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# CRD and Liquidity

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EUROPEAN PARLIAMENT

Financial Services Panel  
Economic and Monetary Affairs Committee

MARCO LAMANDINI  
Full Professor of Securities and Company Law  
University of Bologna

**CRD and Liquidity**

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## Executive summary

The Committee has requested an opinion on CRD and liquidity. This briefing paper is intended to offer a view on this issue, the relevance of which for the sound management and prudential supervision of banks has been clearly highlighted by the current financial crisis. Paragraph 1 provides for a brief overview of the CRD proposed amendments concerning liquidity risk management and supervision. Paragraph 2 briefly discusses these proposed amendments and CEBS's recommendations on liquidity risk management. Paragraph 3 considers liquidity risk management in a banking group perspective, calling for some additional regulatory efforts to address the problem of "liquidity trap" and to strengthen cross border liquidity crisis management.

1.- The CRD proposal, drawing lessons from the recent liquidity crisis, acknowledges that liquidity is a key determinant of the soundness of the banking sector. It is widely accepted, indeed, that if the current crisis tells us anything, it is that a number of market developments, such as the increasing reliance of large banks on market funding (in addition to retail deposits), the increasing use of complex financial instruments (based on a "originate-rate-transfer" model) and the globalisation of financial markets have created significant new challenges in the liquidity risk management within banks.

The current crisis showed that large banks' liquidity was affected, in times of sudden and unexpected fall of confidence: i) by the shortening of maturity in the inter-bank market (with borrowing limited for a time to overnight or a few days); ii) by the drying up of ABS markets (regardless of the assumed quality of the paper as

reflected in external ratings) which, on one hand, left banks unable to access liquidity by securitising portfolios and, on the other hand, left banks exposed to liquidity drains from SPVs conduits on the ground of their often implicit off balance sheet commitments to them; iii) by an unprecedented difficulty in issuing securities in the primary markets and illiquidity of secondary markets. In this context, banks heavily depending on wholesale funding instead of retail deposits (the former much more volatile than the latter) faced a severe liquidity shortage which triggered the need for emergency liquidity assistance by central banks and other public intervention.

The size of the problem showed that widespread liquidity risk mismanagement leads to systemic instability, putting even at risk the wise and sound central banking principle of strict separation between liquidity provision policy and monetary policy. Indeed, the setting of the level of interest rates should be directed solely at the goal of maintaining price stability; charging monetary policy with additional objectives, such as providing exceptional and emergency liquidity support to ensure financial stability, could result in a policy at war with itself. This is particularly true when we face, as it seems to happen these days, inflationary pressures combined with weaker economic activity and financial turbulence.

The current EU framework on prudential regulation in liquidity is quite light. The host supervisor is in principle in charge of monitoring liquidity risks for branches as an exception to the home country control principle (see also Article 41 of CRD). CRD requires banks to address this type of risk but does not get into details. As a matter of fact, point 14 of Annex V to Directive 2006/48/EC sets out –

with quite a broad wording – that “policies and processes for the measurement and management of their net funding positions and requirements on an on going and forward looking basis shall exist. Alternative scenarios shall be considered and the assumptions underpinning decisions concerning the net funding position shall be reviewed regularly”. Point 15 sets out that “Contingency plans to deal with liquidity crisis shall be in place”. In turn, Annex XI provides that “the review and evaluation performed by competent authorities shall pursuant to Article 124 include the following: (...) e) the exposure to and management of liquidity risk by the credit institutions. As a consequence of these vague principles, there are wide differences in national prudential treatments for liquidity risk (most if not all authorities within the EEA recognize, though, the Basel sound practices for liquidity risk management as a general reference) <sup>(1)</sup>.

The proposed changes to Annex V of CRD are intended to set in much greater detail the guiding principles for banks’ liquidity risk management. It is proposed therefore to amend the existing points 14 and 15, so as to make clear, on one hand, that “adequate levels of liquidity buffers” and “robust strategies, policies, processes and systems” are expected in order to “identify, measure and manage liquidity risk over an appropriate set of time horizons, including intra-day”. Note that according to the new point 14a each bank shall adopt the strategies and processes proportionate to its complexity and exposure to risk, considering also the bank’s systemic relevance in each Member State in which it carries on its business. Under the new Article 15 banks are requested to develop a system of limits and

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<sup>1</sup> Compare CEBS, *Survey of the current regulatory frameworks adopted by the EEA regulators*, August 2007, passim.

appropriate methodologies for “the identification, measurement, management and monitoring of funding positions”. The proposal adds to the existing Annex V points 16 to 22 to require banks: i) to distinguish between pledged and unencumbered assets in their liquidity management; ii) to consider different liquidity risk mitigation tools, including liquidity buffers and an adequately diversified funding structure and access to funding sources; iii) to consider alternative scenarios in their liquidity risk management; iv) to consider the potential impact of institution-specific, market-wide or combined alternative scenarios in different time horizons and under varying degrees of stress; v) to have in place and to regularly test contingency plans to address possible liquidity shortfalls.

In turn, and consistently, Annex XI is also amended to subject these new management requirements to the supervision of competent authorities and to spell out in detail, under new point 1a, that supervisors “shall regularly carry out a comprehensive assessment of the overall liquidity risk management and promote the development of sound internal methodologies”. In so doing, they “shall have regard to the role played by the bank in the financial markets and to the potential impact of their decisions on the stability of the financial system in all other Member States”.

2.- The proposed amendments are certainly welcome. They should help boards of directors and senior management to better understand their role and their duty of care vis-à-vis liquidity risk and at the same time they should increase the strictness of the legal requirements on liquidity risk management. They also enhance the

cooperation between banks and supervisors to better detect liquidity risks and better understand liquidity profiles; in this respect banks can rely also, to some extent, on internal methodologies for supervisory purposes.

They do represent, though, still quite vague general principles, still open to a potentially highly differentiated application by banks and enforcement by supervisors.

To be true, these general principles are now better detailed, for the EEA, in a wider set of recommendations issued by CEBS on 18 September 2008 (CEBS 2008 147). They can also heavily rely on the new 2008 Principles for Sound Liquidity Risk Management and Supervision of the Basel Committee. These principles and recommendations are however “only” best practices for banks and “simple” supervisors’ expectations on better liquidity risk management. Nonetheless, they will certainly serve as an important tool of supervisory orientation and are likely to be adopted at national level as supervisory principles; in this way they could and should contribute to bring about more convergence over time in the approaches followed by banks and supervisors within Europe, also through the colleges of supervisors.

However, to my mind, there may be a case here for more regulatory harmonization. Although the liquidity management dimension is increasingly international (and even more so after the EU enlargement: core domestic banks in the new Member State, becoming for the vast majority subsidiaries of larger groups, function as a source of liquidity within the group), national rules and supervisory

frameworks differ substantially. Thus a common position on quantitative requirements (such as liquidity ratios; mismatch limits, assets eligible as liquid assets) as well as on qualitative requirements (such as internal policies and controls, contingency planning, stress testing) would certainly prove very helpful in aligning industry and supervisors' behaviors. Indeed, in my view, it is now time, in the wake of the current crisis, to pursue the more ambitious objective of establishing a common European compulsory and detailed framework for liquidity risk management and supervision. This, on one hand, in order to prevent the evil of regulatory and supervisory arbitrage and the inherent competition in laxity which has been one of the causes of the current crisis; on the other hand, to avoid conflicting national responses to the current liquidity crisis and the likely regulatory overload which could follow.

This regulatory overload could prove very costly and ineffective for cross border groups. It should be recalled, in this respect, that CEBS recommendation 29 does not grant (and, due to its very nature, cannot grant without a CRD provision) to the consolidating supervisor any decision making power in the colleges to set common requirements on liquidity management for cross border groups where national requirements or supervisory practices differ.

Such common requirements would be fully justified, in my view, under the subsidiarity principle: recent European events have clearly showed the macro-prudential effects of cross border liquidity mismanagement. They would also comply with the principle of proportionality because they would and should leave appropriate room

to each bank for individual adjustments depending on its specific features.

As Governor Mario Draghi recently noted at his Bundesbank lecture 2008 “history has repeatedly shown that needed reforms are ignored until a crisis forces action and that the will to reform quickly dissipates after the crisis has passed. This crisis is no different, and this is an opportunity to strengthen the structure of the financial services industry”.

3.- The CRD proposal does not tackle the very topical issue of asset transferability within a cross border group. In emergency situations of illiquidity within a cross border banking group, asset transferability (within 24-48 hours) makes the difference.

To be sure new point 16 of Annex V sets out that, when considering available assets at all times, in particular for emergency situations, banks “shall take into account the legal entity in which the assets reside as well as their eligibility and timely mobilization”. In turn, point 17 sets out that banks “shall also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst legal entities, both within and outside the EEA”.

However, these provisions do not go any further than requiring that the board properly identifies and considers the existing and defective situation of liquidity risk management within cross border groups. Subsidiaries and branches are treated very differently in this

respect. The latter can take advantage of a centralised management of liquidity. The former, on the contrary, when facing a liquidity crisis are not legally entitled to claim the support of the parent company, unless the parent company granted an explicit guarantee and this guarantee complies with home and host company laws. This is why cross border groups suffer from the so called “liquidity trap”: each subsidiary must comply with national supervisory requirements on liquidity computed on a stand alone basis: this makes the liquidity management of a cross border group much more expensive than that of a trans-national bank with foreign branches. This is even more so when collaterals accepted by home and host country supervisors differ.

The Commission is working on this topic within the frame of the revision of the winding up directive (2001/24/EC). In its summary of the public consultation on the reorganisation and winding up of credit institutions, the Commission circumstantiates the importance of assets transferability, the legal obstacles still existing due to company law and insolvency law national fragmentation and possible solutions.

In my opinion, time has come to level the prudential supervision of fully integrated subsidiaries and branches, including their liquidity supervision. Colleges should play a similar role for both.

Also cross border groups, in my view, should be allowed to have a centralised liquidity management reflecting their often integrated economic unity; ring fencing should be avoided. However, the parent company’s right to reap the (liquidity) fruits of a subsidiary, both under ordinary and emergency circumstances, should go along with a duty to assist the subsidiary in times of need and to compensate its minority

shareholders and creditors, if and when the asset transfer may cause harm to them. This would apply at the European level – at least in the banking field – principles already embedded in some national laws (as for instance Articles 2497 and following of the Italian Civil Code) Appropriate “group contracts”, approved by the competent home and host supervisors (also within the colleges) should be put in place.

The tricky exercise consists here not only in solving long lasting company law and insolvency law national discrepancies in respect to the concept of group interest and the treatment of cross border groups in insolvency but also in finding a balanced approach for an equitable “burden sharing” among home and host countries. It is clear, indeed, that internal arrangements whereby the parent company is legally entitled and at the same time obliged to transfer assets to the subsidiaries facing an emergency situation (and viceversa within the group) are viable insofar as the bail out costs of the whole group are equitably split among all Member States where the group operates.

But does CRD matter in this respect? In my view, it does. If cross border asset transferability is allowed, Article 69 should be extended so as to cover also cross border groups. The CRD proposal should therefore tackle also the very issue of consolidated versus solo liquidity risk management and supervision. A number of cross border groups already manage liquidity risks on a centralised basis and would deserve more attention also in the CRD framework.