FSC Newsletter

Number 3 Year 2008

Financial Services Commission

Liquidity Risk Management

Background

The market turmoil that began in mid-2007 has re-emphasised the importance of liquidity to the functioning of financial markets and the banking sector. In advance of the turmoil, asset markets were buoyant and funding was readily available at low cost. The reversal in market conditions illustrated how quickly liquidity can evaporate and that illiquidity can last for an extended period of time. The banking system has come under severe stress, which necessitated central bank action to support both the functioning of money markets and, in a few cases, individual institutions.

In February 2008 the Basel Committee on Banking supervision published Liquidity Risk Management and Supervisory Challenges. The deficiencies outlined in that paper highlighted that many banks had failed to take account of a number of basic principles of liquidity risk management when liquidity was plentiful.

Many of the most exposed banks did not have an adequate framework that satisfactorily accounted for the liquidity risks posed by individual products and business lines, and therefore incentives at the business level were misaligned with the overall risk tolerance of the bank.

Many banks had not considered the amount of liquidity they might need to satisfy contingent obligations, either contractual or non-contractual, as they viewed funding of these obligations to be highly unlikely.

Often firms viewed severe and prolonged liquidity disruptions as implausible and did not conduct stress tests that factored in the possibility of market wide strain or the severity or duration of the disruptions.

Contingency funding plans (CFPs) were not always appropriately linked to stress test results and sometimes failed to take account of the potential closure of some funding sources.

In order to account for financial market developments as well as lessons learned from the turmoil, the Basel Committee conducted a fundamental review of its 2000 Sound Practices for Managing Liquidity in Banking Organisations. The Guidance is called Principles for Sound

Liquidity Risk Management and Supervision. This guidance is arranged around seventeen principles for managing and supervising liquidity risk which the Commission will be adopting

Commission's adoption of the principles and relevance for firms

The Commission follows the Basel Committee's Principles of Sound Liquidity Management and expects banks to comply with these principles. These can be found at: http://www.bis.org/publ/bcbs144.pdf

The Commission will expect all banks to incorporate the principles into their Liquidity management process.

As part of its duties under Principle 14 below, the Commission will be reviewing the bank's liquidity policies against the principles as part of its risk assessment process.

Summary of the Principles of Sound Liquidity Management

The Basel Committee's Guidance on Liquidity Risk Management has been significantly expanded in a number of key areas. In particular, more detailed guidance is provided on:

- the importance of establishing a liquidity risk tolerance;
- the maintenance of an adequate level of liquidity, including through a cushion of liquid assets;
- the necessity of allocating liquidity costs, benefits and risks to all significant business activities;
- the identification and measurement of the full range of liquidity risks, including contingent liquidity risks;
- the design and use of severe stress test scenarios;
- the need for a robust and operational contingency funding plan;
- the management of intraday liquidity risk and collateral; and
- public disclosure in promoting market discipline

The principles also stress the importance of effective cooperation between supervisors and other key stakeholders, such as central banks, especially in times of stress.

The guidance focuses on liquidity risk management at medium and large complex banks, but the sound principles have broad applicability to all types of banks. The implementation of the sound principles by both banks and supervisors should be tailored to the size, nature of business and complexity of a bank's activities.

Summary of the 17 Principles

Fundamental principle for the management and supervision of liquidity risk

Principle 1: A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system.

Governance of liquidity risk management

Principle 2: A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.

Principle 3: Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank’s liquidity developments and report to the board of directors on a regular basis. A bank’s board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.

Principle 4: A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

Measurement and management of liquidity risk

Principle 5: A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.

Principle 6: A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.

Principle 7: A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers 4 Principles for Sound Liquidity Risk Management and Supervision to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

Principle 8: A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.

Principle 9: A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor the legal entity and physical location where collateral is held and how it may be mobilised in a timely manner.

Principle 10: A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.

Principle 11: A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust.

Principle 12: A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding.

Public disclosure

Principle 13: A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.

The role of supervisors

Principle 14: Supervisors should regularly perform a comprehensive assessment of a bank's overall liquidity risk management framework and liquidity position to determine whether they deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system.

Principle 15: Supervisors should supplement their regular assessments of a bank's liquidity risk management framework and liquidity position by monitoring a combination of internal reports, prudential reports and market information.

Principle 16: Supervisors should intervene to require effective and timely remedial action by a bank to address deficiencies in its liquidity risk management processes or liquidity position.

Principle 17: Supervisors should communicate with other supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management.

Communication should occur regularly during normal times, with the nature and frequency of the information sharing increasing as appropriate during times of stress.

For the full details of the seventeen principles for managing and supervising liquidity risk can be found in http://www.bis.org/publ/bcbs144.pdf

Branches and Subsidiaries

Branches should note that the host supervisor needs to understand how the liquidity profile of the group contributes to risks to the entity in its jurisdiction.

Banks that that are part of a banking group can rely on the group for liquidity purposes as long as the bank ensures that the liquidity policy covers these risks and meets the above principles. Banks should also be able to present details of the policy to the Commission upon request.

Local subsidiaries also need to have a policy detailing the monitoring that is carried out in Gibraltar in relation to liquidity risk management, for example, what type of intra day monitoring is carried out in Gibraltar and how the subsidiary relies on the group for positioning etc.

Proposed Revisions to Pillar 1, 2 and 3

The Basel Working Group on Liquidity have identified areas for refinement in the Basel II framework, based on areas of recent financial sector stresses. The overall objective is to strengthen the framework to help make the banking system more resilient to financial shocks. Proposals of the three workstreams will be combined into a single consultative document that is expected to be issued by early 2009 by Basel.