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September 4, 2009

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration

Re. Proposed Interagency Guidance –
Funding and Liquidity Risk Management
(Docket nos. ID OCC 2009-0009; OP-1362; ID OTS-2009-0011)

Dear Sirs:

The Special Committee on Liquidity of the Institute of International Finance is pleased to offer comments on the captioned Proposed Interagency Guidance. The Institute is an association of about 370 financial institutions from around the world. As the Institute is focused on international markets and international regulation, it customarily does not comment on national proposals; however, it may do so when there is a national proposal of particular international significance. Thus, although the Special Committee commented on the Basel Committee paper cited in the Proposed Interagency Guidance, it concluded it ought to do so in this instance as well. These comments are given from an international perspective and do not necessarily reflect all the comments that members may give in their own comments or via US-focused associations.

The Institute has been focused in particular on liquidity for some time now, including the publication in March 2007 of the *IIF Principles of Liquidity Risk Management*[1]. The recommendations of that report were updated and augmented in part III of the *Final Report of the IIF Committee on Market Best Practices*[2], published in July 2008 and recognized in your proposed guidance. A number of the recommendations made in those reports anticipate the Proposed Guidance with respect to liquidity buffers, stress testing, governance, and other matters. Some of the high-level themes of those reports were further developed in the recent report, *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability* (July 2009).[3]

While the difficult experience of the financial crisis may create a temptation to maximize the liquidity maintained in individual entities, the Special Committee's view of the correct lessons of the crisis – and of the needs of the system as it approaches recovery – is rather to ensure that local liquidity requirements are not set at excessive levels and take into account the group-wide liquidity management frameworks of firms to free up liquidity for deployment where needed

[1] Available at http://www.iif.com/press/press+25.php
[2] Available at http://www.iif.com/press/press+75.php
[3] Available at http://www.iif.com/press/press+76.php

within global groups to allow them to maximize efficiency. This will not only contribute to supporting global liquidity (and raising local requirements will inevitably do the opposite) but it will help the international banks to return to more generation of credit for the real economy (whereas costly local liquidity requirements, especially when combined with all the other changes being implemented, will do the opposite).

The position advocated here is not laissez-faire or a return to the status quo ante 2007. The IIF recommendations since 2007 and now the Basel principles have set out a rigorous approach to liquidity-risk management that reflects sound practices for the future, and indeed practices that have helped many firms cope with unprecedented difficulties. The danger now is not that the problems of lack of sufficient regulatory or management attention to liquidity, adequate internal pricing of liquidity, or use of questionable assets for liquidity buffers seen before the crisis will persist, but rather that, if each country imposes high local requirements without taking into account the ability of global firms to manage internal pools of liquidity, the efficiency of the overall system will be seriously reduced, and recovery will be restrained to the same extent.

International Dimension. The Institute is pleased to note the extent to which the Proposed Guidance draws upon the Basel Committee's "Principles for Sound Liquidity Risk Management and Supervision" (September 2008). As stressed in *Restoring Confidence, Creating Resilience,* it is absolutely essential for global recovery and for the future efficiency and effectiveness of international prudential regulation for there to be the maximum convergence of regulation on international standards and principles, and to maintain the role of the Basel Committee in establishing them.

Despite the grounding of the Proposed Guidance in the Basel Principles, the absence of the international dimension otherwise is notable. We will return to this point below, but, as developed at some length in *Restoring Confidence, Creating Resilience,* it is important that not only the standards of regulation be well coordinated internationally, but that there be substantial international coordination and cooperation in implementation as well. This is particularly important insofar as supervision of liquidity issues in international banks is concerned, given that the effective deployment of the liquidity resources of an international firm can make a real contribution to maintaining liquidity and the availability of credit in global markets; and, as recognized in the Proposed Guidance, it is important for supervisors to have a view on the overall liquidity position of a group. Further, a consistent and meaningful regulatory regime is necessary to promote efficiency of implementation and to provide a level competitive field.

For this reason, it would be helpful to include in the final guidance discussion of the role that the colleges of supervisors mandated by the G20 and being implemented under the auspices of the Financial Stability Board could play in achieving efficiency (reduction of duplication and inconsistency) and effectiveness (clear sight, consistently high standards) in liquidity-risk management. The key to the effective regulation of internationally active firms is substantial international coordination and cooperation. Harmonization of standards and close cooperation of supervisors is key to maximize the efficiency of the deployment of liquidity and liquidity buffers globally, which contributes to maintaining liquidity in global markets; and, as recognized in the Proposed Guidance, it is important for supervisors to have a view on the overall liquidity position of a group.

We applaud the interagency approach to the extent that it recognizes the need to focus on a bank's own liquidity risk management models, rather than specific quantitative standards, which continue to be suggested by some commenters and authorities. We believe that such quantitative standards would not be truly comparative among banks and could be potentially misleading if taken out of the context of a broad assessment of a banks liquidity position and risk management processes and practices. The interagency guidance generally continues the approach of the Basel Committee in recognizing a principles-based approach to liquidity supervision. Such an approach provides for a more flexible review of a banks liquidity risk management processes and allows for changes to adapt to the evolutionary nature of businesses, products and markets.

The emphasis of regulatory evaluation of liquidity risk management at an individual firm should be an assessment of its liquidity position and processes. A standardized, more-quantitative regime is unlikely to capture the specific business models, liquidity positions and vulnerabilities of individual firms. As discussed in the Institute's reports on liquidity, each firm has a unique profile for which a customised combination of measurement and monitoring tools is appropriate.

Comments on Specific Points

Paragraph 11. The principles set out in this section are sound and generally congruent with the Institute's recommendations on liquidity-risk management (as, indeed, are most of the recommendations of the Proposed Guidance). Only one observation suggests itself: the time horizons implied in the "formulation of plans and courses of action for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions" are left open ended and this is entirely appropriate.

As is the case with many elements of liquidity management the Institute believes these planning horizons should be determined by each firm as appropriate in discussion with its regulators, working through the firm's college. However, we do note that there has been discussion of defining such terms more prescriptively in other countries. To the extent those terms are not left flexible (which would be our recommendation), any definitions should be established through the Basel Committee, so that there is a common understanding and approach, and that the distortions and deviations that would arise from multiple definitions can be avoided.

Paragraph 12. As already noted, agree that a variety of measures and conditions should be specified at individual firms and would emphasize that different metrics, limits, targets and triggers would be appropriate for individual firms. As pointed out in the March 2007 IIF report, the concept of liquidity is complex and any suggestion that a single metric will adequately reflect the true liquidity risk of a firm is misguided. A range of metrics, customized to the particular firm, is necessary to evaluate the liquidity position of the firm in an accurate way that will be meaningful in assessing the risks it faces.

Paragraph 20. The principles of risk reporting for management purposes set out in this paragraph are appropriate, and indicate the type of approach managements ought to take. However, we caution that some countries are taking a highly detailed approach to liquidity reporting, which we would urge the US agencies to resist in international discussions. Whatever approach is eventually adopted at the international level should be globally consistent; however, the Institute endorses the approach stated here and would argue against a great deal of precision.

Going beyond reporting for management purposes to reporting for regulatory purposes, we note that some countries appear to be developing very detailed regulatory reporting requirements that may be duplicative of, but in different formats than, or even at odds with, internal management or home-country reporting. It is important that appropriate metrics be developed by the individual firm, in conjunction with its supervisors. Metrics for management and supervisory purposes should not be ratios set in stone but useful points of reference to tack trends affecting the firm (which would then be required to explain and respond appropriately to such trends); compare and contrast with trends identified in peer firms (on a comply or explain basis as previously advocated by the IIF if applicable); and take soundings across a suite of firm-appropriate metrics so that management and supervisors both understand the whole picture, stressing that no one metric can give the whole picture and that relative strengths and weaknesses on different metrics may balance out or, conversely, indicate that there are vulnerabilities that might otherwise not be noted.

Once again, liquidity is an international issue and it would make sense for efficiency for quality-of-supervision, and for consistency purposes for there to be one, consistent set of reports for each group, without duplications, which would be channeled through the home regulator. Except perhaps for very specific items unique to the local jurisdiction, liquidity reporting should as much as possible be channeled through the home regulator and the college of supervisors. For colleges to work well, and to be able to respond quickly to market events or events affecting a specific firm, it is important for them to have common information, without the opportunities for misunderstanding that would be created by divergent approaches to similar items.

Within the principles of the foregoing three paragraphs, there is a good case to be made for convergence on common reporting of liquidity across the globe, to minimize costs for international bank but also to build a common language to be used across colleges as well as within each college for each group, as argued in the preceding paragraph.

Paragraphs 21 and 22. In contrast, the discussion of entity and group liquidity analysis and reporting raises some troubling issues.

The draft guidance appropriately points out the need for financial institutions to take into account all legal, regulatory and operational constraints to transferring liquidity across its constituent legal entities or across its branches in different countries, as indeed the IIF reports have also done. The draft guidance does not introduce or expressly advocate the imposition of regulatory constraints on the transfer of liquidity across legal entities or branches. However, we are troubled by the general trend taken by regulators in other countries toward restricting the free flow of liquidity across the constituent legal vehicles and international branches of internationally financial institutions.

The IIF reports cited above stress some basic themes that bear repeating: management of liquidity in international groups will often best be done on a group-wide basis. While firms may have more or less centralized or localized liquidity-risk management, many firms have found that liquidity can most efficiently be managed on a group wide basis, or in some cases on a basis of pooling the major currencies for use by offices in the major financial centers. Of course, local requirements in each jurisdiction must be met, but, in general, both the firm's efficiency and that of the system as a whole will best be served if the group has the flexibility to deploy liquidity where and when needed within the group, and "trapped pools of liquidity" in particular jurisdictions are avoided.

Thus, while it is certainly true, as paragraph 22 states, that a firm ought to develop a group-wide view of liquidity risk exposures and identify constraints on the transfer of liquidity within the group, the Special Committee is concerned about the intended scope of the statement that "separately regulated entities will need to maintain liquidity commensurate with their own risk on a stand-alone basis." First, it is not clear whether "entities" includes branches of foreign banks. Secondly, the apparently broad scope of the "stand-alone" concept as applied to subsidiaries is also concerning. Thirdly, it is not clear whether the intent is to announce a change of prior US supervisory requirements or practice.

While it is understood that minimum needs of local subsidiaries have to be planned for, and that requirements of other legislative structures that have an impact on liquidity, such as Regulation W and Sections 23A and 23B of the Federal Reserve Act must be complied with, a stand-alone approach to liquidity in local entities can come to undermine global efficiency of firms and contribute to tightening up liquidity and credit in global markets when fluidity is most needed (these points are developed further in the aforementioned reports).

This is a particularly sensitive issue at the present time, when restarting the global capital markets is important and liquidity is still precarious in some respects. Certain other authorities, such as the UK FSA, have taken what the Institute regards as a potentially counterproductive approach to "stand-alone" requirements, one that carries a grave risk of exacerbating regulatory fragmentation and of fragmentation of otherwise-liquid global markets.[4]

The guidance should encourage the ability of firms to borrow within normal good practice and applicable prudential regulation from constituent legal entities or international branches that have excess liquidity. In general, we believe that the reduction of barriers to the transfer of liquidity enhances the liquidity risk management of firms and would reduce risk to the financial system. Additionally we believe that this free flow of liquidity is important to allow firms to continue to provide credit to clients and promote stronger economic activity.

In addition, rigid local-entity requirements, if applied to an extent that would hamper a group's normal liquidity-management procedures, could engender additional serious operational inefficiencies and risks. For example, if firms were induced to hold a buffer of high-quality assets in a given currency, such as US Treasury obligations, outside of its home market, because of restrictions on movement of funds when and where needed within the group, the firm would incur significant extra costs and reduced flexibility, to the detriment of overall system efficiency and with potentially little gain for anyone, including the jurisdiction that set requirements intended to ring-fence such liquidity.

[4] See *Restoring Confidence, Creating Resilience,* Section 3.6, at pp. 52-53.

Paragraph 29. In general, the approach suggested is congruent with the IIF liquidity recommendations; however, the last sentence, requiring estimates to "assume the inability to obtain unsecured funding …" is not evidently risk based, may be too rigid and could provide misleading or unhelpful results for certain firms. Depending on a firm's business model, the depth and extent of "sticky" deposit funding, and the diversification of other funding capacity that is available to a high confidence level, the most realistic but still severe scenario is more likely to be less than a total inability to obtain such funding. Strong firms, with well-diversified and material unused funding access in multiple products currencies, and markets should not be automatically subject to the deterministic assumptions that might be appropriate for weaker firms. Indeed, requiring the assumption generally (however correct it may be in specific cases determined on a Pillar 2 basis) actually could create disincentives to pushing compliance with the principle of diversifying funding sources to the maximum feasible extent.

Paragraph 30. The discussion of a cushion of unencumbered assets is unobjectionable in itself. We support the basic principle behind the creation of a liquidity buffer composed of highly liquid assets and we agree that the size of this cushion should be informed by the firms risk tolerance as expressed through its stress testing. The guidance should explicitly state that liquidity cushions need to be developed during relatively benign market conditions – the general thought would be that firms should be required to build liquidity when they don't need it as it is more difficult, or impossible to build this in times of stress.

However, the question is how narrowly this concept would be interpreted. The example given of US Treasury securities "or similar instruments" could be less than helpful if interpreted narrowly. The Special Committee is concerned that there may be a tendency in this and other countries to interpret liquid assets narrowly; however, doing so would be a mistake to the extent that an overly restrictive approach could slow recovery and harm funding and market liquidity from a macroprudential viewpoint, even if it might be the most conservative approach conceivable from a microprudential point of view, looking at the firm level. [5]

Certainly, for internationally active banks, it would not be appropriate to interpret "high-quality U.S. Treasury securities" narrowly. As the Special Committee has argued in other contexts, it would be important, depending on the facts and circumstances of each institution, to allow a relatively broad range of highly liquid instruments in each currency in which the bank has significant operations, which would generally correspond to the instruments acceptable in the ordinary course of business as collateral by the relevant central bank (this would not generally extend to those instruments that are accepted only on an emergency or exceptional basis, but should include liquid instruments generally accepted by the relevant central bank – a category that is likely to be broader in the post-crisis world than it was before 2007). As it relates to the liquidity cushion, regulators should be encouraged to expand and harmonize the types of collateral they accept and remove barriers to transfer of collateral, having regard to the relevant central bank criteria.

A critical question is how the buffer of liquid assets would be funded. Contingency planning for liquid assets must address funding as well as the assets themselves, and this in turn raises the

[5] A fuller discussion of this topic may be found in Section 3.6 of *Restoring Confidence, Creating Resilience.*

issue of the target survival period. Thus, the appropriateness of assets retained for the purposes described in Paragraph 30 would depend in part on how they were funded; this dimension should not be overlooked in defining "highly liquid assets" that are "readily available".

The question raised here is one of interpretation; it would perhaps be helpful to have some indication that the highly liquid assets a bank has available in compliance with this paragraph is a matter for interpretation under the facts and circumstances and should not be hemmed in unnecessarily. We would not advocate going into a great deal more detail for purposes of this guidance.[6]

Paragraph 35. We agree on the need for "early warning indicators" and are encouraged by the emphasis on tailoring these to the individual firm's liquidity risk profile. We are also in favor of a non-prescriptive approach to any actions required upon activation of any early warning signals as actions to be taken, if any, will reflect the particular facts and circumstances.

We agree with having a "liquidity event management process", as clear roles and responsibilities for decision making, and identifying a range of alternatives through the liquidity planning process are an important part of crisis management. We are heartened that there is no suggestion of a priori prescriptive actions. A response will need to be tailor made based on the facts and circumstances existing at the time of the emergence of a potential or actual disruption.

Presumably, in the future, the "early-warning indicators" will be issued as part of the macroprudential process being devised by the FSB and future macroprudential or systemic risk processes that will emerge in conjunction therewith in the US and other jurisdictions. As the Institute has stressed in the *Restoring Confidence, Creating Resilience* report, it is highly important that international coordination on these matters be maintained through the FSB, even if, in some cases, the "early warnings" may initially be specific to one or another market.

Paragraph 42. The term "independent party" is understood to mean the internal audit department. This understanding is consistent with the approach of member firms.

Paragraphs 43 and 44. . As noted above with respect to Paragraph 21, it is quite possible to exaggerate the "stand-alone" approach to liquidity. While each entity should be able to meet its immediate and legally required needs, group resources should be deployable on a prudent basis for efficiency and also for systemic-resilience reasons. Thus, the general principles described in these paragraphs should be formulated for the final guidance in such a way as not to be over-interpreted.

The worst situation would be to require a maximalist approach at both the holding company and the subsidiary level – in other words, double buffers. Instead, a reasonably flexible approach, allowing the group to deploy liquidity when and where needed once local requirements are met, is likely to be more efficient and effective in the long run, both for firm and for the system.

From the point of view of international banks, these paragraphs are disturbing because they include no recognition of the needs or resources of internationally active banks. Whereas even

[6] See the further discussion at page 55 of *Restoring Confidence, Creating Resilience*

the UK FSA's recent proposals provide a waiver option for foreign banks in order to avoid duplication and inefficiency where the home country regime is sufficiently robust to cover the needs of offices in Britain of foreign firms, there is no indication here of such an approach. While international banks from countries with strong regulatory systems would be able to argue forcefully that they maintain adequate liquidity from a group perspective (regardless of the exact corporate structure), the absence of any recognition of the need to look to the group and to home-country regulation of liquidity could cause misunderstandings or unfortunate effects in the application of the Proposed Guidance. Again, it would be appropriate to assess holding-company and group liquidity through the group's college of supervisors, and that part of the supervisory process could usefully be mentioned here.

We hope that you will find these comments, offered from an international, cross-border perspective, helpful not only for the eventual issuance of final guidance but for purposes of discussions at the Basel Committee.

Should you have any comments or questions, please feel free to contact the undersigned, or David Sunstrum of the IIF (+1 202 857 3615; dsunstrum@iif.com).

Very truly yours,