POSITION PAPER

ESBG Position in the CEBS consultation on "CEBS Guidelines on Liquidity Cost Benefit Allocation" (CP 36)

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ESBG appreciates the opportunity of contributing to CEBS' consultation on Guidelines on Liquidity Cost Benefit Allocation (CP 36).

General remarks

ESBG agrees that the crisis has shown the need for better liquidity management in many financial institutions. The present Draft Guidelines are indeed likely to lead to greater awareness as regards the wider funding costs and may in general help improve the management of liquidity within the financial sector. However, we would point out that in many regionally oriented retail banks, our members being amongst them, the liquidity situation proved robust even during the peak of the crisis.

Nevertheless, ESBG finds that the proposed recommendations are overly wide reaching. The present approach resembles the establishment of "best practices", while we believe that a focus on less ambitious "minimum standards" would be more suitable and also more in line with the proportionality principle. In addition it is important that the present draft Guidelines should not be stricter than previous CEBS recommendations in its Technical Advice on Liquidity Risk Management (CEBS 2008 147).

In this context we also would strongly welcome if in relevant sections of the guidelines indications were given on the applicability of the proportionality principle and especially on the expectations concerning the sophistication and extent of cost measurement for smaller non-complex credit institutions. We have concerns that otherwise the Guidelines will create unrealistic expectations pressuring smaller institutions to invest in complex measurement mechanisms, which go hand in hand with significant and disproportionate costs. Furthermore, the proportionality principle should also be applied according to the refinancing situation and funding structures of an institution.

This being said, we generally agree that – if necessary – in addition to "direct funding costs" (e.g. the immediate cost of (re-)financing) also "indirect funding costs", for instance as arising from the need to hold liquidity buffers or arising from haircuts to asset values, should be taken into account when deriving internal prices for liquidity. We appreciate, too, that the guidelines are not prescriptive as regards the overall organisational set-up of the new allocation mechanism. In addition, we welcome that the management body or a government body to which the management body delegates its powers (in particular referring to the Asset/Liability Committee) should be informed of and approve the policies of both internal and external costs. We also understand that this would apply to changes in methodologies and processes.

Yet, we are apprehensive that in the present form the guidelines will pose a challenge for those institutions where market prices for important funding sources are not readily available (especially those with a strong retail deposit base) and where, as such, a comprehensive definition of costs to be measured cannot be satisfied due to the absence of suitable data or due to the institutions' very funding structure. We would greatly welcome the introduction of a caveat, highlighting that the comprehensiveness of the expected cost measurement (beyond direct funding costs) depends on information availability and funding structure.

Furthermore, we foresee that in some cases liquidity costs in the trading book can be difficult to assess, for instance if market curves are not available for all products such that the cost assessment needs to draw on proxies for market realities. In addition, institutions which are active in treasury issues must apply specific curves. Keeping abreast of the ongoing changes in the market will require continuously assessing all changes in all respective market curves.

Furthermore, we find the additional concepts of "marginal costs", "average marginal costs" and "current costs" not very clear. We would ask CEBS to either clarify these notions or to drop them since at present they may create considerable confusion.

Concerning the process of allocating liquidity within the institution, we would invite CEBS to underline that the liquidity allocation does not always need to take place on a loan-by-loan basis, but that pooling can be acceptable for instance in the mortgage area, but also for other assets. Otherwise, following the Guidelines would carry disproportionate costs.

As regards the use of the internal prices for liquidity we would invite CEBS to express in more clarity that the derived internal price of funding primarily serves for the institution to better understand its own liquidity situation (and to anticipate future liquidity related problems). It should be highlighted more strongly that this internal price is not to automatically determine the price and amounts at which banks are to lend or offer funding on the markets. As we understand, it the Guidelines leave room for separate decisions by the management, as long as these decisions are made in full awareness of the internal 'neutral' price of liquidity.

We also stress that the application of the liquidity cost-benefit allocation mechanism should not have a sudden severe impact on lending activities and supply of credit to the economy.

Concrete comments

On **page 3**, the second sentence under 'Content' should be amended in line with the arguments on proportionality given above. We would recommend the following formulation: "Respecting the proportionality principle, they are intended to apply to a wide range of institutions in terms of size, business model and funding structure". This also would clarify the understanding of the needs for 'regular updating' of the mechanism mentioned in § 18).

Guideline 1

On **§ 4**: Institutions are to define their risk tolerance to set the context for a functioning liquidity allocation mechanism. We consider it vital to clarify that this refers to 'liquidity risk tolerance' only.

Guideline 2

On **§ 9**: as concerns the role of the allocation mechanism as a tool for managing the balance sheet structure, we remind that balance sheets are not only managed via liquidity allocation alone, but that capital and risk allocation are also crucial. It should be clarified that the liquidity allocation mechanism

is to be used for planning mainly the liquidity structure of the balance sheet and in context of the other balance sheet drivers.

On § **10:** We appreciate that the part of a bank's organisation to be responsible for implementing and monitoring internal prices has not been specified. We also understand the reasons for advocating that this 'area or function' should not have a profit target. Yet we would like to stress that, especially for smaller or non-complex entities, this requirement should not give raise for the need to substantially change their organisational structure.

Guideline 3

On § **14**: We agree that sufficient granularity of the liquidity allocation mechanism is important and we appreciate the reference to proportionality as regards size and sophistication of the institution. However, we stress that aiming at granularity should not culminate in the expectation that individual internal transaction prices be derived for each individual funding operation, irrespective of its nature and context. Equally, we foresee that for some funding operations there are no suitable market transaction prices to which internal prices could be aligned.
We would invite CEBS to clarify that there are areas where funding operations with similar liquidity profiles can be pooled, and that in such cases there can be one 'collective' internal price. We also would urge CEBS to mention that, depending on the funding operation, as well as on the institution's funding structure and funding sources, it cannot be expected that a comprehensive measurement of liquidity costs is possible in all cases, and hence that internal prices may sometimes not go substantially beyond what is implied by the 'direct cost' component.

Guideline 4

On § **15**: We understand that CEBS is concerned that assuming absolute stability of sight deposits as a funding source would give rise to myopia and limit the internal price to the 'direct' funding costs. However, we believe that here bank specific factors are vital and point out that especially traditional retail banks have long standing experience in managing effectively and safely sight deposits as well as term deposits. As a result, even during the crisis, such banks have generally experienced stable – or even growing retail deposits. Furthermore, any generalised approach to potential draw-down rates is problematic (which is also underlined by the difficulties to find a correct calibration in the 'Basel III' and 'CRD IV' proposals). We therefore believe that in the present context a direct reference to sight deposits and a generalised requirement to anticipate sight deposit draw-downs is not appropriate. We would recommend CEBS not to single out this particular funding source and to leave the choice of how to address possible indirect funding costs to the discretion of the individual bank.

On § **17**: CEBS foresees that credit lines, too, should incur a charge reflecting the cost of the liquid funds that must be available should the line be drawn. Here no distinction is to be made between committed and uncommitted/implicit credit lines. ESBG does not agree with the latter point, since uncommitted/implicit credit lines are less likely to be drawn on by the client. This should be reflected in the liquidity charges. There also are differences according to the counterparty to whom a credit line has been extended. During the crisis it was observed that uncommitted and unsecured credit lines among financial institutions often were cancelled, while uncommitted credit lines to non-banks were

maintained. On this basis we would propose as a reformulation of the third sentence: "For credit lines with an evident implicit support, the business units granting the facilities…"
We also would remark that at present most institutions do not charge internal prices for committed credit lines. Therefore we see a danger of distortions to competition, if not all institutions comply with this Guideline. Furthermore we anticipate that prices for clients will increase.

On **§19 – 20**: §20 appears to mainly repeat in more concrete terms the content of §19. We therefore believe §20 to be unnecessary and recommend that it be dropped. In addition, we recommend a reference to the proportionality principle. §19 could be amended as follows: "Respecting the proportionality principle, the transfer prices should reflect current market and stressed funding conditions as well as the actual institution-specific circumstances, and should reflect both direct and indirect costs, including the cost of a liquidity buffer[5] (see the example in Annex 2)."

Guideline 5

On **§ 23**: It is recommended that for the establishment of internal prices and yield curves institutions should use benchmarks observed in the market. Here we find the examples of EURIBOR and LIBOR curves, as well as of swap curves and CDS levels, rather arbitrary. We would prefer a more general example and ask for such explicit references to be deleted, since in praxis the use of yield-curves is much more diverse.

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5,972 billion (1 January 2008). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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