

Dear Sirs

Please find below my responses to the paper "Guidelines on Liquidity Cost Benefit Allocation". Thank you in advance for the opportunity to comment and for your time.

First, if I may, I append some general remarks on internal funds pricing (or funds transfer pricing, FTP). This is followed by responses to CP36.

A bank's internal liquidity pricing methodology is a key element driving the business model. The price at which an individual bank business line raises funding from its Treasury desk is a major parameter in business decision making, driving sales, asset allocation, and product pricing. It is also a key hurdle rate behind the product approval process and an individual business line's performance measurement.

Therefore the price at which cash is internally transferred within a bank should reflect the true economic cost of that cash (at each maturity band), and its impact on overall bank liquidity. This would ensure that each business aligns the commercial propensity to maximise profit with the correct maturity profile of associated funding. From a liquidity point of view, any mismatch between the asset tenor and funding tenor, after taking into account the "repo-ability" of each asset class in question, should be highlighted and acted upon as a matter of priority, with the objective to reduce recourse to short term, passive funding as much as possible. Equally, it is important that the internal funding framework is transparent to all trading groups.

A measure of discipline in business decision-making is enforced via the imposition of minimum return-on-capital (ROC) targets. However, banks do not always set different target ROCs for each business line, which means that the required discipline breaks down. But a uniform cost of funds, even allowing for different ROCs, will mean that the different liquidity stresses created by different types of asset are not addressed adequately at the aggregate funding level.

For example, consider the following asset types:

- a 3-month interbank loan;
- a 3-year floating rate corporate loan, fixing quarterly;
- a 3-year floating-rate corporate loan, fixing weekly;
- a 3-year fixed-rate loan;
- a 10-year floating-rate corporate loan fixing monthly;
- a 15-year floating-rate project finance loan fixing quarterly.

These asset types demonstrate the different liquidity stresses that each places on the Treasury funding desk. Allowing for different credit risk exposures and capital risk weights, the impact on the liability funding desk is different for each asset. We see therefore the importance of applying a structurally sound transfer pricing policy, dependent on the type of business line being funded.

Therefore as a driver of the economic decision-making process, the cost at which funds are lent from central Treasury to the bank's businesses needs to be set at a rate that reflects the true liquidity risk position of each business line. Where this policy is not followed, transactions are entered into that produce an unrealistic profit. This profit will reflect the artificial funding gain, rather than the true economic value-added of the business line.

Many banks operate an internal funding model in which there is a fixed internal funding rate of Libor plus (say) 15 bps for all business lines, and for any tenor. But such an approach does not take into account the differing risk-reward and liquidity risk profiles of the different businesses. The corporate lending desk will create different liquidity risk exposures for the bank compared to the CDO desk or the project finance desk. For the most efficient capital allocation, banks should adjust the basic internal transfer price for the resulting liquidity risk exposure of the business. Otherwise they run the risk of excessive risk taking heavily influenced by an artificial funding gain.

An artificially low funding rate can create as much un-manageable risk exposure as a risk-seeking loan origination culture. A regulatory requirement to impose a realistic internal funding arrangement will mitigate this risk. A bank may consider the following approach:

- a fixed add-on spread over Libor for term loans or assets over a certain maturity, say two years, where the coupon re-fix is frequent (such as weekly or monthly), to compensate for the liquidity mismatch. The spread would be on a sliding scale for longer term assets.

For example,

Period to Maturity	< 6mths	6mths – 12mths	1yr – 5yr	> 5yrs
Assets	Libor	Libor + 4bps	Libor + 8bps	Libor + 12 bps

The extent of the spread is critical and should reflect solely the liquidity stresses originated by the business line. The calculation of this spread is important and is discussed below.

Responses to CP36:

1- Introduction

Agreed the concepts discussed and their importance.

3- Contents

Paragraph 4: The description of what the FTP should include at its base level appears slightly complex. At the aggregate level, the Treasury desk will wish to account for all these components, however the base index price (before any liquidity add-in spread) need not consider the cost of contingent liquidity risk. Managing this risk, beyond a BAU level, is the responsibility of Treasury and ALCO but to add in this component seems excessive. If one is reviewing the FTP spreads every (say) three months, any increase due to rising contingency costs can be added here. Commenting on Footnote 1 to this paragraph, actually if the 3-year loan is fixed rate then the appropriate funding cost is the 3-year funding cost, but if the loan is floating then there is a case for saying the cost is the 3-mo CP cost PLUS the appropriate FTP liquidity spread.

4- Guidelines

Guideline 2, Para 10: Agreed, but where a bank has organised its Treasury desk as a profit centre and not a cost centre (a common and perfectly rational and logical business model), Treasury should still be the department that should be responsible for managing and implementing the FTP regime, because it manages the funding process. It is a straightforward accounting mechanism to strip out the return generated from lending to internal business lines from the Treasury recorded return, thus ensuring that no artificial profit is created and providing comfort to business lines that the correct mechanism is being followed.

Guideline 4, Para 15: The behaviour of such deposits can be extrapolated from past behaviour, to gauge an idea of stickiness. However, a conservative approach must be applied. A stable deposit base during a period of market confidence is not necessarily a guide to behaviour in market correction.

Para 19, 20: I cannot see the logic of including the cost of the liquidity buffer in the FTP cost. This is a cost of liquidity that the business itself should absorb, as it required under (say) FSA rules. (For example, the liquidity buffer book could sit in ALCO. If it sits in Treasury the cost can still reside there). The cost of a liquidity buffer is presumably (i) the higher cost of setting up term funding to fund the buffer (ii) the opportunity cost foregone of holding the buffer rather than higher-paying assets. However does the return of the LAB also get split out to the business lines?

Annex 1

The key calculation is what spread to add-on to FTP (Libor) for assets that create liquidity stresses for the bank. Methodologies for calculating the spread add-on to FTP for illiquid assets are included; the average of these is an appropriate measure.

- i- the funded versus unfunded rate for the specific bank (swap versus bond)
- ii- the spread of the swap curve over the risk-free curve
- iii- the difference between (a) paying fixed on the term swap and (b) paying fixed on the same-tenor money market swap (OIS swap)
- iv- the difference in cost of funds across the term structure for the bank itself (1, 2, 3, 4, 5 years, 10 years, etc)

v- the CDS-ASW basis for each maturity band

Note also that many banks will not be able to match fund a completely illiquid asset. For example a project finance loan, which is illiquid and un-repoable, cannot be match funded. An FTP spread would cover this illiquidity and enforce pricing discipline, although only up to a point.

Thank you for your attention.

Best regards
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