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Aimee Staude
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10 June 2010

Dear Ms Staude,

Sent by e-mail to: cp36@c-eps.org

Response to CEBS CP 36 – Guidelines on Liquidity Cost Benefit Allocation

The trade associations AFME, BBA and ISDA and their members welcome the opportunity to respond to the Consultation Paper CP 36: *Guidelines on Liquidity Cost Benefit Allocation*. The industry supports the Basel Principles for *Sound Liquidity Risk Management and Supervision* (including Principle 4) and the CEBS *Technical advice to the EU commission on liquidity risk management* (including recommendation 2) and the subsequent amendments to the CRD (Directive 2009/111/EC). Given the experience of the crisis in 2008, the industry has recognised the need for improvements and has actively been developing adequate liquidity pricing mechanisms along with other liquidity risk management tools.

While Members see adequate allocation mechanisms of liquidity cost, benefits and risks as an integral part of liquidity risk management, it must be recognised that there is no single methodology or level of granularity to fit all firms given the diversity of approaches to the management of treasury risk, business and funding models, and operations. We thus welcome the principles based approach suggested by CEBS and encourage a proportional application of the guidelines based on a firm's nature, scale and complexity.

We offer the following key messages and detailed suggestions on how it might be possible to improve the clarity and applicability of the guidelines:

Key messages

Timing of the paper

We support the development of guidelines in this vital area of liquidity risk management. However, we would question 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 powers for the EBA (the extent of which are uncertain). Our members have reviewed CP 36 on the basis that they are guidelines and not technical standards. If the EBA decides to develop binding standards addressing liquidity cost benefit allocation we seek confirmation that the EBA will give firms (and other stakeholders) the opportunity for further review and comment.

Objective of the paper

Broadly, firms are supportive of the view that firms should have liquidity cost benefit allocation mechanisms and welcome the development of principles. However, other firms challenge whether the guidelines as currently drafted could be misinterpreted by local supervisors to dictate internal practice. This is not how we see them.

For example, the consultation paper is unclear on what the guidelines are seeking to address. We suggest 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.

Proportionality and principles based approach

We welcome and stress the importance of proportionality. Further we support a principles-based approach but are concerned that, in some instances, the detailed text supporting the proposed guidelines is overly prescriptive and limits firms in the implementation of their pricing methodology. We urge CEBS to allow for flexibility in transfer pricing methodology and practice to reflect different business models and products. Moreover, the requirement that the transfer pricing is to percolate to transaction/product level is potentially misleading given the number of modelling decisions that need to be made to reach such a level of granularity (see comment below on paragraph 12 with regard to Guideline 3). We suggest that granularity should be limited to an appropriate level of decision making (e.g. at the level of a pool of similar products or portfolio of transactions rather than individual transactions) and this approach should be reflected in the text.

Assumptions underpinning the guidelines: Liquidity and credit risk

When thinking about transfer price discovery, we are of the view that the guidelines need to take care to distinguish sufficiently between liquidity and credit risk.

Assumptions underpinning the guidelines: Determination of a benchmark

While CEBS description of the determination of a benchmark, for the purposes of selecting an internal pricing yield curve, might be fitting for some firms with particular lines of business, it may not fully apply to all firms/businesses. We note that the description might be reflective of the firms sampled in Annex II but not suitable for the entire population of firms that are going to be affected by these guidelines.

For example, consider two firms: (a) a holding company and (b) a bank (that is part of the group). The holding company will issue a lot of debt, so it will be able to fairly easily identify an external benchmark for the purposes of identifying the internal liquidity pricing curve. However, for the bank, identifying an internal pricing yield curve is much more difficult if, say, it relies on deposits for its funding (its curve will be a function of deposit spreads). This is not something that a firm can easily identify and a benchmark cannot be found on a Bloomberg screen, although paragraph 23 would seem to indicate that CEBS is not fully aware that liquidity price discovery is different from say interest rate price discovery where rates are easily observable in the market.

We stress that merely linking a liquidity curve to an external benchmark may not reflect the internal transfer pricing properly. Interest rate markets may have established benchmarks, while liquidity premiums for an institution are more complex to determine. We urge CEBS to acknowledge this fact.

For example paragraph 8 (final) talks about the 'objectivity of internal prices'. The paper appears to assume that pricing liquidity is a clear cut process. As stated above this is not always the case.

We question whether CEBS assumptions about pricing arise from the small sample of firms on which the paper is based. Although firms were told at the CEBS hearing of 1 June 2010 that the methodology used was actually more robust than depicted by the paper, we would suggest a fuller description of the methodology. We remain sceptical that the sample size may have lead CEBS to draw conclusions that are not applicable to all firms.

Assumptions underpinning the guidelines: Internal Pricing Policy

We urge CEBS to recognise explicitly that firms need to have the freedom to price customers in the market on a marginal basis and have an internal pricing policy that allows firms to clear all costs and price on an average and/or blended basis. Client pricing is normally based on marginal costs. However, marginal costs do not take into account, for example, the sunk costs associated with launching new products, starting up a business or when the market is out of equilibrium; consequently firms also collect average cost information and consider these costs in the context of their internal pricing policies. The guidelines need to allow for (or reflect) a blended cost and allow firms to determine which measure is most appropriate.

In this regard both paragraphs 19 and 25 are of concern. Paragraph 19 refers to transfer prices and current market conditions. In our detailed comments we have suggested that the paragraph should refer to a firm's internal pricing policy and explicitly recognise such policies will reflect historic and current costs.

Paragraph 25 focuses on the marginal cost of funding and details a number of aspects of marginal cost pricing. Our members are of the view that this focus is misplaced, so we have suggested that the paragraph be re-drafted to focus on firms pricing policies.

Sample size

Annex II of the paper indicates that CEBS has based its guidelines on a small sample of only five firms of various sizes. At the open hearing of 1 June the CEBS panel indicated that the actual approach adopted was more robust. The practices of five firms were observed but the information was shared with a wider expert group in advance of the guidelines being discussed. Although we take some comfort that efforts were taken to guard against the potential bias introduced by working with a small sample size, we would suggest in future that a wider sample of firms be consulted to fully reflect the wide spectrum of firms' business models and transfer pricing practices,. The trade

associations – AFME, BBA and ISDA – would be happy to assist in nominating Members for future surveys.

Detailed Comments

Guideline 1

Guideline 1 appropriately puts firms' liquidity cost allocation mechanisms in the context of their liquidity risk management framework. However, the Guideline also states that the mechanism should be consistent with its 'risk tolerance'. We suggest that the guideline should be amended to specify that the mechanism should be consistent with the firm's 'liquidity risk tolerance' to ensure that liquidity risk is not confused with credit risk.

Paragraph 4

We make a similar comment in regard to paragraph 4. The first line of the paragraph states 'institutions must have a clear definition of risk tolerance'. Although the footnote indicates that CEBS is referring to liquidity risk tolerance, it would be helpful if CEBS could clarify in the paragraph that they are referring to 'liquidity' risk tolerance. Again this amendment would help to ensure that liquidity risk does not get confused with credit risk.

Guideline 2

Guideline 2 is concerned with the governance structure supporting the allocation mechanism. We agree that such a guideline is sensible and important. Nevertheless, we are concerned that some of the detail deviates from this broad principle. Of particular concern in this regard are paragraphs 8 and 10.

Paragraph 8

The second and third sentence in paragraph 8 attempts to address incentives for behaviour and objectivity of internal prices. As discussed at CEBS open hearing, we understand that the intent of paragraph 8 was to promote 'neutral' price discovery recognising that firms, for competitive reasons may deviate from this price. While this clarity is welcome, we suggest that firms have an internal pricing policy and that deviations from this policy are possible for business strategy reasons. Consequently we suggest that Paragraph 8 simply states the following:

The prices generated by the agreed methodology should be used for the internal pricing of liquidity, performance measurement and appraisal of new products or business for all significant business activities, both on- and off-balance sheet. Any deviations from this pricing needs to be subject to a formal approval process. If management wishes to incentivise certain behaviours, this should be subject to a separate approval and reporting process. The objectivity of the internal prices should be maintained for the correct pricing and reporting of liquidity.

Paragraph 10

Paragraph 10 addresses the view (which our members support) that in the context of this paragraph profit centres are responsible for trading but cost-centres are responsible for internal pricing. However, we are of the view that there is potential for misunderstanding the intent of the paragraph. The first sentence of the paragraph:

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 role.

and the following phrase from the second sentence:

'...personnel working within the area should not be set profit targets for this activity,'

could be interpreted as applying to the whole Treasury or ALCO function.

To address this concern and reinforce the notion of independence we suggest the following modifications to the paragraph:

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.

Guideline 3

While Guideline 3 is concerned that the output from the allocation mechanism shall be used, it is careful to take into account issues of proportionality. Our membership is supportive of this principle but in reference to paragraphs 12 and 14 we question whether the detail supporting the guideline is overly prescriptive and potentially disproportionate for smaller and/or less complex firms.

Paragraph 12

The second line of paragraph 12 states that:

... The internal prices should percolate down to decision makers at transaction level to ensure maximum impact,

Not only is this text overly granular and disproportionate but it is inconsistent with paragraph 14 which states that:

The liquidity allocation mechanism should generate prices that can be used at an appropriate level of granularity, reflecting the size and sophistication of the institution.

We therefore suggest the following amendment to paragraph 12:

... The internal prices should percolate down to an appropriate level of decision makers at transaction level to ensure maximum impact. ...

Paragraph 14

While we suggest that paragraph 12 needs to align to the first sentence of Paragraph 14, the final line of paragraph 14 is of concern to members because it does not allow for differences between internal prices and market prices that may arise for competitive reasons or cost recovery. We therefore suggest that the final line of paragraph be removed.

~~*... Internal prices should be aligned with market transaction prices" will not be feasible due to the nature of fast moving day-to-day transactions.*~~

Guideline 4

Guideline 4 addresses the scope of application of internal prices stating that it should be sufficiently comprehensive to cover all significant parts of assets, liabilities and off-balance sheet items regarding liquidity. Our members support this principle and we offer a number of suggestions regarding the drafting of paragraphs 15, 16, and 17.

Paragraph 15

Paragraph 15 is concerned with detailing types of bank liabilities (i.e. sight deposits, fixed term funds, and retail funds) and identifying some of the pricing issues that should be addressed. This is a complex area and gives rise to questions of definition. We suggest this detail is unhelpful and that paragraph 15 should state simply:

~~As one of the common main parts of banks' liabilities, sight deposits should be properly treated according to its liquidity characteristics and behavioural patterns. It is widely argued that retail funds are stickier than wholesale funds. In the case of fixed term funds, a customer in the retail market could be considered less sensitive than one in the wholesale market. Similarly, in a liquidity crisis, retail funds have a lower probability of withdrawal (or slower reaction time) and therefore are more valuable for liquidity purposes. However, the risk that some retail sight deposits may be withdrawn should be priced in. It is equally important that deposit gatherers are rewarded for raising stable liabilities.~~

Paragraph 16 (linked to 17)

Paragraph 16 is concerned with transfer pricing and holding of trading book assets or other marketable assets. The paragraph confuses the expected holding period of the asset with the market performance of the assets. Firms' methodologies for calculating funding prices for trading book assets vary considerably. Moreover, terms and definitions such as 'holding period' can have very different meanings for different firms and be confused with the market performance. We suggest that the transfer prices need to focus on the liquidity characteristics of the assets and not the intention of the holder. So we suggest that the text of this paragraph should state:

~~Appropriate internal funding prices should be charged for holding trading book assets or other marketable assets in accordance with the liquidity characteristics of those assets. (AFS4 portfolio). The funding price charged should reflect both the expected holding period and the market liquidity risk (change in marketability). This can be achieved by calculating prudent maturity charges (e.g. haircuts) for marketable assets which reflect possible abrupt adverse changes in marketability. These charges may be determined by stress and scenario testing (consistent with those used for the liquidity buffer calculation).~~

Paragraph 17

Paragraph 17 considers the charges committed lines, uncommitted lines and implicit support should attract. We have a number of comments to offer.

First, in regard to the first line of text, we do not know what the funding requirement will be, so we suggest that the text be modified, as follows, to include the word 'expected':

Committed credit lines should incur a charge to reflect the cost of liquid funds that must be available to meet the expected funding requirement.

In regard to the third line of text, we suggest the following wording is more indicative of the relationship between committed and uncommitted lines.

~~... For uncommitted credit lines and implicit support evident implicit commitments the business units granting the facilities should be charged in a manner similar to that applied to committed lines.~~

Furthermore, we believe that paragraph 17 needs to recognise the option and ability to cancel where there are no implications for business/client relations and reputation risk

Guideline 5

Guideline 5 is concerned with the principle that internal prices should be determined by robust methodologies, taking into account the various factors of liquidity risk. We are concerned that the detail supporting the guideline, in connection to paragraph 23, does not sufficiently reflect that there is no simple defined liquidity cost curve and, as previously stated in connection to paragraph 25, does not distinguish between average cost and marginal cost.

Paragraph 23

Paragraph 23, as currently drafted gives the impression that defining a benchmark liquidity cost curve is a simple process depending only on handful of factors. This is not the case, and furthermore it must be noted that for most instruments a definite liquidity cost curve does not exist. In the case of deposits, by alternating pricing on deposits the price of liquidity can be discovered, but it is not something that is observed on a screen.

Paragraph 23 identifies six possible adjustments to a base curve. Although these are identified as examples, they may not be true for all firms. We suggest that the final line introducing the examples should be replaced with:

Adjustments to a base curve are often necessary to reflect unique attributes of the financial institution itself and/or an instrument. ~~The most common examples are:~~ Some examples that may be applicable to some institutions are:

Also, the paragraph needs to recognise the differences between firms and holding companies as we see a wider range of experiences than provided by the five sample firms reflected in the annex (see comments under key messages).

Paragraph 25

We urge CEBS to recognise explicitly that firms need to have the freedom to price customers on a marginal basis and have an internal pricing policy that allows firms to clear all costs and price on an average and/or blended basis. Client pricing is normally based on marginal costs. However, marginal costs do not take into account, for example, the sunk costs associated with launching new products, starting up a business or when the market is out of equilibrium. So firms collect average cost information and their internal pricing policy allows average costs and / or blended costs to be reflected.

In this regard both paragraphs 19 and 25 are of concern. Paragraph 19 refers to transfer prices and current market conditions. We suggest that it should address a firm's internal pricing policy and recognise explicitly that such policies will reflect historic and current costs.

As indicated in our opening remarks, we urge CEBS to recognise explicitly that firms need to have the freedom to price customers on a marginal basis and have an internal pricing policy that allows firms to clear all costs and price on an average and/or blended basis. It is difficult to segregate average from marginal cost and it should be left to firms to determine which is more relevant to its internal pricing policy.

Paragraph 25 explicitly focuses on the marginal cost of funding and details a number of aspects of marginal cost pricing. This focus and detail is misplaced, so we suggest that the Paragraph be re-drafted so that the first four sentences are replaced with the following:

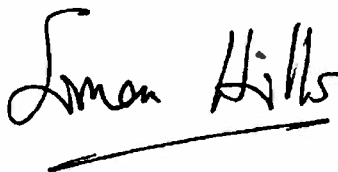
~~*The internal transfer pricing policy should reflect funding costs. The internal prices used should reflect the marginal cost of funding. The price should reflect the marginal cost over a homogenous product group as an average, but it should also reflect current costs. Funding already acquired (tapped) should already be taken into account in the prices of products sold (or being sold). To achieve a reliable marginal funding cost, an institution should be able to adjust transfer prices according to current demand for new funding, mainly, when calculating the contingent liquidity cost price. 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 transfer price according to its expected balance sheet term structure (Dynamic Price Setting).*~~

We hope you will find these comments useful. Please do not hesitate to contact us should you wish to discuss our suggestions in further detail.

Yours sincerely,



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