BAFT-IFSA

October 4, 2013

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

Re: Basel III Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools – Issues for Global Correspondent Banking Services

Dear Mr. Ingves:

BAFT-IFSA is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT-IFSA member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system.

BAFT-IFSA supports the goals of the Basel Committee on Banking Supervision ("Basel Committee" or "the Committee") in promoting a more resilient banking sector and agrees that a strong banking system is the basis for sustainable economic growth. An integral part of this important effort has been the establishment of a basis for a quantitative liquidity regime. In this regard, the Liquidity Coverage Ratio ("LCR" or "Framework") is an important tool for proper liquidity risk management globally.[1] We believe, however, that the LCR would benefit from clarification as it relates to correspondent banking services. As discussed herein, BAFT-IFSA believes that the current definition of correspondent banking under the Framework does not match the modern operational nature of the services offered. This directly affects the applicable inflow and outflow factors in the LCR calculations and could detrimentally impact the provision of real economy financing through correspondent banking relationships.

Introduction and Overview:

The LCR recognizes deposits arising from operational accounts (OPAC), which are assigned a 25% run-off rate. To be deemed OPAC, it is understood that the account should exhibit payments and collections being executed on behalf of the client. It is also understood that OPAC treatment is to be applied across all client segments. This lower LCR outflow factor recognizes the highly stable nature of cash balances linked to operational accounts held by banks on behalf of their clients.

The OPAC qualifications center on the client's utilization characteristics. The qualifying activities in the context of an operational relationship include - for Financial Institutions (FI) - "clearing, custody, or cash management activities" that meet certain criteria.[2]

Other non-OPAC deposits are assigned different run-off rates: 40% for non-operational corporate client balances and 100% for deposits arising from "correspondent banking". Under the LCR, correspondent banking is defined as "arrangements under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services in order to settle foreign currency transactions (e.g. so-called nostro and vostro accounts used to settle transactions in a currency other

[1] Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools,* January 2013

[2] IBID; Para 94

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than the domestic currency of the respondent bank for the provision of clearing and settlement of payments)."[3]

However, this definition of correspondent banking has led to some confusion. In this context, the current definition does not match the practical fact that much of financial institutions' correspondent relationships *are* operational in nature. Using this narrow definition ignores the broader basket of correspondent banking activities, and may detrimentally affect the run-off rate of deposits through the erroneous, broad-brush application of a 100% LCR outflow factor. Clarification on a broader definition explicitly allowing for the inclusion of correspondent banking relationships as operational, and the allowance for a 25% outflow calculation for those operational deposits, will help support the necessary provision of correspondent banking services to client banks, and thereby ensure the ability of client banks to continue to service the cash management needs of organizations that drive the real economy. Such a clarification would not change the basic functional premise of the LCR or its overall effectiveness as a sound risk management tool.

The Nature of Correspondent Banking Services:

BAFT-IFSA believes that the nature of correspondent banking should be considered by the Basel Committee when determining clarity around its LCR definition and calibration. Correspondent banking's operational aspects and direct link to underlying commercial activities and international trade, we believe, have not been fully recognized by the Framework.

1. The Operational Aspects of Correspondent Banking

In practice, a correspondent bank account is an account held by one financial institution with another financial institution in a currency where the account holder has limited or no ability to transact. The use of a correspondent fills a settlement or capability gap and a correspondent bank account may facilitate settlement of transactions on behalf of the client bank or the client bank's customers. In both cases, the correspondent is acting as an independent intermediary in the flow and the respondent has a substantive operational dependency on the correspondent.[4] Such correspondent clients may demand far greater OPAC services including domestic or cross-border clearing / payments and collections, foreign exchange settlements, standard settlement processes, automated collections, and standing orders.[5]

These correspondent OPAC balances are highly correlated with transaction volumes. The accounts display deposit stickiness because the balances are supported by underlying commercial payments and collections. These payments and collections create mismatches in timing of settlements, which require retention of liquidity buffers, prefunding, and balances in credit. The impact on net outflows that a bank offering correspondent services will experience in a stress situation will be a function of the number and complexity of the underlying client accounts and proprietary flows, including those related to standing settlement instructions.

[3] IBID; Para 99, Footnote 42

[4] IBID, Para 93 defines operational deposits as deposits left with a bank to facilitate access to payment and settlement systems

[5] The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is the main channel for correspondent banking services globally. Please see Annex 1 for a description of the different correspondent banking activities within the relevant SWIFT message categories. Please refer to Appendix 2 for a detailed commercial flow of an operational correspondent banking transaction.

2. The Substantive Dependency Aspects of Correspondent Banking

Dependency on an incumbent provider is a significant part of correspondent banking activity. This is due to the fact that client treasury and operating platforms are more tightly integrated into the bank provider's processing and information delivery platforms in order to drive process and cost efficiency and more effectively manage centralized treasury processes and global account structures.

If transfer is considered for any reason, a client must first evaluate current and potential providers capable of providing a similar level of service. While many enterprises maintain relationships with multiple providers, the array of services and geographical coverage is typically not easily replicated. If current providers cannot assume the processing, enhanced full due diligence of alternative providers must be performed, including Know Your Customer (KYC) and Anti-Money Laundering (AML) checks on new relationships, legal review of new account terms, and negotiation of service agreements. These processes will typically span several months.[6]

However, a respondent bank has the added burden of ensuring underlying clients are provided with new payment and collection account information so that they may amend their individual settlement instructions on the changeover. As a result, it is not unreasonable to expect that a change in correspondent banking arrangements will likely take as long, if not longer, than similar migrations in other wholesale client segments.

The average lifespan of an operating relationship substantiates the significant dependencies inherent in such a relationship. As a result, the substantive dependency on the service provider can be equally demonstrated across financial, non-financial and correspondent bank operating relationships.[7]

3. The Real Economy Aspects of Correspondent Banking

Both the foreign currency and transactional/operational aspects of correspondent banking are vital to support downstream clients and the real economy.[8] In particular, correspondent banking actively supports trade flows between regions, as the banks to buyers and sellers are the intermediaries to settling import and export activity. This activity greatly expands the geographic scope of export financing to the end-user.

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[6] Additionally, prior to implementing any new service relationship, clients must notify their customers, counter-parties, and vendors of new remittance instructions, providing sufficient lead time for those impacted to adjust their own internal processes and systems. While most disbursement activity can be quickly migrated once new transaction accounts have been opened, movement of collections and redirection of funding activities will often occur over a longer timeframe. Even disbursement activities will require Enterprise Resource Planning (ERP), treasury and other workstations to be updated with new payment and account information. Finally, account structures, including pooling and cash concentration arrangements, will need to be reconfigured at the successor institution. Not all of these steps can be concurrently executed. The requisite time span, including the time required to follow-up with remitters to ensure payment/settlement instructions have been appropriately revised, will typically push all-in migration timeframes well beyond a 30 day period.

[7] The LCR defines "operational" accounts as those held in relation to cash management, custodian, and clearing services where the institutional customer has a "substantive dependency" on the provider of these services. OPAC deposits are considered "by-products" of the underlying services when the residual cash balances result only from the provision of those services. Qualifying deposits are assigned a 25% run-off factor (Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools,* January 2013; Para 93)

[8] In specific examples, correspondent banking can support businesses and consumers through enabling the provision of remittances (whereby when a consumer or commercial customers require funds to be transferred to a beneficiary in another country, correspondents will fund their operating account to cover the remittance requests); export bills collection (whereby when the underlying trade documentation indicates the export should settle in a certain currency, the correspondent will designate a bank in the appropriate currency to be their receivables concentration bank for export collections); Import Letter of Credit (LC) reimbursements and payables (whereby a correspondent designates a bank as their LC issuing or reimbursing bank and funds the account to cover import disbursements); and foreign exchange (whereby when a client is buying/selling currency, the settlement of the non-local currency side occurs with the correspondent's bank in the currency market).

As banks rarely have a presence in all markets accessed by their clients, correspondent banking facilitates movement of funds between importers and exporters. Transactions executed by the banks are effected through local clearing systems and ensure prompt and timely receipt by clients. Once funds are applied and reconciled, goods can be released and accounts payable and receivables updated. This allows for client credit profiles to accurately reflect the relationship between the importer and exporter. Additionally, as trade is increasingly denominated in emerging currencies (such as RMB), these clearing networks are established in new currencies for bank-to-bank settlements where the underlying transaction is trade related. This enables the continued flow of trade credit into global markets at a time when imports may be critical and exports can generate much needed foreign exchange.

Due to this close link with international trade, correspondent banking has become an increasingly important way to drive growth in emerging markets. Banks in developing economies frequently lack presence outside of their home country or region. Correspondent banking therefore represents a cost-effective mechanism to enable banks in developing countries to serve their clients who are engaged in cross-border trade with more developed markets, while effectively managing their own liquidity flows through the correspondent relationship. Clearing systems in developing markets increasingly upgrade their capabilities to support cross-border flows and look to ensure the highest degree of interoperability with other clearing and settlement systems around the world. This drives efficiencies and automation which clients are able to benefit from as funds are applied more promptly and carry sufficient information to facilitate their reconciliation.[9]

The Impact on Correspondent Banking Services from the Current LCR Calibration:

Due to the fact that correspondent banking globally supports significant transactional and operational services, BAFT-IFSA believes the impact on the real economy from a lack of clarity in the treatment of correspondent banking operational activity under the LCR would be significant.

As noted, within the LCR framework, all deposit balances held in accounts classed under correspondent banking relationships would appear to attract an outflow factor of 100%. While we understand the motivation of the Basel Committee to ensure a conservative approach to liquidity risk management, empirical evidence does not support such a high outflow factor for all correspondent services, particularly due to the operational, substantive dependency and real economy aspects of modern correspondent banking.[10]

A 100% outflow factor will directly affect the buffer of high quality liquid assets (HQLA) that a correspondent bank needs to hold, thereby mandating that every dollar deposited in a correspondent bank account would require the correspondent bank to hold four times more liquid assets to support the deposits against stress outflows than the same dollar deposited in a corporate operational account. The current calibration also discourages a correspondent bank from attracting the kind of client bank deposits that are reliable even in times of name specific stress. A highly operational correspondent banking

[9] Please see Appendix 3 for an example of an emerging market correspondent banking transaction.

[10] In a study conducted by The Clearing House (TCH), industry wide data was collated from 11 major banks during the 2008 financial crisis. The results found that operational financial institution (FI) accounts exhibited average outflows of 10%, compared to non-operational accounts at 80% within the LCR window. FI Operational accounts exhibit lower outflows under stress and the accumulated data supports the methodology applied in segregating operational versus non-operational accounts for purposes of the LCR.

relationship leads to reliable core deposits even when stress situations occur. This runs contrary to what the LCR intends to achieve in terms of lowering liquidity risk.

Correspondent bank deposits will be, in many cases, uneconomical and will ultimately offer lower returns and higher associated charges. This will lead to a reduction in money supply, as deposits are not used to finance trade and commerce. Correspondent banks will lose the value of the deposits held by financial institutions, thus decreasing the return on risk-weighted assets and increasing the required hurdle rates to extend financing. The increase in the liquidity premium could be significant enough to preclude the correspondent bank from extending products like trade finance, or would cause an increase in the cost of that financing. Additional costs of borrowing to fund commercial assets will likely ensue and a concentration of volumes in top clearers will lead to less competition and will potentially create an uneven playing field with significant downstream implications.

In particular, the high costs of correspondent banking will drive client bank deposits away, and service providers will substitute such reliable funding with wholesale debt, thereby increasing the liquidity risks in the banking sector. If the adoption of regulatory standards are not uniformly enforced in local markets, international banks will be disadvantaged and transactional flows may be diverted to banks that may not be equipped to comply with the higher standards of compliance, liquidity and capital required to support cross-border transactions.[11]

Recommendation on the Clarification of Correspondent Banking Services under the LCR:

BAFT-IFSA understands the rationale behind bifurcating unsecured wholesale funding from other sources based on assumed levels of sophistication, sensitivity and the resulting stability of the funding source in a stress scenario. However, correspondent banking activities are highly operational and include a great degree of substantive dependency of the client on the bank, which is similar to other operational relationships ranked by the LCR as more stable.

The industry therefore respectfully recommends the Committee to further clarify its view of correspondent banking activities and outflow factors applied to correspondent bank accounts. The Committee should apply similar tests and characteristics of operational accounts and relationships - as defined within the Framework - uniformly across all client segments.

Taking an activity-based approach, flows generated by correspondent transactions with underlying commercial operations relating to banks and their customers should be classified as operational in nature in the definition of correspondent banking, as they behave in a similar fashion to those of Corporate Operational relationship accounts. These balances should qualify for the 25% operational outflow factor as applied to both financial and non-financial customers.[12] This clarification in approach and definition will help ensure the continuation and availability of correspondent banking services to the end-user by

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[11] In September 2013, the Financial Stability Board (FSB) published an updated report monitoring the effects of agreed regulatory reforms on emerging market and developing economies (EMDEs). The report found that EDME's had specific concerns regarding the impact of implementation of Basel III liquidity requirements, including the limited availability of HQLA in certain markets and types of market participants, which may lead to the hoarding of such assets with adverse effects on domestic capital market development; the potential impact of liquidity requirements on the availability and pricing of banks' long-term lending activities (e.g. infrastructure financing); and the intensified competition for deposits that may be prompted by the calibration of outflow rates for different types of liabilities. These concerns run in parallel to industry concerns that a 100% run-off rate for correspondent operational activity could foster similar systemic issues and lead to a significant weakening of correspondent banking service availability and affordability in the developing world. (Financial Stability Board: *Monitoring the effects of agreed regulatory reforms on emerging market and developing economies (EMDEs)*; September 12, 2013).

[12] Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools,* January 2013; Para 93

mitigating unintended consequences from the current calibration of the LCR. Recognition of the operational aspects of modern correspondent banking will aid in strengthening the overall effectiveness of the LCR and the broader Basel framework globally.

Conclusion:

BAFT-IFSA believes that by clarifying and correcting the treatment for correspondent banking operational relationships, funds that may be inappropriately tied up in HQLA will be available to support commercial activities. This will have a positive effect on global economic activity and international trade, spurring job creation and growth in the real economy. We very much appreciate the opportunity to highlight these issues and look forward to further dialogue with the Committee going forward.

Very truly yours,

Tod R. Burwell

Tod R. Burwell
President and Chief Executive Officer

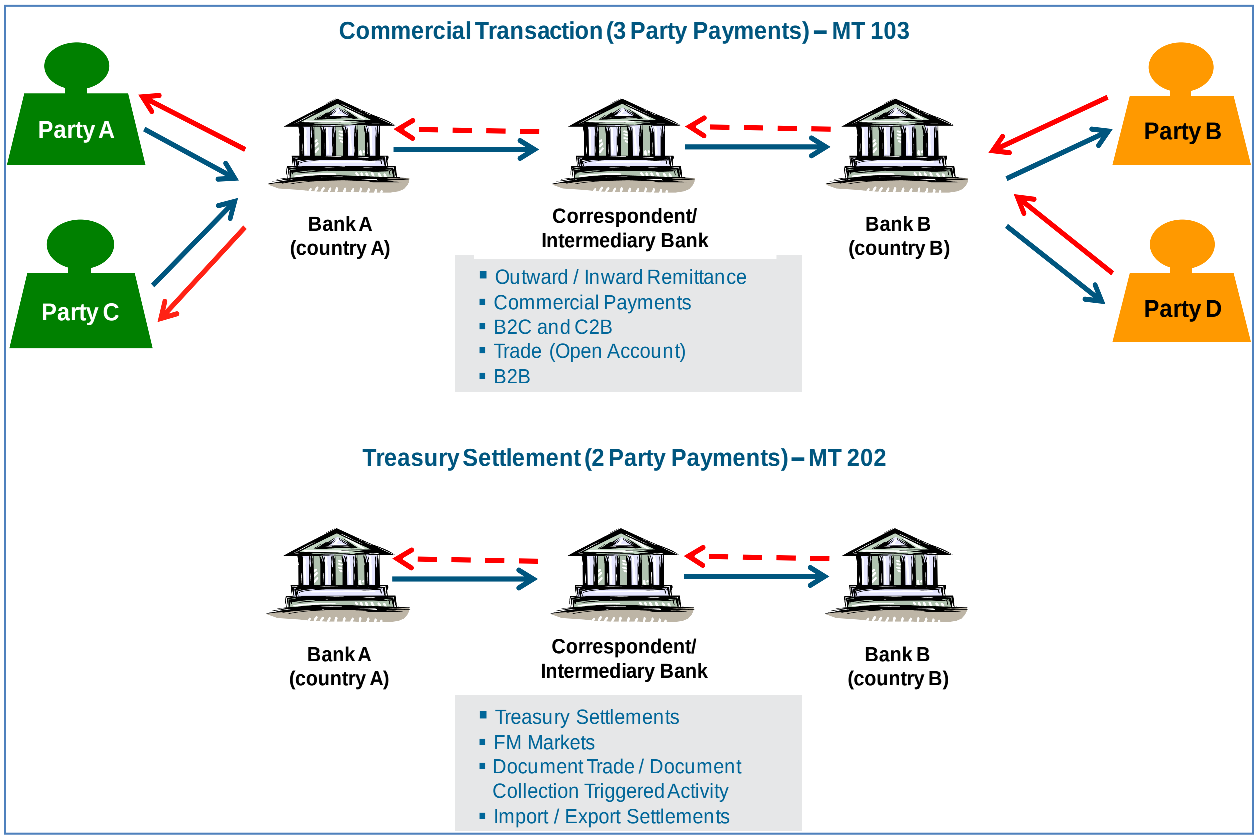
Appendix 1

Description of OPAC Correspondent Banking Activities

SWIFT Category	Description	Comments
1	Customer Payments and Checks	Payments in which the ordering party or the beneficiary, or both, are not financial institutions.
2	Financial Institutions Transfers	Sent by or on behalf of ordering institution directly, or through correspondent(s), to the beneficiary's financial institution, to order the movement of funds.
3	Treasury Markets – Foreign exchange/ Money Markets and Derivatives	Provide details on the confirmation, settlement and advice/instruction related to Treasury Markets deals.
4	Collections & Cash Letters	Exchanged between banks in the handling of documentary and clean collections.
5	Securities	Exchanged among financial institutions involved in securities transactions.
6	Treasury Markets – Syndications	Sent between financial institutions involved in a syndication.
7	Documentary Credits and Guarantees	Exchanged between banks involved in the documentary credit and guarantee business.
8	Travelers Checks	Exchanged between issuers and remitting, selling, and refund agents handling Travelers Checks.
9	Cash Management and Customer Status	Five types of messages exchanged between financial institutions, either on behalf of themselves, other financial institutions, or customers.

Appendix 2

Operational Use of a Correspondent Banking Network



Appendix 3

Importance of Correspondent Banking to Emerging Markets