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Liquidity management - new rules on the way

Summary of FSA measures and BIS recommendations

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Context

The FSA (Financial Service Authority- the UK bank regulator) in London published their policy paper on managing bank liquidity this week. The FSA is the first financial regulator to do this, as they are keen to protect London's primacy as a financial centre and want to implement measures to avoid further crises quickly. The policy paper concludes a consultation process, which started in December 2008 after the Basle Committee published their first post crisis paper in September 2008.

The UK generally support a principal based regulatory approach, and this is reflected in the policy paper. The policy will be implemented over the next 2 years in the UK, starting in December 2009 with the qualitative implementation. The quantitative implementation of high quality assets will be put into effect later. As Reuters pointed out, there are good reasons for allowing a gradual market adjustment, as bank holdings of UK government debt will have to rise about 40% to meet the standards.

The CESB and BIS are also examining the question of liquidity adequacy, but as the FSA points out, it will be sometime before anything will be agreed on internationally. Liquidity adequacy has not been subject to the same level of regimentation as capital adequacy, because the questions are more difficult to fit into a fixed framework of rules. The principal based UK system is possibly better adapted to responding to this question.

(Principles for Sound Liquidity Risk Management and Supervision, Basel September 2008
Financial Services Authority, Strengthening liquidity standards 08/22, London December 2008)

Principals of sound liquidity management

The Basel Committee listed principles covering 5 general areas.

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.

Governance of liquidity risk management

Principle 2: A bank should clearly articulate an appropriate liquidity risk tolerance for its business strategy.

Principle 3: Strategy, policies and practices must ensure that the bank can maintain sufficient liquidity. Management should continuously monitor the bank's liquidity and report to the board of directors on a regular basis.

Principle 4: Liquidity costs, benefits and risks as well as new product approval processes for all significant business activities (both on- and off-balance sheet) must be applied for all business lines.

Measurement and management of liquidity risk

Principle 5: A sound process for identifying, measuring, monitoring and controlling liquidity risk must be in place.

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 funding strategy must provide effective diversification in the sources and tenor of funding. This includes strong relationships with funds providers from divers funding sources. The capacity must be gauged to raise funds quickly from each source.

Principle 8: Intraday liquidity positions and risks must be managed to meet payment and settlement obligations on a timely basis under both normal and stressed conditions.

Principle 9: Collateral positions must be managed, differentiating between encumbered and unencumbered assets.

Principle 10: Stress tests must be conducted for a variety of short-term and protracted institution-specific and market-wide stress scenarios. The outcomes should be reflected in adjustments to liquidity and risk management strategies and be used to develop effective contingency plans.

Principle 11: A bank should have a formal contingency funding plan (CFP) with a strategy for addressing liquidity shortfalls in emergency situations.

Principle 12: A cushion of unencumbered, high quality liquid assets must be held as insurance against a range of liquidity stress scenarios.

Public disclosure

Principle 13: Information must be disclosed regularly to enable market participants to make an informed judgement about the soundness of the bank's its liquidity risk management and its liquidity position.

The role of supervisors

Principle 14: Supervisors must review a bank's overall liquidity risk management framework and liquidity position. The adequacy of the framework must be assessed for the bank's role in the financial system.

Principle 15: Supervisors should supplement these reviews 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 if required.

Principle 17: Supervisors should communicate with other supervisors and public authorities to facilitate effective cooperation on the supervision and oversight of liquidity risk management.

Implementation

The FSA has already formulated rules on bank liquidity management. General implementation across the Euro area will take a little longer. Unlike capital adequacy requirements for risk weighted assets, liquidity requirements cannot easily be prescribed be a series of relationships based on data extracted from the balance sheet.

The business model of the bank plays a major role in how a bank regulates it liquidity requirements. These include important areas, such as client relationships, (corporate, institutional are retail), the legal and national structure of the bank's group and the business areas covered by the bank.

Liquidity coefficients do exist (one of them is the capital adequacy ratio) but these do not tell us much about whether a bank can activate liquid assets in a crisis. It was the inability of banks to raise cash in the interbank money market which forced central banks to provide large scale liquidity and eventually forced governments to effectively nationalize these banks in many countries. A credit crunch which froze interbank lending was the transmission belt which paralyzed the banking system last year.

It is on this critical point of crisis control that we are likely to see general fixed rules. The day to day matter of liquidity management may well be left as a process governed by generally agreed principals, but basically at the discretion of banks.

What will the changes be?

Stress testing

The FSA policy paper demonstrates a much more rigorous approach to stress testing. The stress test scenarios used in banks must be realistic and they must be orientated towards real risks threatening the bank's operation model. This means a careful adaptation of the stress tests towards institution specific stress situations.

At the level of a crisis affecting only the institution, the requirement is to look at the impact of a 2 week credit freeze followed by a prolonged down-grading of the rating.

More generally, a stress test must also be executed, measuring the impact of a systemic shock making unsecured liquidity general unavailable.

The bank must follow up the stress test with suitable procedures to eliminate or significantly reduce weaknesses found. The procedure in the bank must also ensure that new business processes and new products are checked for their impact on liquidity management as part of the compliance procedure.

Minimum quality requirements on assets

We can expect to see quantitative requirements on the composition of portfolios, with banks expected to hold a certain portion of their assets in treasuries or similarly liquid assets. The FSA includes various states in their eligibility criteria. Generally, we can expect banks to balance their portfolio by the way their business is distributed internationally. The existing collateral eligibility criteria of central banks for refunding operations are presumably likely to be key criteria in determining the minimum requirement for these assets.

The FSA mentions that liabilities with retail clients will be preferentially treated compared to wholesale liabilities. This is a push back to the old structure of the bank as a deposit taker (rather than fee taking seller fund distribution platform). It recognizes the fact that the last crisis has hit mainly commercial banks or institutions with high dependency on the wholesale market for funding (like Northern Rock). Savings banks, post-banks etc have generally survived quite well, as long as they did not take large positions in risky assets. Presumably, the Basel Committee will follow this.

The costs of liquidity adjustments

Realizing the changes in liquidity management requirements will not be free. There will be a considerable amount of thought required in examining business structures and to ensure the stress test scenarios are suitable. The results of such tests must be examined and transformed into business procedures and compliance rules to correct weaknesses found.

Banks will be required to hold a higher proportion of lower yielding treasuries than most would like.

Client structures will be favoured which offer banks preferential access to liquidity, possible to the detriment of more profitable business.

Macro problems involved

The demand for high quality securities by banks will increase. This may push down yields on this category of securities, though with huge increases in government deficits feeding into the securities market as new issues, this is unlikely to be a long-term problem. There may, however, be short-term problems of market adjustment to sudden changes in demand as measures are introduced.

The FSA explicitly mentions that they are waiting for the after effects of the crisis to dissipate, before introducing the quantitative measures. This will presumably mean there will be rising short-term rates, at the same time new pressure is coming onto bond yields. [One would assume this perspective offers room for buy short/ sell long and sell treasury/buy euro swap strategies in the coming period.]

How has the market taken it?

Quote from a BBC interview with Stephen Green 07.10.2009, from HSBC,

«It (the banking industry) … owes the real world a commitment to learn the lessons. Some of them are about governance and ethics and culture within the industry,» he said. …He added that the industry needed to *«pay much more attention to liquidity»* than it had done previously.

Harmonization of question of liquidity management?

The CEBS published a consultation paper on the 10th July 2009, with comments request by the 31st October. Coordinated European measures are expected at some time in the future, but there no harmonized rules are currently planned.

This is partly because the subject does not easily lend itself to a fixed structure of management, but also because the interests of the EU countries are very different, depending on the role their banks play in financial markets. However, most countries have recognized the need to improve their current requirements for liquidity management, though this remains at a national level.

There is general agreement among regulators, that there is little point making one-size-fits-all regulations, when banks have very different liquidity requirements and liquidity access. Internally generated models are likely to be the rule for large and sophisticated institutions with international branches and subsidiaries and complex product lines. One can imagine a simpler set of standardized liquidity regulations for smaller institutions. This thinking is reflected in the draft of French measures due to be implemented in July 2010. The rules proposed in France will make internal models applicable to institutions, instead of legal entities. This will apply to more sophisticated institutions, while a simpler general model can be used by small institutions.

Sources: BBC, BIS, Bloomberg News, FSA, Reuters News.

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