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*Banking Supervision
And Accounting issues Unit*

The Director

Paris, June 10th 2010

**French Banking Federation's Response to Consultation Paper on
CEBS's Guidelines on Liquidity Cost Allocation**
(CP36) Published March 10th 2010

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 430 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The French Banking Federation (FBF) welcomes the consultation process that CEBS is using to help elaborating sound regulation that strikes the right balance between the supervisory objectives and operational issues that banks confront with.

FBF concurs with the CEBS objectives of making sure that funding costs and benefits are part of the activity and transaction decision process.

FBF welcomes the phase-in process and proportionality principle that are suggested in the CP so that the 30th March 2011 application date can be met.

All along the phase-in process, attention will need to be paid to make sure that European banks are not at competitive disadvantage *vis-à-vis* non-European banks. The scope of CP36 application needs clarification: should it be required to non European subsidiaries of European banks, there would most probably be an uneven playing field.

FBF concurs with the principle-based approach and the CEBS Guidelines:

Guideline 1- The liquidity cost benefit allocation mechanism is an important part of the whole liquidity management framework. As such, the mechanism should be consistent with the framework of governance, risk tolerance and decision-making process.

Guideline 2- The liquidity cost benefit allocation mechanism should have a proper governance structure supporting it.

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Guideline 3- The output from the allocation mechanism should be actively and properly used and appropriate to the business profiles of the institution.

Guideline 4- The scope of application of internal prices should be sufficiently comprehensive to cover all significant parts of assets, liabilities and off-balance sheet items regarding liquidity.

Guideline 5- The internal prices should be determined by robust methodologies, taking into account the various factors involved in liquidity risk.

FBF has specific comments or suggestions that are detailed thereafter on:

1. Risk tolerance
2. Transaction vs. pool of transactions
3. Before-the-fact vs after-the-fact funding charge
4. Current vs. time-lagged funding costs
5. Observable funding costs
6. Measuring ALM Treasury funding cost-driven results
7. Other issues

1. Risk tolerance

CEBS paragraph 4 states that *“Institutions must have a clear definition of risk tolerance”*. This should be considered in light of the Basel Committee on Banking Supervision’s proposal for liquidity regulation that is based on hard-wired one-size-fits-all assumptions and that sets risk aversion to so high a level that banks are basically prevented from choosing their own risk tolerance.

Two statements of CP36 are inconsistent:

- Guideline 1, “[...] the mechanism should be consistent with [...] risk tolerance”
- Page 4 footnote 1: *“if a 3 year 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.”*

If CEBS’s intention is to force internal funding cost to derive from match term funding costs, it should be elected as a Guideline... but it would conflict with the Guideline 1 (since most probably, the liquidity management framework does not require match term funding).

FBF suggests that CEBS clarifies its recommendation.

Should match term funding be required, it should be made clear that the term should be derived from the *expected* term (including expected prepayment and rollover) rather than from the *contractual* term.

Lastly, paragraphs 20 and 21 of the CP36 refer to behaviour model. It is not clear whether those behaviour models should be driven by regulatory requirements (ex: suggested BCBS NSFR rollover assumptions for corporate loans may entail that the behaviour models should be assumed to be rolled over, and consequently internally fund charged with this rollover assumption).

2. Transaction vs. pool of transactions

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 transaction level (rem: the criteria that are mentioned in CP36 §16 make very much sense).

It would be clearer if CP36 explicitly mentioned that pool-based funding charge processes are acceptable. Pooled-transactions need to be homogenous in terms of characteristics (types of contracts, maturities) and actual funding management.

3. Before-the-fact vs after-the-fact funding charge

So as to be part of the transaction decision process, the funding cost needs to be known at inception of the transaction to the decision maker. It should reflect the funding risk that is transferred to the department that actually manages funding risk (ALM Treasury in the remainder of this paper).

Should there be a residual funding risk, consistent with the risk tolerance of the bank, the bank should be able to choose *whether or not* to allocate the actual *after-the-fact* residual funding risk cost to the business line.

However, if the actual *after-the-fact* residual funding risk cost is *not* reallocated to the business line, the expected *before-the-fact* cost of the residual funding risk should be embedded in the funding cost at inception of the transaction.

The difference between the expected *before-the-fact* funding cost and the actual *after-the-fact* funding cost, which affects ALM Treasury, should be measured so as to make sure that there is no systematic bias in the internal funding cost.

For instance, the liquidity buffer funding cost is not known at inception for the maturity over which the liquidity buffer will need to be maintained. The bank may choose *not to* reallocate the *after-the-fact* liquidity buffer funding cost to the business line, provided that the internal funding cost at inception of the transaction takes into account the *before-the-fact* expected liquidity buffer funding cost.

4. Current vs. lagged funding costs

Over the last few years, actual market funding costs have been quite volatile, even more so for banks.

Should "instantaneous" funding costs be required to be used for internal funding costs, the banks could not amortize the changes in market funding costs *vis-à-vis* their clients. In volatile market environments, the banks would be stuck in a *stop-and-go* mode that is detrimental not only to banks but to the economy as a whole.

Conversely, if internal funding costs depart too much from current actual funding costs, it would create wrong incentives: the banks would originate more loans and fewer deposits when its internal funding costs are lower than actual current funding costs.

That is why FBF suggests that CP36 mentions that funding costs should be derived from a combination of observed actual funding cost over a recent period and expected funding cost over the near future period. The past and future periods would be no longer than a few months long. The banks would then be in a position to amortize market funding costs while not departing too much from the then current market funding costs.

5. *Observable funding costs*

CP36 refers to “market transaction prices” to derive funding costs. The definition of “market transactions” needs to be clarified so that funding costs that are derived from them are not too judgemental, notably in disentangling the different component in their prices, such as funding cost, commercial margin, transaction costs...

6. *Measuring ALM Treasury funding cost-driven results*

Even if ALM Treasury should not have a profit target, FBF recommends that ALM Treasury profit and loss (P&L) deriving from the funding costs should be measured, monitored and reported.

This is the application of the “*What is measured gets managed*” principle.

The incentive for ALM Treasury to have a clear understanding of the funding cost-related P&L should be considered a sound principle in the funding risk management. This notably contributes to make sure that the funding risk costs are not systematically unintentionally biased.

That’s why FBF recommends amending Guideline 2:


Guideline 2- The liquidity cost benefit allocation mechanism should have a proper governance structure supporting it. The results from funding costs should be measured, monitored and reported with other funding risk metrics.

7. *Other issues*

Even though CP36 requires consistency with the general funding risk management framework, FBF suggests that CP36 explicitly mention that internal funding costs should be broken down by currencies (since they are currency-dependent) and take into account both expected and actual early termination (early termination cost priced in at inception, breakage cost at early termination date, or a combination of both).

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do so is to establish appropriate regulations. FBF is looking forward to constructively working with the CEBS.

Yours sincerely,



Jean-Paul CAUDAL