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Consultation paper *"International framework for liquidity risk measurement, standards and monitoring"*

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Consultation paper *"International framework for liquidity risk measurement, standards and monitoring".*

Please find our remarks on the following pages.

Do not hesitate to contact us should you have any questions.

We will remain at your disposal,

Yours sincerely,

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General Manager

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1. GENERAL COMMENTS

The members of the EACB appreciate the Basel Committee's efforts to strengthen the regulatory framework and for banks in general and in particular to improve their liquidity risk management. Recent developments have shown that there is an urgent need for improved liquidity risk management. However, we think that liquidity standards should be introduced not only for banks, but also for other market participants, as financial institutions, investment firms, etc.

We would like to underline, however, that co-operative banks were less affected by the recent crisis than other groups, as regards liquidity problems. This has to do with a specific business model and governance, but also with some very specific group structures and practices.

We do not think these stabilizing elements, especially group structures, are sufficiently considered. We even fear that those structures and practices that have stood the test of the crisis, helped our members and stabilized the economy (e.g. liquidity schemes) would be wiped out.

While we agree with the need to strengthen the regulatory framework and to improve the liquidity risk management of banks in general, we would like to warn against applying a too simplistic approach, by presuming that a fixed ratio, in particular the NSFR, could give a fair view of the liquidity risk position of all institutions, irrespective of credit ratings, business models, regional and country specific issues.

Liquidity risk largely depends on business models of financial institutions (e.g. commercial banks, investment banks, settlement banks, etc.). The required size of liquidity buffer is determined by the risk management framework which are established within and tailored to each financial institution. By consequence, the profile of liquidity risk is rather unique to each financial institution. We therefore think that the criteria for risk management should rather be a pillar2 criterion.

Moreover, there are doubts regarding some concepts of the ratios, e.g.:

- The stock of highly liquid assets that banks have to hold under the LCR is meant as a defence against market stress. But how can it fulfil that function if banks have to meet the LCR requirements at any time, even in times of stress?
- Under the NSFR, even a perfectly matched position, e.g. a one year corporate loan funded by a one year corporate bond would lead to insufficient coverage.
- In our opinion, the definition of 'stable' and 'less stable' funding does not appropriately recognise the value of a well diversified funding base, the relationship with customers, etc.
- The stress scenarios mechanically apply to all institutions in the same way without taking reputation or rating into consideration. However, the recent crisis has shown that institutions of undisputed reputation and good ratings could even increase deposits.
- Equally, the NSFR scenario does not seem to take into account any management intervention, as retail and corporate lending will largely be continued as before. If a bank will not receive any wholesale funding for a period of one year, it is quite unrealistic to assume that management will not intervene.

In addition, we are seriously concerned about side-effects of certain elements and not least seriously concerned about the general economic impact of the ratios:

- We fear that the category of highly liquid assets for the LCR, as suggested, will rather lead to a new concentration risk in the banks' balance sheets and trigger parallel behaviour during market stress. During a market wide crisis all institutions will be trying to liquidate the same asset class and could thus lead to illiquidity.

- Banks' future obligation to hold important amounts of sovereign bonds, together with the "substantial downgrading" of securities issued by financial institutions will result in huge changes of financial markets. These changes will significantly affect the profitability, but also the lending capacity of banks, especially if sovereign securities are relevant for a leverage ratio.
- The standards will seriously affect the maturity transformation function of banks. For many retail banks, maturity transformation is not only one of the major sources of their income, but also their central role in their (often local) economies. We expect a highly negative impact on the real economy.
- With such a restrictive liquidity system in place, we would expect that other unregulated parts of the economy will try to take over parts of the role of the banking sector by offering more competitive products, e.g. mortgages by insurance companies, etc.

Finally, with regard to such serious concern, we think that it will be highly inappropriate to implement the recent Basel concepts without an extensive analysis of their impact. Since the results of the current impact assessment will only be available after the current consultation, a well-founded discussion of major elements is not possible at this stage.

Moreover, a single impact assessment, based on first concepts and by consequence on data of limited informative value, will not be sufficient. Supervisors should rather continue the dialogue with the industry when the results of the first impact assessment are available and concepts are revised and envisage another impact assessment.

In addition, it has to be recalled that this is the first time that the liquidity-related standards are introduced on a global level. Due to their severe impact a one year pilot period should be provided prior to their official introduction to enable all parties concerned to improve their understanding on trends, assessments and other metrics relating to the liquidity information.

2. THE TREATMENT OF INTRA-GROUP DEPOSITS IN CO-OPERATIVE BANKS

The non-consolidating co-operative groups in Europe and Japan are two or three-tiered organizations. They are made up of autonomous, local cooperative banks and their central institutions. Very often they use common brand names and logos. As a general rule, local banks are the major, if not the exclusive shareholders of "their" central bank. There are robust division-of-labour arrangements in place: broadly speaking, in many ways the central banks is a wholesale service provider for the local retail banks, which normally do not have access to capital markets.

Due to those arrangements[1] with their central banks (and other jointly owned central service providers) local banks are able to offer customers a complete range of banking products and services. Those central institutions provide payment and security services, but also cash clearing liquidity transfer within "their" co-operative group. Typically, within these decentralized structures, there will be liquidity flows from the deposit-taking entities to the central institution, which will then either transfer it to other local banks or invest on the capital market.

There are strong incentives for both sides that this process is functioning well. In some jurisdictions local banks are even obliged to respect minimum levels of deposit to be held at the central bank.

While we share the opinion that generally interbank deposits can be volatile and interbank funding may not be regarded as stable, the present crisis has also shown that the deposits from the member institutions of a co-operative group behave in a different manner. The deposits of other members of the group have proven to be highly stable, with low run-offs (if at all).

As regards undrawn credit lines granted by central banks to local banks, we suggest to apply a specific treatment so that local banks that have received those credit lines could assume they are always able to draw upon them and the central banks having granted them would assume liquidity outflows, to be calculated by an appropriate weighting

[1] In many countries' decentralized banking network banks have established cash-clearing/liquidity systems, around their sectoral central bank. While in most cases these liquidity systems are based on agreements, there are also cases where those systems are established by law. In this context it has to be considered that decentralized banking sectors contribute substantially to the stability of the financial markets, as recognized by rating agencies and even the IMF Working Paper 2007: "Cooperative Banks and Financial Stability".

- The risk management of the bank is in many organizations complemented by liquidity/cash clearing arrangements with the network's central bank. Such arrangements imply that the local bank should/is obliged to hold their liquid assets entirely or mainly with the central institution in the form of inter-bank deposits or to hold a certain amount of its deposits with the central bank. The liquidity management of the sectoral central bank has to respect high standards.
- The agreements and credit lines are especially designed to be served in times of crisis (e.g. short-term liquidity squeeze, etc.). Thus, especially in times of a liquidity crisis, local banks and central bank are obliged to stick to their arrangements. The more liquidity is concentrated within this system, the better the settlement within the system works.
- The stabilizing structures, which protect effectively against external crises, are only possible by the way of equity holdings within the consolidating group or decentralized banking groups. Equity "builds" the stabilizing structure. It has to be pointed out that these agreements are in place for decades and have proven their merits, not only in the current crisis.

factor (e.g. 25%) in order to take into account the benefits of a well diversified network of local banks.

Both the requirements for the LCR and NSFR would put these existing structures into question, while exactly these structures have certainly helped co-operative banks to master the crisis. Destroying solid structures of proven value could certainly not be the aim of the Basel Committee.

Therefore, we think that an approach that is only favouring the consolidated entities (para 133) would be too simplistic and ignore the realities of many co-operative networks Thus we suggest that the Committee considers that depending on the risk characteristics of the specific co-operative groups when calculating the liquidity ratios, institutions and their supervisors could have a choice:

- To appropriately consider deposits within co-operative groups in the relevant context of both LCR and NSFR as stable or as "original deposit as taken at regional/local bank level and/or
- To grant a possibility for a treatment similar to consolidating entities, if certain criteria, as mentioned above, are met and/or
- to allow that the liquidity ratio for the central institution is calculated on a case-by-case basis.

Preferably, the possibility of such treatment should be explicitly stated in the framework.

3. THE SUGGESTED RATIOS

A. THE LIQUIDITY COVERAGE RATIO (20-77):

General Remarks

As expressed above, we already have some difficulties to understand the philosophy of an LCR as it is presented. If banks have to hold a buffer of highly liquid assets at any time (nr. 32), how can it fulfil any buffer function in times of stress? Thus, institutions would be forced to hold a position of highly liquid assets that is reasonably higher than the minimum level in order to ensure that they can meet the criteria even when under stress (see also para 24), especially since it has to be expected that in such times the value of those might decrease. This would make the requirement even more burdensome.

The definition of the 30-day stress scenario needs to be reconsidered. While it is likely that all institutions will face both institution-specific and systemic shocks during acute liquidity stress, it is not evident that all of the suggested shocks materialize for all institutions in a similar manner. During the financial crisis some of the co-operative institutions saw an increase in retail deposits, rather than a run-off, while a run-off materialized for other banks. Systemic shocks are the ones most likely to hit all institutions. However, institution-specific shocks should be seen much more in context with reputation, rating and customer proximity. This would also create some positive incentives for banks.

Other key elements are the characteristics of highly liquid assets, the assumptions for defining an acute stress scenario and the haircuts applied for the various classes of eligible securities. The haircuts do not seem to be based on comprehensive research, behavioural studies or other evidence and therefore seem to be rather arbitrary. We would expect that through impact studies and ongoing gathering of data, the respective parameters will be reviewed and adjusted in order to be based on solid evidence.

In particular, we have serious doubts about the exclusiveness granted to sovereign securities for the stock of highly liquid assets. This preference seems to ignore that also sovereign securities could be affected by systemic shocks. Especially in times of stress there can be significant spreads regarding sovereigns in one currency zone. Especially when big institutions are trying to liquidate the same asset class, problems could arise.

The criterion induces a parallel behaviour that in itself could be the source of future problems when imposed on a whole industry. If all institutions, including the big ones, will be focusing on the same kind of government securities as assumed liquid assets, this will lead to a new concentration risk in the banks' balance sheets and asset classes could become illiquid during a market wide crisis.

Furthermore, the requirement to dispose of a stock of highly liquid sovereign assets will probably lead to higher prices of banking products in the longer run, since banks will have to compensate lower yields. We therefore think that banks should be allowed to a liquidity reserve that is much more diversified:

- In many jurisdictions state guaranteed bank securities play an important role and are held in large numbers by banks. They are fully equivalent to sovereign securities in terms of liquidity and should be fully eligible as highly liquid assets
- Especially covered bonds should be included in the stock of highly liquid assets. In Europe the market for covered bonds has been resilient throughout the crisis. However, we would like to point out that while the inclusion of corporate and covered bonds that are traded on *"large and active" markets* is understandable from system perspective, it is at the same time discriminating (favouring countries with big graded companies)

- We also think that the liquidity clearing on the basis of collateralized stable repo-markets with high turnovers can provide a strong contribution to reducing liquidity risk.
- But we also doubt that the differentiation between securities from financial institutions and non-financial corporates is justified. Especially, we fear that such privileges may turn out as an invitation to circumvent criteria.
- The approach does not consider to an appropriate degree those assets, which would enable a bank to pledge with central banks in order to overcome acute liquidity shortfalls throughout jurisdictions. Since Credit Claims constitute a significant liquidity potential, we think that they should be taken into consideration as well. Co-operative banks as retail banks dispose of a large amount of high quality retail assets. Such assets, especially those with a maturity of less than one year, can be monetized rather easily.
- We think that it is disproportionate that banks have to fulfil the LCR requirements in all significant currencies. At the composition of the liquidity buffer the swap market should have also be taken into account.

Specific Remarks

Para 21:
There is no indication for the valuation of the assets (market value or book value). This should be clarified.

Para 22/23:
The suggested stress scenario seems disproportionate. It seems that all elements that occurred during the recent crisis are summarized in 30 days. We do not consider this to be realistic.

Para. 34:
Securities of state-owned banks (with a state guarantee) and other PSEs that fulfil specific public tasks should be considered highly liquid as well. The same should apply to securities of regional governments or municipalities. This treatment should refer to all securities issued by the entities mentioned if they are denominated in domestic currencies, independently from their risk weights under the standardised approach. Such requirement could otherwise create difficulties for banks in jurisdictions, where the sovereign rating is below AA-.

Para 38:
We consider the run-offs to be too high in general. As indicated above, such figures should be based on solid evidence.

Para 41:
The differentiation between stable and less stable deposits will be very difficult to handle in practice. Especially in retail banks this could require highly burdensome assessments. Furthermore, many of the distinguishing factors may be difficult to align (e.g. internet access to transactional accounts). Some criteria are questionable from various perspectives (“deposits of sophisticated individuals”.

We suggest coming up with a more pragmatic approach and to attribute to retail deposits a single run-off factor of 7,5%. Similar reflections apply under para 51, 53 and 54.

In case of institutional protection schemes (created in accordance with art. 80.8 Directive 2006/48/EC) all deposits covered by the scheme should be considered stable.

Para 41,43,45,and 55:
As we have pointed out above, deposits of co-operative banks within their network (at both central bank and retail member levels) have strong cohesive characteristics, reflecting strong ties/ or unique arrangements with members. Those features should lead to low run-off factors for those deposits. Otherwise structures that have stood their test during the crisis would be questioned.

Para 66:
The distinction between credit facilities and liquidity facilities will require further explanation. In co-operative networks central institutions sometimes provide liquidity facilities for the member banks in relation with the minimum reserve requirements, but these liquidity facilities have very little in common with the liquidity facilities in securitisation deals.

As mentioned above, with reference to undrawn credit lines granted by central banks to local banks, we suggest to apply a specific treatment so that local banks that have received those credit lines could assume they are always able to draw upon them and the central banks having granted them would assume liquidity outflows, to be calculated by an appropriate weighting factor (e.g. 25%) in order to take into account the benefits of a well diversified network of local banks.

B. NET STABLE FUNDING RATIO (NSFR) (78-91):

General Remarks

We fear that the Net Stable Funding Ratio, as suggested by the Committee would seriously hamper the central economic task of banks, especially of co-operative banks, which is maturity transformation. Instead, banks will be obliged to match the maturities of their lending and refinancing activities.

Taking up the required amounts will have to be done increasingly by the way of issuing corresponding long-term securities, which, if available at all in required volume maturities, are not attractive to other banks, since not eligible as highly liquid assets.

The suggested calibration of the NSFR would lead to a tightened competition for (stable) deposits at higher prices than witnessed today (which will put significant pressure on banks' profitability). Institutions would pursue loyal customers.

However, already by now, the access of banks to the savings market may be affected, even restricted due to a number of external factors. Even today such access may be constrained in some jurisdictions by the structure of savings markets, especially when other competitors, such as pension funds and insurance companies have certain direct or indirect tax advantages. This puts banks at a disadvantage compared to its peers already today. As a result of this structural imbalance, banks in such jurisdictions would need a comparatively higher amount of longer term and more expensive wholesale funding to comply with NSFR requirements.

In all jurisdictions a competition for deposits will lead to higher deposit prices. Those higher deposit prices will be rolled out to loan pricing. In general, the proposal will increase incentives for saving (depositors) and decrease incentives for borrowing (debtors). This can be seen as an income transfer from borrowers to depositors and lead to reducing the dynamics in the economy. Most probably, however, unregulated parts of the economy may step in and fill the gap. Especially large corporates with retail customer relations, such as telephone or utility companies could seek to incentivize their customer accounts (e.g. prepaid accounts), while drawing advantage of a higher appreciation of their securities (lower coupons).

Furthermore, the NSFR seems to be inconsistent in so far as it does not apply the same kind of assumptions to the asset side as to the liability side. If for retail lending with a maturity of less than one year it assumed that 85% will be rolled, and at the same time 'stable' retail deposits are for 85% included as available stable funding, the percentages are the same, but the actual amounts involved are completely different as only a small part of the retail lending will be with a maturity of less than one year, and a large part of the stable retail deposits will be withdrawable at short notice. This creates a substantial gap. Transforming retail deposits into retail lending is the classical transformation function of co-operative banks. Also a perfectly matched position of a one year corporate loan funded by a one year bond creates a substantial gap, as the corporate loan requires 50% stable funding, whereas the one year issued bond has no value at all as available stable funding.

Moreover, the NSFR scenario does not seem to take into account any management intervention, as retail and corporate lending will largely be continued as before. If a bank will not receive any wholesale funding for a period of one year, it is quite unrealistic to assume that management will not intervene.

The current proposal implies that irrespective of the current credit rating, the impact of the stress scenario will be the same for every bank. This is not true. Also for the short term wholesale funding markets, a high credit rating and/or good reputation has a beneficial impact for a bank's access to funding. We therefore think that even for a bank with an external public rating of at least AA, 20%-30% of the outstanding amount per wholesale funding source (including central bank and fiduciary deposits, and funds from asset managers and pension funds) should be recognised as available funding in the calculation of the NSFR.

In general, financial institutions should be given the opportunity to demonstrate the stability of their deposits for their national authorities instead of applying fixed multipliers for all institutions.

Specific Remarks

<u>Para 83:</u>
The NSFR is based on a stress scenario over one year. We consider it highly unrealistic that management intervention is not taken into account as retail and corporate lending is presumed to continue as before. If a bank will not receive wholesale funding within a certain time span, management intervention is to be expected. Therefore the NSFR should rather ensure that the current business is appropriately funded.

<u>Para 84:</u>
While there are reasons not to consider central bank lending facilities in individual cases, we doubt that it is appropriate to exclude such facilities in cases of a systemic shock: The role of a lender of last resort is part of central bank tasks.

<u>Para 86:</u>
Due to their cohesive features, co-operative deposits, as described above should probably be treated as part of the Available Stable Funding (ASF) deposits, similarly to the retail deposits (see above).

Next to this, we reiterate our doubts about the full exclusion of any deposits of financial institutions.

Again, we raise doubts considering the appropriateness of the distinction between stable and less stable deposits. We think that in practice such differentiation will be highly burdensome if not impossible. Furthermore, we think that the rates for available stable funding under the NSFR should and the run-offs under the LCR should be convergent (especially for deposits).

The calibration of the ASF-factor for wholesale funding provided by non-financial customers (50%) seems to be far too conservative.
Secured and unsecured borrowings and liabilities with maturities of one year or greater should also be fully eligible when the relevant option is a call option of the borrower (as probably in the case of securities). But also in the case of creditor options we recommend to consider (statistical) average maturities.

<u>Para 89:</u>
We consider the attribution of a 20% RSF-factor to covered bonds inappropriate. Covered bonds haven proven, next to sovereign securities, to be the most reliable long-term instruments for refinancing. Even in the most difficult periods of the recent crisis neither the primary nor secondary market for covered bonds was affected. We therefore think that an RSF-factor of 5% should be attributed to covered bonds rated AA- to A-.

We also think that the presumed roll-over rates of 50% for loans to non-financial corporate clients and of 85% to retail clients seems far too high. Based on empirical evidence more realistic rates should be fixed.

As we have indicated already above, the fully coverage of maturities beyond one year with stable funding seems inappropriate.

C. MONITORING TOOLS

<u>Para 107:</u>
For cooperative banks at regionally or nationally level, funding from member cooperatives is naturally a dominant source of funding. In many cases this may give rise to some geographical concentration as well, reflecting size of local economy. Any regulatory treatment of concentration should take into account these intrinsic characteristics.

<u>Para 135:</u>
Liquidity-related information and especially the standard-related information should not be disclosed until market reputation is established. We support the idea of enhanced disclosure of liquidity-related information to the supervisors. However, casual disclosure of liquidity information to the markets without having established market reputation may expose financial institutions to both the reputational risk and the risk of unexpected and excessive market pressures.