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Comments on Consultation Paper No. 28 „Liquidity Buffers and Survival Periods“ by the Committee of European Banking Supervisors (CEBS) of 7 July 2009

Dear Sir or Madam,

On July 7, 2009, the Committee of European Banking Supervisors submitted a Consultation Paper on "Liquidity Buffers and Survival Periods“. We welcome the opportunity to comment on this paper.

General

We explicitly welcome the **principle-based nature** of the CEBS guidelines. A principle-based regime is indispensable in order to adequately take account of the wide variety of business models and types of liquidity risk management. We particularly feel that it is appropriate that CEBS refrained from specifically listing those assets which are eligible to the liquidity buffers. However, only very few types of securities will meet the eligibility criteria for liquidity buffers specified under Guideline 4. Hence, we anticipate an increased demand for such securities. This effect will materialise once these new CEBS requirements come into force (potentially even earlier). In turn, this may lead to disruptions in the securities markets.

Along with the general assessment of the impact which the proposed measures will have on banks and national economies (paragraph 18), we recommend implementation of an impact study by CEBS before this paper will come into effect. This will help gauge and assess potentially negative effects on securities markets.

We particularly welcome the fact that the proportionality principle is highlighted as an overarching principle (paragraph 13, 33, 34). In this context, the idiosyncrasies of those banks that belong to a financial network should be taken into account when assessing the liquidity buffers. For instance, this applies to the use of adequate stress tests which have an impact on the amount of the liquidity buffer.

In our view, the risk-based approach for treatment of liquidity risks (paragraph 35) appears essentially correct. However, we can only subscribe to part of the views expressed under paragraph 15 concerning market failures. Especially deposit protection schemes - along with provisions on the liquidity buffers under national law - help to reduce the external costs.

Furthermore, we particularly welcome the fact that in its paper CEBS wants to further investigate the impact of individual measures involving a tradeoff between securing financial market stability on the one hand and the cost burden for individual banks on the other hand. The following comments are primarily geared towards the six guidelines contained in the Consultation Paper. Notwithstanding the foregoing, the end of the comment letter will also contain a response to the questions posed in the Consultation Paper (paragraphs 19 and 20).

Specific comments

Guideline 2 (Stress Scenarios):

Under Guideline 2, the level of the liquidity buffers should be measured on the basis of stress tests whereby idiosyncratic and market specific stress scenarios as well as a combination of the two should be applied. In our view, the requested combination of idiosyncratic and market-wide stress scenarios should not be understood as a simple addition of both scenario types. This is due to the fact that a host of interactions exists between the two types of scenarios. Hence, in our view, the application of idiosyncratic stress scenarios on the basis of the current financial market crisis already constitutes a combined stress scenario.

Furthermore, we should like to point out that the impact of the financial market crisis was the result of a series of diverse stress events. The survival period stipulated by CEBS, however, is only supposed to last one month. In our view, it would be inappropriate to request "compressing" the impact of the financial market crisis (which by now has lasted for two years) into a one month window of time when defining the parameters of the stress scenarios. We would therefore appreciate a clarification.

The presentation of the idiosyncratic stress scenario in paragraph 38 contains excessively detailed provisions. For instance, in CEBS' view, it is plausible to assume that there will be no rollover of any unsecured wholesale funding during stress events. We feel that this view is too conservative and that it lacks any empirical evidence even at the peak of the crisis. Hence, it should merely be used as an example for an idiosyncratic stress scenario which is not relevant for all banks. Whilst the funding possibilities deteriorate in a stress situation, to a certain extent borrowing in the capital market still remains an option. Banks should be allowed to use other assumptions concerning rollover during stress events particularly as regards credit lines which are being provided by wholesale clients with excellent customer loyalty.

Due to the direct link between the amount of the liquidity buffers and the results of the stress scenarios that have been applied we feel it is of major importance that supervisory authorities develop a uniform understanding with regard to the appropriate composition of stress scenarios. Otherwise there would be a risk of competitive distortions. Ensuring a uniform understanding of the underlying concept of market shocks would appear particularly helpful for market-wide stress scenarios (paragraph 39).

For banks which primarily funding on money and capital markets, market-wide stress scenarios are of particular relevance. In view of the proportionality principle we kindly request a clarification that the consideration of market wide stress scenarios is expected primarily from capital-market oriented institutions. This also applies to the use of combined scenarios.

In our understanding, the request under paragraph 41 that liquidity based stress scenarios shall be compatible with the other stress scenarios that are being used by the bank merely constitutes a check of economic plausibility.

Guideline 3 (Survival Period):

The compulsory contemplation of two survival periods (one week and one month) does not appear significant and would result in an unnecessary effort for banks. In our understanding, the two-tier approach only ensures that the liquidity buffers shall be made up of suitable assets which can be respectively sold during the assumed stresses in the two periods. However, *per se* the two-tier structure will probably not have any management effect. Hence, banks should set a liquidity buffer level that allows them to survive both a moderate, protracted stress event but also an acute, short-term stress event during a one-month period. Hence, the assumed survival period should only amount to one month.

Guideline 4 (Composition of the liquidity buffer):

There should be no excessively narrow definition of assets eligible to the liquidity buffers. This is due to the fact that this might *inter alia* incur hefty price hikes for assets that are central bank eligible.

In our view, the single and decisive criterion for the assets underlying the liquidity buffers should be their central bank eligibility. At any point in time during marginal lending, banks have to be able to draw upon securities that are central bank eligible. The additional request that those securities which are being used as a liquidity buffers in the first days of a stress scenario should remain liquid also in “private markets” would lead to a situation where banks would not be allowed to recognise at least parts of their marginal lending facility in their liquidity buffer. As a result, *in lieu* of a true and fair view, a bank’s liquidity situation would be presented as worse than it actually is. Furthermore, also the criterion of central bank eligibility is based on market liquidity.

Last but not least, the question arises which objective criteria should be used for defining assets that are "highly liquid in private markets”. The request that assets have to be highly liquid in private markets should therefore be deleted.

Furthermore, the explicit reference to cash and unencumbered assets implicitly suggests that banks will be incapable of drawing upon unsecured borrowing facilities during the stress scenarios under observation. As has already been pointed out in our comments on paragraph 38, this does not appear realistic particularly as regards banks which can draw upon credit lines of wholesale clients featuring a high degree of customer loyalty.

This would pave the way so that also funding facilities in the unsecured market could – at least in part – be eligible for recognition. Of course this presupposes that this approach is appropriate for the respective bank.

Furthermore, in our view, banks should be entitled to recognise those securities in the liquidity buffers in an appropriate manner that are most suited to their requirements. The extent to which these assets are eligible for recognition should depend on marketability of these assets. Here, the predicted haircuts are to be taken into account.

Pursuant to paragraph 58, assets eligible for emergency facilities shall not be deemed as liquidity buffers during "normal" periods. We feel that this is appropriate. However, during stress situations, assets should be eligible to the liquidity buffers which then, in turn, would be eligible for recognition as emergency facilities. After all, in this case, the assets could be used for maintaining liquid funds. Furthermore, a definition would be required as to which central bank measures shall be subsumed under the term "emergency facilities".

Pursuant to paragraph 59, banks are supposed to test periodically whether assets that are central bank eligible will also remain acceptable collateral for central banks. Furthermore, portfolios containing a large variety of assets are deposited with the central banks as securities. Particularly amongst large, internationally active banks, the implementation of tests for each individual asset would result in an enormous effort and create additional costs which would not live up to a cost-benefit analysis. Furthermore, it cannot be ruled out that the implementation of actual transactions for testing purposes would send undesired signals to the market which could potentially have an adverse affect for banks. We would appreciate a specification as to how the ongoing tests of the central bank eligibility should take place.

Furthermore paragraph 59 requests banks to demonstrate „that they are not relying too heavily on access to central bank facilities as their main source of liquidity". We understand CEBS's concerns over the role of central banks as "lender of last resort". However, we would appreciate it if there was a clarification that the regular participation in open market operations shall not be interpreted as an instance of "relying too heavily on central banks". Furthermore, we would appreciate a specification as to the criteria around which an overly heavy reliance on central bank facilities shall be defined.

We would like to point out that the scope of the presentations on paragraph 61 does not extend to those cases where prudential supervision rules already foresee the provision of liquidity for certain portfolios over several months. For instance in Germany, as far as mature Pfandbriefe are concerned, the corresponding liquidity – defined on a daily basis - has to be kept available for a period of 180 days in advance (§ 4 subparagraph 1a Pfandbrief Act). Hence, the German regulator requires Pfandbrief banks to hold liquidity 1:1 for these portfolios over 6 months in advance. Furthermore, the quality of the assets which have to be held is defined under German law. Hence, the points made should be further elaborated in order to clarify that such positions which are fully backed by liquidity under prudential supervision law can be exempt from the calculation basis for the liquidity buffer.

Guideline 5 (Diversification of Assets):

We agree with CEBS that a sufficient diversification of the assets in the liquidity buffers is very important for marketability. Notwithstanding the foregoing, the request to avoid large concentrations of securities even if they are central bank eligible would have to be revisited. In our view, a concentration in these securities can be deemed safe, provided it stays within the concentration limits established by the central bank.

Furthermore, we feel that – due to regulatory reasons - banks should not be obligated to acquire holdings with long terms to maturity nor should there be a statutory obligation to enter into transactions denominated in foreign currency. The composition of the liquidity buffers should rather more take adequate account of the bank's individual liquidity risks concerning the maturities of the currencies held.

For smaller banks and retail-oriented banks, the requirement pursuant to which banks have to be active on a regular basis (paragraph 64) in any market in which they hold assets for liquidity purposes is excessive. Usually these banks belong to a financial network and partly their market access only takes place through the central institutes. One argument which would particularly speak against such a request consists in the extremely high transaction costs in relation to the traded volume. Also central institutes or capital-market oriented banks could, at best, only meet this requirement on a random basis.

Guideline 6 (Appropriateness of the liquidity reserve with regard to the group's structure and activities)

Pursuant to this Guideline, the location and the size of the liquidity buffers within the banking group should adequately reflect the structure and activities of the group. In our view, this provision also implies that the liquidity buffers may be presented at an aggregated level for the banking groups. We would appreciate a clarification.

We would also appreciate a clarification as to the interpretation of the language "self-sufficient in terms of liquidity" in paragraph 67. In our view, only legal entities should be subsumed under the term "self-sufficient".

We welcome the fact that paragraph 69 stipulates that there is not only one single model for the organisation of liquidity management. A centralised liquidity risk management is deemed acceptable provided there are no impediments to the transfer of liquidity within the group and that the relevant regulators are satisfied that the ability to move funds between entities would be resilient also during stress situations. Also at this juncture, we feel it is important that the relevant regulators develop a shared understanding and that they will subject banks to homogenous reporting requirements. For large, cross-border banks, heterogeneous requirements that differ between national regulators tie up considerable resources and create additional transaction costs.

Annex – Cash flows and liquidity potential

The Annex contains a schematic view presenting liquidity-based cash flows. Hereunder, paragraph 2 refers to the difference between contractual and behavioural cash flows. In our understanding, the contractual cash flows shall be relevant for liquidity risk management. In the context of paragraph 13, these contractual cash flows would have to be presented in a behaviourally modified manner on a proportionate basis to reflect the type and scope of a bank's business activity in the scheme. A double presentation would neither generate more insight nor could this be reasonably expected especially from banks as far as the operational side is concerned.

Feedback on the questions contained in paragraphs 19 and 20

(1) If the composition of liquidity buffers was to be restricted to assets that are both highly liquid in private markets (including in stressed time) and central bank eligible:

1.1 Would you foresee any shortage of eligible assets, such as government bonds, or any increase in the concentration or cost of holding such assets? Any impact on less liquid assets?

In our view (cf. also our comments above), prior to the coming into force of the CEBS Guidelines, an impact study should be conducted in order to gauge the effects on the capital markets as well as on issuers of liquid and less liquid securities particularly during first-time application of these provisions (one-offeffects). We feel that the requirements proposed by CEBS with regard to the liquidity buffers may influence various markets, particularly the market for government bonds. At this juncture, the impact depends both on the amount of the mandatory liquidity buffers and on the severity of the imputed stress scenarios as well as on the limitations with regard to the assets that are eligible to the liquidity buffers.

We expect an increased demand for high-quality government bonds. As a result, the costs for holding these securities could see a further increase. Furthermore, the risk of lower market liquidity in this segment may increase. This is due to the fact that there are very large volumes resting in the liquidity portfolios which are tagged with a “buy and hold status”. At the same time, the demand for securities which are no longer eligible for recognition could drop. This, in turn, could put these securities under pricing pressure.

1.2 Would you expect any potential pressure points due to possible inconsistencies in the definition of the liquidity value of eligible collateral and the liquidity value of assets/collateral taking into account in the computation of the net cash outflow?

This question is vague.

1.3 What conditions, if any, should be fulfilled in your view before a narrow definition could be applied, without undue side effects? (For example: availability of collateral, transition arrangements including its length, etc)

Cf. our comments on question 1.1.

Furthermore, we would like to point out that – under the proviso of our caveat articulated with regard to Guideline 4 - we feel that the principles proposed by CEBS for the assets eligible to the liquidity buffers are essentially appropriate. Before fixing a more narrow definition of the liquidity buffer, there should be an analysis of the vertical and horizontal scope of the relevant market. In addition to this, banks would have to be granted a reasonably long time horizon for acquisition of eligible securities without significant market interference and for a sale of securities that are no longer eligible for recognition in a way that is benign for the market.

In principle, however, we do not recommend a narrow definition / specification of the liquidity buffer.

(2) Would you consider that a too narrow definition of assets eligible to the buffers could entail a possible sub-optimal allocation of means from a macro-economic perspective? Would you see a risk of wrong incentives? Please specify, if observations/expectations refer to particular markets.

The increased demand for highly liquid securities can also cause shifts in the issuer markets. Depending on whether or not the securities of an issuer are eligible to the liquidity buffers, this can have a considerable influence on the demand for and liquidity of these securities. Here, also a potential differentiation between states as issuers of bonds may play an important role.

(3) How would you assess the reference to central bank eligibility for the purpose of specifying which assets should be eligible to the liquidity buffers?

We feel that the reference to central bank eligibility is appropriate. This is due to the fact that – contrary to market liquidity - this constitutes an objective criterion, which also remains valid in the event of substantial market shocks.

20a) How does the return on liquid assets compare to the return on less liquid assets? Do you anticipate a (significant) impact on ROE?

The return on assets depends on whether or not the higher demand can be met by increased supply. Should banks primarily draw upon government bonds for building up the required liquidity buffers then we expect a significant increase in the acquisition costs for first-grade government bonds. This would translate into shrinking ROEs.

20b) Do you believe that CEBS's proposals could lead you to restrict your lending capacity or increase the cost of financing for borrowers?

According to Principle 4 of the document entitled "Principles for Sound Liquidity Risk Management and Supervision" published in September 2008 by the Basel Committee on Banking Supervision, banks should incorporate the liquidity costs in the product pricing, performance measurement and new product approval process. Higher liquidity costs which are triggered by large liquidity portfolio holdings should be allocated accurately to the party which incurred them. This will drive up product prices and hence significantly impact lending.

As noted above, more stringent requirements with regard to the amount of liquidity that has to be kept available by banks will translate into lower ROEs for said banks. To compensate this shortfall, banks will therefore seek more risky transactions. Furthermore, the additional securities holdings also require backing with regulatory capital. More likely than not, this will equally have a dampening impact on lending.

20c) Do you foresee any impact of these proposals on your business models or activities? Do they present any level playing field issues with competitors other than credit institutions?

On the one hand, CEBS's proposal presents level playing field issues for those banks that, to date, have not kept sufficient liquidity buffers in place which would allow them to survive a variety of stress scenarios. On the other hand, the playing field would tend to improve for those banks which already have a large liquidity buffers in place. What is more, there would be a risk of competitive distortion in the event of a heterogeneous interpretation and application of the provisions by the international banking community.

The CEBS Guidelines induced change in the returns on securities, such as the expected reduction of the return on first-grade government bonds. This could also impact the investment behaviour and investment companies' potential yields.

20d) Do you consider that these Guidelines can help to restore confidence in the interbank market? To improve funding costs?

In our view, the Guidelines put forward by CEBS can help to restore confidence in the interbank market. However, confidence in the interbank market is determined by further factors, which means that the effect of the liquidity buffers should not be overestimated. What is more, in order to achieve the underlying rationale, the prudential supervision requirements must be implemented in a uniform manner at an international level.

A bank's funding costs are especially determined by its external ratings. The credit rating agencies' scores take the banks' existing liquidity buffers into account. The impact on the rating and thus on the individual bank's funding costs depends on which changes to the liquidity buffers will result from the CEBS Guidelines.

If you have any further questions, please do not hesitate to contact us.

Yours faithfully,
For Zentraler Kreditausschuss (ZKA)
Bundesverband der Deutschen Volksbanken Raiffeisenbanken e.V.

p.p.
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