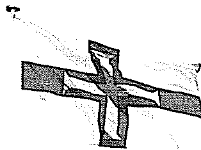

Dr. JEREMY QUICK
Deputy Director of Banking

Our Ref: JQ/LQ/LH

Mr Stefan Walter
Secretary General, Basel Committee on Banking Supervision
Bank of International Settlements, Centralbahnplatz 2
Basel,
Switzerland

8 June 2010

Dear Stefan

International Framework for liquidity risk management, standards and monitoring ('the paper')

I am writing to you with some comments on the above paper. These have been informed by a local Quantitative Impact Study (QIS); the results of which are summarised in an attachment.

The Commission suggests that, while maintaining the need for conservative assumptions and acknowledging limited evidence on which to base assumptions, a carve-out should be allowed to supervisors in determining the discount factors for fiduciary and own company deposits that have characteristics that are neither strictly retail nor wholesale. The carve-out would also cover deposits related to custodian activity that would take a while to run-off and to off-balance sheet committed facilities to funds which are unlikely to be ever drawn down 100%.

Fiduciary and Own Company Deposits

The liquidity provisions in the paper make a general distinction between retail deposits– which are assumed to be relatively stable - and wholesale deposits – which are assumed to be highly volatile. However, fiduciary and own company deposits are somewhere in-between. For example, in Guernsey:

- *Swiss Fiduciary Deposits* are closely-related to retail deposits as, although they are interbank deposits (and therefore nominally wholesale), they are in practice bundled retail deposits – and therefore largely mimic retail deposit behaviour

- *Third party trust deposits* are made by depositors who are less market-sensitive than wholesale deposits; not least as such depositors may well be purchasing bundled services form the local financial group (of which the bank is just one part) that may include custody, as well as fund administration and management services. Nevertheless, such deposits are still likely to be significantly more volatile than retail deposits; especially as they are professionally managed and as they may not be covered by a local deposit compensation scheme

- *Own party trust deposits* share all the characteristics of third party trust deposits but may be less volatile as they belong to the same financial group as the bank into which they are depositing; although they retain a fiduciary duty of care to their clients

- *Own Company deposits* that may appear 'corporate' but in fact facilitate personal investments by wealthy private individuals –i.e. are in fact natural. These deposits will be more volatile than ordinary retail deposits; but not as volatile as wholesale deposits.

The experience of the 2007-9 crisis suggest that the above liability types are not unduly volatile. Of course it would be premature to draw concrete conclusions from this. However the experience of 2007-9 and the above arguments suggest that the above liability classes should not be assumed to be entirely volatile.

Deposits with Custodians
It can be expected that, unless some specific contingency plan exists, it would take a financial third party (such as a fund) some time to run off its deposits related to assets held by a custodian due to the operational complexity of such a task. This deposit cannot therefore be deemed to be entirely volatile.

Off-balance sheet committed facilities to financial firms
In Guernsey, these facilities are usually offered to funds for exceptional liquidity purposes. In the 2007-9 crisis, draw-down rates generally remained limited; not least due to alternative mitigation devices such as gating. This experience belies the paper's assumption that all such exposures should be assumed to be drawn down at 100%.

Conclusion
While in principle the Basel liquidity proposals are aimed at large internationally active banks, in practice they will be applied, like other Basel guidelines, to all banks, including those with specialist business, as itemised above. The paper currently treats specialist business as akin to wholesale business and therefore entirely volatile. In practice, there is limited evidence as to how such liability classes behave. However the general evidence of the 2007-9 crisis, together with arguments around the nature of this business, suggest that such business is neither retail nor wholesale but somewhere in-between. The easiest solution to this problem would be to allow regulators to estimate discount factors for specialist business as they think appropriate – i.e. a carve-out. Over time, generic and more accurate discount estimates may emerge. However, to assume that such business is as volatile as the wholesale deposits, seems inappropriate at present.

More generally, allow me to express the Commission's overall support for the Committee's proposals to strengthen the global banking system, especially around capital. Finally, the Commission is content for this letter to be made public.

Yours sincerely

Jeremy Quick

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Liquidity – Quantitative Impact Study (QIS)

The Commission created two scenarios to test the current liquidity of Guernsey subsidiaries in relation to the Basel proposals.

Both scenarios use the Basel one month Liquidity Coverage Ratio.

Scenario A

In this scenario the Basel proposals were applied without change. Basel allows local supervisors to determine the volatility of 'retail' deposits. The Commission considered that for Guernsey banks, where the level of deposit from natural persons is often high and where the deposit base can be sophisticated; it should be assumed that a significant proportion of deposits would leave over one month period.

It was assumed that banks otherwise at risk of non-compliance with the Basel proposals would make themselves compliant by moving from non-qualifying into qualifying bonds.

Up streamed funding was treated as an inter-bank deposit.

The analysis showed that most banks in Guernsey would be able to comply with the Basel proposals on this basis; reflecting the generally strong liquidity profile of a jurisdiction that supplies exogenous funding. However several banks would not be in this position. These banks are adversely affected by the Basel treatment of Swiss Fiduciary deposits, trustee deposits, committed facilities and custodianship in general.

Scenario B

In this scenario the Commission applied the same assumptions as in scenario A but changed the assumptions around Swiss fiduciary deposits (assuming very limited attrition as if they are more like 'ordinary' retail deposits) and deposits from third party trustee (very significant attrition), own trustee (significant attrition) and own company (significant attrition). Committed facilities to financial firms were factored down from 100% to 10% in alignment with non-financial firms. No adjustment was made specifically in relation to custodial activities.

This approach results in no bank being materially non-compliant.

<u>Conclusion</u>

The Commission acknowledges that the assumptions applied for scenario B are subjective and illustrative; however it considers that they are also conservative.

The QIS suggests that the Basel proposals would affect several Guernsey banks adversely. However, if the Commission were to apply its own approach, these outliers would be eliminated.

For the record, there are no significant issues around the one year Net Stable Funding Ratio; and this could be remediated by buying FRNs with shorter maturities.