. It is apparent that excluding any substantial category of liquid assets for eligibility will delay or permanently impair the recovery of these funding markets, thereby limiting access to credit for the broader economy. An excessively narrow definition would have ongoing effects on the market, effects which would need to be considered carefully as central banks consider what should be the "new normal", as well as being considered cumulatively with other regulatory and accounting changes.

Question 3
Central bank eligibility is not necessarily synonymous with liquidity in the broader market. For example, the ECB currently accepts certain loans and self-securitizations while the underlying market is still less than liquid.

The purposes of the buffer need to be kept in mind: there may be highly liquid assets that are not central-bank eligible but that are, as argued above, appropriate especially at the longer end. While it is conceptually possible that there may be instruments that are central bank eligible but not appropriate for liquidity buffers, exclusion of any instrument that is central bank eligible should be carefully considered. Exclusion of such instruments may have significant and possibly unnecessary consequences, depending on the facts and circumstances.

While the IIF fully acknowledges that the first line of defense in either a firm-specific or system-wide crisis is not the central bank, central bank–eligible assets will generally have the ability to generate cash by sale, repo, or other use as collateral in the market. Any discussion of the role of central bank eligibility in business planning, especially for liquidity risk management, requires central banks to establish the "new normal" of their operations, for normal times and for periods of systemic stress. Constructive clarity is needed as to what facilities are permanent and what are not before we can be sure that the universe of eligible securities is suitable to support liquidity needs of firms and new regulations.

Once central banks have established the framework for future participation in normal markets, they should become more transparent about the process to be followed during extraordinary events, for example, the types of additional collateral that could be pledged, haircuts that could be applied, limits by asset type (if any), and the delivery form of such assets. We understand that there is a fear that greater transparency on the part of central banks would lead to moral hazard. It is IIF's belief, however, that the benefits of increased clarity on how central banks would respond to different types of crises outweigh this risk. To the extent possible, the more protocol that is established prior to such an event, the better prepared both firms and supervisors will be to address a crisis. Such clarity would be extremely helpful in the context of the system-wide stress requirements. To be clear, this constructive clarity would not, however, extend to firm-specific lender-of-last-resort situations, as to which constructive ambiguity remains appropriate.

We have argued since our 2007 report on liquidity that more consistency and interoperability of central-bank collateral would contribute to the resiliency of liquidity in the international financial system. After extensive initiatives by central banks worldwide to steady financial markets, the question is what new global pattern of collateral eligibility will emerge from the present extraordinary measures. While it is clear that many of these extraordinary measures should not be maintained when the system returns to normal, we also consider a return to the status quo ante unlikely. Rather, we hope central banks will work to maximize the compatibility of their requirements and facilitate interoperability wherever possible (including developing the legal and IT infrastructure where it is still lacking).

In that context, CEBS, as part of this new liquidity buffer regime, should work towards these goals with relevant central banks, and certainly not apply narrower norms for liquidity buffers than do the central banks for widely available instruments.

Paragraph 20
As the Institute has stated in several other contexts, including in addressing the G20, there is certainly a substantial risk of negative impact on the real economy of overly restrictive liquidity-buffer requirements, particularly in the context of leverage ratio and capital changes. This is hard to quantify in the absence of specific proposals, but there is no doubt from our members' liquidity managers or economists that effect could be substantial.

Question a.
The more restrictive the list of securities eligible for liquidity buffers, the greater the impact on ROE. Because of the increased demand for eligible assets that would result from a narrower definition, eligible assets will yield less than if more are allowed. There will also be a greater opportunity cost for non-eligible assets that will yield more if fewer assets are allowed. ROE impact will depend on more than just the eligible assets; the size of buffer and spread between funding costs and asset yield, which will increase the longer the liquidity buffer needs to be funded for, will determine ROE as well.

At a time when banks need to raise more capital in response to market demand and regulatory pressure, decreasing firms' ROE will make capital raising more expensive, with the most impact on the firms in the most difficult market situations. Once again, the specifics of implementation of the leverage ratio could exacerbate these effects.

Question b.
Depending on the variables mentioned above, banks will often need to reduce lending capacity in order to retain enough assets to sustain the liquidity buffer at regulator-mandated levels. Reduced levels of credit available to customers will leave unmet demand for financing, which would lead to increased financing costs, as well as the obvious effects on the real economy.

Question c.
It is hard to analyze the full impact of these proposals on business activities because of the uncertainties about the specifics of numerous other new supervisory and accounting requirements and guidelines currently being debated. Thus, it cannot be said whether the effects of combining the numerous different business restrictions will magnify the effect of just one.

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

These proposals will also affect loan business strategy if mitigation costs are appreciably higher than current liquidity risk management practices. It is difficult to give a precise answer but the direction of the impact is quite evident.

Question d
We believe that these proposals can have a positive effect on the interbank market if the proposals are risk-based, in the vein of previous regulatory policy. As long as implementation is done in incremental steps and based on realistic analysis of the impact of these guidelines on the markets for all securities and the firms themselves, then confidence can be restored. However, if the proposals are implemented immediately and without regard to banks' individual business models and funding profiles, and without a cumulative impact study with other regulatory and accounting changes, then there is a chance it will prolong the time required for recovery.

Paragraphs 25, 26 & 30
These paragraphs are important and further point out the importance of "counterbalancing capacity", which is discussed at some length in the Appendix and clearly important to CEBS's thinking, but seems not to have been as fully factored into the guidelines as might have been expected.

We understand that the concept of counterbalancing capacity is held to be broader than the concept of the buffer; however, a realistic assessment of a bank's buffer should take greater account of the counterbalancing capacity in its liquidity structure and planning. Appropriate attention to counterbalancing capacity could, subject to well-informed supervisory oversight, be used to attenuate some of the impact of a narrow definition of eligible assets on a firm's overall lending capacity.

Paragraphs 33 & 35
We note with appreciation that CEBS has recognized that liquidity is largely institution-specific. We hope that CEBS will make this point as necessary in other international regulatory fora.

CEBS's commitment to a risk-based approach is fully endorsed by the industry. At a time when some are hesitant about Basel II and other risk-based regulatory structures, it is invaluable to see CEBS maintain its dedication to what is in fact the only way to achieve effective regulation.

Paragraphs 38 & 39
Requiring banks to calculate liquidity buffer requirements using a common assumption of no rollover of wholesale funding access is not risk-based. Strong firms with well-diversified and material unused funding access in multiple products, currencies and market places should not be assigned the same deterministic assumption that weak firms with little funding capabilities and capacities are. It also is inconsistent with the CEBS principle that calls for firms to diversify funding access. Were this assumption to be imposed, firms that diversify funding access better than others will be penalized in their buffer calculations through a more conservative assumption relative to those that did not.

The extent to which a percentage of loss of wholesale funding capacity is assumed in calculating a firm's buffer should be determined in discussions between the supervisor and the bank, giving consideration to each firm's internal and external environment and its respective expected capabilities and capacities. Any portion of unused funding capacity that can be considered available at a high confidence level under a specific crisis scenario to renew or raise new liabilities should be considered as part of a buffer. While these issues will affect different banks differently, it must be kept in mind that companies that are not financial institutions and do not have access to central banks must keep their money someplace, even in the most dire crisis. That means they will tend to move toward the soundest banks, as indeed there was a dramatic move out of US money-market funds to US banks during the aftermath of the Lehman failure.

We understand from the London hearing that the "no rollover" assumption was merely meant as an example of the kind of severe but plausible assumptions banks might make for stress-testing purposes. While this assumption might sometimes be appropriate, this may not always be the case. Thus, it would be helplful to clarify the intent of giving an example rather than setting an expectation.

While the point is not raised directly by CEBS, banks' responses to the stresses described in this part of the paper will be affected by any forthcoming requirements on "core funding." Any rule requiring reliance on "retail" deposit funding would introduce new challenges and possibly some distortions. As stated in the IIF *Restoring Confidence* report[5], "The assumption that retail deposits (however defined) are the most "sticky" may obscure the fact that certain classes of small and medium enterprises (SME) and corporate and institutional wholesale deposits, may, in fact, be highly stable 'relationship deposits' for a number of business reasons, whereas some forms of retail deposits (for example, brokered and "teaser-rate" deposits) may be less stable."

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[5] IIF *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability* (July 2009), available at http://www.iif.com/press/press+76.php

Lack of a more nuanced definition of what qualifies as "wholesale funding" under this scenario would force banks to be overly reliant on retail deposits, which is likely to increase competition for such deposits and thus make them less stable and "sticky" as firms compete for funding.

Thus the stresses that need to be used pursuant to this discussion will be substantially affected by any future regulatory requirements in this area.

Paragraphs 43 & 44
The proposed two phases of one-week and one-month survival periods seem appropriate, and it is correct to differentiate the kinds of stresses that are faced in an immediate crisis and as the crisis works itself out over the following period, for which a month is a good approximation. Moreover, it is appropriate to note that the inference is that the funding for assets available for those two periods would have to be longer; hence the last sentence of paragraph 43, referring to additional planning measures beyond those periods is suitable and reflects prudent practice. The reasoning of paragraph 44 is correct.

To answer a question posed at the London hearing, we do not believe that longer survival periods should be defined for purposes of the guidelines. Clearly banks' liquidity risk planning needs to extend much further than these horizons to assure banks' adaptation to circumstances and survival as going concerns. Some banks, depending on their facts and circumstances, might choose to adopt longer periods for their own planning.

But, following the logic and reasoning of CEBS's paper, the proposed periods are appropriate to capture the short-term resilience goals of buffers. Mandatory longer periods would have additional cost and economic-impact implications that would need to be taken into account. To this end it is useful to note, as was said at the hearing, that the term "survival period" is somewhat misleading: it does not imply that a bank would plan only to survive for those periods, but that it would maintain buffers as "insurance" for such periods to assure its ability to cope with a crisis while taking other measures in line with its overall liquidity policies and risk appetite for longer-term survival. This point might well be clarified in the final guidance paper.

Paragraph 58
The IIF agrees with CEBS's clarification that the relevant collateral lists for central banks are those that are in place during normal times. This is important given the necessity to avoid creating a stigma on the use of "normal" central bank facilities. As amply demonstrated by the recent crisis, it is important that, when there is a risk of systemic difficulties, participating in normal central bank operations does not reflect ill on a particular bank. Only then can these facilities truly be useful in periods of uncertainty regarding liquidity.

Paragraph 59
This paragraph is consistent with the position the IIF liquidity group has taken since its 2007 report on constructive clarity: banks need to have a clear understanding of central bank policies for normal operations and operations for systemic situations (reserving constructive ambiguity for bank-specific lender-of-last-resort actions).

While we agree that banks should normally not rely "too heavily" on access to central bank facilities as their main source of liquidity, we note the (appropriate) elasticity and subjectivity of that standard.

Clearly it will need to be a subject of Pillar 2 discussion with supervisors. It might, however, be appropriate for CEBS to note that this notion of "too heavily" may vary considerably depending on market conditions, especially in crisis or near-crisis contexts.

Paragraph 60
The dangers of regulatory conflict resulting from growing fragmentation of regulation, even in Europe, and the serious problems posed by "trapped pools" of liquidity are very real and growing. These issues have an impact on the efficiency and effectiveness of regulation and on economic efficiency; moreover, they may compromise the single market in Europe. While CEBS is right in this paragraph to warn that banks must manage around these problems as best they can, we also hope that CEBS will undertake to minimize fragmentation and trapped pools through its activities insofar as possible.

Paragraph 61
We agree that the determination and implementation of the liquidity buffer needs to be a dialogue between the supervisor and the individual firm and that the guidelines should not be construed to constrain adaptations from time to time, within each bank's dialogue with its regulators. See the discussion of Guideline 5, above.

Paragraphs 67-8
The indication here that CEBS will investigate the degree to which legal entities should be self sufficient may raise some concerns. This is a major point for many firms. Restricting liquidity at the legal-entity level will hamper the ability of firms to manage liquidity effectively at the group level. We acknowledge that firms must manage to local requirements and needs, and firms may organize their liquidity management on more centralized or more decentralized models depending on many things, including business strategy.

But it is important to underscore that the efficiency of a global system will be enhanced if (a) local requirements are kept to the minimum reasonably necessary to protect local interests and (b) international operating requirements and collateral criteria are harmonized as much as possible. It is important that firms be able to deploy liquidity resources when and where needed in a global system. Large groups operate internal "markets" that contribute to managing global liquidity, including in stressed conditions.

We are concerned that if, as appears increasingly to be the case, supervisors react by maximizing local requirements, the resulting fragmentation and increase of "trapped pools" of liquidity will reduce rather than increase global liquidity, and impede rather than facilitate recovery. There are issues of management efficiency within groups, and specific impacts depend on each firm's mix of business, including the extent of local deposit business, but the broad concern is whether a new, resilient, risk-sensitive, and flexible financial system will be built to support a globalized economy, or whether regulatory fragmentation. These issues are all the more acute in Europe, where some firms have made significant investments in single-market structures that would be compromised by such fragmentation.

Good internal risk management – and strong and consistent supervision – can do much to alleviate the concerns behind "ring fencing", and the overall strength of the European and global markets will be enhanced by taking an approach that focuses on internal risk management and strong supervision, as indeed most of CEBS's guidance does, rather than ring-fencing. At the supervisory level, good supervisory coordination through colleges, especially in the EU, should alleviate most or all of the concerns that lie behind the recourse to ring-fencing.

Self-sufficiency rules that end up making subsidiaries dependent on third-party credit will increase their exposure to wholesale market volatility, on either the asset or liability side, depending on the specifics of their businesses. There will thus be increased wholesale market exposure of the whole group, if funds cannot be raised or used in the group, as well as an increase of risk-weighted assets (which will have an impact on leverage ratios) because of the lowered efficiency of liquidity management though local markets.

Moreover, any rules intended to increase the "self-sufficiency" of subsidiaries will increase direct costs as well as lowering balance-sheet efficiency, especially if, as is often the case, the risk-management expertise (a scarce resource) needs to be hired in the subsidiary itself. They will also be required to give up margin to brokers to achieve in the market the balancing that can now be achieved more efficiently, with greater effectiveness and less risk, on an intercompany basis.

Another concern is the increased level of interest-rate risk firms would have to bear in maintaining eligible assets, which typically may be expected to have terms of 30 days to past one year. This is particularly a concern with respect to subsidiaries, to the extent that contemplated changes and large-exposure limits make it less feasible for subsidiaries to invest within the group. If they have to bid for third-party paper, it will often be difficult to match their risk profiles and eliminate interest-rate risk, as is generally the case with internal investments. Thus rule changes may have the unintended effect of increasing interest rate risk.

Paragraph 69
The IIF strongly supports CEBS's statement that there is no single model for managing liquidity. Every firm has a unique exposure to different markets and businesses, so to try to place a mechanistic structure on top of that can only lead to missed risks. It is especially true in the sphere of liquidity that strong group risk management is the only way to good control, and, as a corollary that good supervision is equally essential. This concept is discussed in some detail in the 2007 *Principles of Liquidity Risk Management Report*. The industry's experience so far is that this is the most effective and thorough way to manage the liquidity risk of individual firms.

Reporting
The Consultation Paper details a proposal on reporting cash-flow projections in Appendix A. The IIF will not comment on the specific structure of the reporting, but instead would like to ensure that there is a sense of proportionality in the requirements. Will the reporting requirements be useful enough to justify the time and technological investment required? Any proposed reporting standards need to be coupled with assurances that such standards will be put to effective use.

There is as well a serious international-coordination issue: while some additional liquidity reporting to the authorities is appropriate, the new requirements should be proportionate, useful and, above all, consistent internationally so that the costs and dangers of inadvertent non-compliance that result from divergent requirements can be avoided. The proposed sharing of "group information" in particular would be hard to meet on a timely basis without appropriate standardization (and a reasonable phase-in period).

The goal should be a "common language" of liquidity and liquidity reporting, to facilitate both process and understanding for both firms and supervisors (and colleges).

A further point of importance about reporting, but one that sometimes leads to confusion is that it is highly desirable for reporting templates to become standardized over time, to increase comparability for supervisors and reduce multiplication of work and chance of error for groups. However, standardization of templates does not imply standardization of the metrics used to manage risk, which will vary substantially from group to group. This is a fundamental point.

CEBS has made admirable progress towards an internationally consistent pattern of reasonable and useful reporting to supervisors with their "Liquidity ID" initiative. The IIF applauds any steps that can help integrate the same reporting across supervisors into internal processes, which should facilitate a better result for all parties. But, to reiterate, these procedural and reporting reforms should not constrain use of differing assumptions (which, of course, must be well-justified by each group) or impose the same metrics for management purposes on all groups, despite their substantial differences of business and structure.

Conclusion

The events of the past year have shown that the quality of liquidity risk management was not sufficient at some global financial firms. However, a great deal of work has been done, and is still being done, in virtually all banks to make improvements where needed with reference to the Basel Committee's liquidity principles, CEBS's September 2008 Recommendations on liquidity risk management, and the Institute's own Recommendations on liquidity-risk management. Liquidity buffers need to be in place to ensure the survival of firms during both idiosyncratic and systemic crises. However, in designing new requirements, the needs of the global system -- not just the risks of each national system -- and macroprudential concerns such as the effects of liquidity constraints on credit provision especially for the modern, developed economies that CEBS oversees need to be evaluated carefully in developing any requirements. The IIF applauds that CEBS is committed to a principles-based approach and to monitor the implementation's effects on the industry and economy on an ongoing basis, and hopes that a robust, continuous dialogue will be maintained between supervisors and the industry to ensure a viable final result.

Members of the Liquidity Working Group would be pleased to meet with CEBS to discuss any aspect of the Consultative Paper or this letter.

Should you have any comments or questions, please feel free to contact the undersigned, or David Sunstrum of the IIF (+1 202 857 3615; dsunstrum@iif.com).

Very truly yours,