

**Comments on the Consultative Documents
(BCBS 165, December 2009)**

***International Framework for Liquidity Risk, Measurement,
Standards and Monitoring***

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I am a Phd student at the University of Limoges (France), since November 2008, in association with JPLC, an independent financial markets advisory firm.

My research topic focuses on bank liquidity creation and transformation risk, working on standardised measures of bank liquidity creation and transformation risk and trying to highlight bank sensitivity to liquidity scenarios changes.

In this note, I propose some comments¹ on the consultative document BCBS 165, highlighting the necessity to:

- Compute liquidity measures under stress scenarios based on previous crisis episodes;
- Establish market confidence on bank liquidity risk measures;
- Consider the macroeconomic impact of banks holding large liquidity buffers

I. Introduction

1). One of the most notable differences in the recent banking crisis from other crisis was the “run” on wholesale fundings rather than on deposits. Banking supervisors and regulators were not equipped to deal with such a situation (for example, Goldman Sachs and Morgan Stanley were converted into Bank Holding Companies to access to governments liquidity facilities). Going forward, the aim is to promote better liquidity management (for example, by considering banks reliance on market funding source or stock of unencumbered liquid assets).

2). Even if liquidity transformation is the pre-eminent function of banks, the mismatch between assets and liabilities has to be under control. Nevertheless, the coverage of liquidity risk is different from the coverage of other financial risks. There are two underlying facts: i) banks can never entirely avoid liquidity risk because of their intermediation function; ii) banks need a central bank as lender of last resort to address severe or prolonged funding crisis.

3). With the development of securitization markets, banks were not encouraged to correctly evaluate borrowers’ credit quality. The “lend to securitize model” has lead to largely

¹ The opinion expressed in this paper are those of the author and do not necessarily reflect the views of the University of Limoges or of JPLC.

increased risks in the financial system. So, banks have to be encouraged, by keeping at least part of the risk themselves, to better assume their intermediation function by improving the quality of their loan portfolios.

4). Developing too much standardized principles could lead to procyclical imbalances, encouraging banks to adopt similar strategies. And when a shock occurs, all banks will be affected in the same way. Standardisation of bank regulation can improve transparency and harmonisation for risk management across countries. But, a key issue is to what extent too much standardisation can become damageable.

5). These liquid asset buffer requirements could be costly for banks (i.e., cost of asset portfolio reallocation and opportunity costs of detaining liquid assets with lower returns). In addition, banks are liquidity providers affecting the successful channel of savings to investments in order to finance production. Hence, the negative consequences of detaining more liquid assets instead of financing loans to customers should be considered.

7). Before implementing additional liquidity ratios, it should be considered to what extent liquidity risk is already taken into account by current capitalisation levels. In the literature, it is commonly admitted that banks hold capital in excess compared to regulatory requirements. And because current risk weighted assets only refer to credit, market and operational risks, banks could hold excess capital partly to be hedged against liquidity risk.

Regulatory standards – summary

9). The two proposed liquidity ratios indicate to what extent a bank is able to face to its liquidity requirements with its own available liquidity. But, beyond a sufficient excess above 100% (such as 110%), they should not indicate the ratio in order not to create competition amongst banks hurting the liquidity globally provided by the banking sector to the economy.

Liquidity coverage ratio

11). The definition of high quality liquid assets must not take into account the possible securitization of loans. Consequently, only level 1 assets can be considered in the measure, level 2 and 3 assets being not qualified.

15 b). Bank funding concentration has to be considered at a micro level. But also, supervisors should appreciate if a particular bank is dominant on a particular funding market segment. The key issue is to estimate the bank systemic dimension if it stops lending in the inter-bank market.

15 c). Even if unencumbered assets are eligible to prime brokers or central banks, they have to be of the highest quality, marketable and with short term maturity to be subject to low haircuts (and generate important cash value). Indeed, during crisis, with the “flight to quality”, banks will have difficulties with any lower quality asset.

15 d). Bank specific market data are useful indicators of individual bank actual or future difficulties. But, attention must be paid that market data is reliable (for example, LIBOR levels were no longer so at the worst time in the recent financial crisis).

In addition, it is important to have multiple inputs into the risk assessment process, by using the best available data. It is also important not to depend on any one model or method of estimating losses. It is precisely the combination of rigorous, data-driven analyses and considered judgment that made the risk measure successful. The interactive and iterative nature of the process helped refine each method of assessment.

II. Regulatory standards

Liquidity coverage ratio

18). Good management-information systems are critical to the ability of firms to manage their risks. Assessing risk exposures across an entire organization is essential to understand the potential effect of correlated risk exposures that may reside in distinct business lines as well as different legal entities and regulatory jurisdictions.

20). and 25). a). The list of eligible high quality liquid assets has to be determined based on their liquidity in stress time only (irrespective of their liquidity in normal time) and they can only be so if accepted with reasonable terms by central banks.

21). Similar comments as in 9). The liquidity coverage ratio has to be equal or greater than 100%. But, to restore their confidence on banks, financial markets could require a higher limit (for example, 110%) to account for a sufficient buffer against unexpected liquidity shocks.

26). Banks should be explicitly constraint to diversify their stocks of high quality liquid assets in order to prevent liquidation at fire sale prices if the other banks need simultaneously to liquidate similar assets.

If banks have to increase their stocks of high quality liquid assets, the higher demand for these assets will favour price increase and possible asset price bubble build-up. In addition, it is an incitation for governments to increase their debts financed by banks.

27). and 28). Similar comments as in 15. c).

29). All high quality liquid assets are not detained in the same proportion according to bank missions and size. The key issues are the impact on their profitability and on global economic performance with the reduction in credit offer. Going forwards, regulators should encourage banks to well monitor their borrowers, investing in high quality loans rather than high quality liquid assets.

32). Banks should be constraint to formally disclose how they manage the implementation of liquidity risk management and how they manage their stock of high quality liquidity assets. Emergency plans must precisely define the circumstances when liquidation has to be carried out, the main procedures and persons in charge of the decisions. The aim is to ensure prompt asset liquidation.

33). Regulators should impose banks to publish frequent and detailed reports about their regulatory liquidity ratios. In addition, reports have to be the more standardised as possible in order to facilitate comparisons between banks (i.e., similarly to 10K reports, or FIDC call report data or Pillar III reports).

36). and 37). Haircuts on corporate bonds and covered bonds (i.e., the 20 and 40%) have to be calibrated in a worldwide basis because banking regulation is designed for all banks all over the world. However, each bank should consider the worst case between the standard haircut and the haircut valid in the central bank where it is susceptible to pledge the asset considered. Furthermore, in addition to consider bid-ask yield spread, regulatory haircuts have to be gradual according to bond rating and maturities to avoid “cliff effects”, especially in light of the limits of rating reliability during the recent crisis.

38). In the determination of expected cashflows, the stochastic characteristic (possibly linked to the crisis dimension, the state of real economy, borrowers' credit quality...) of some cashflows has to be taken into account with assumptions and coefficients calibrated under stress time scenarios. These scenarios must consider severe but plausible events, including low probability events with potentially highly adverse effects.

41). The definition of stable retail deposits must be consistent with the past experience of the bank during crisis. Deposits cannot be considered as "stable" if they have in the past suffered withdrawals in excess of the 7.5% ratio.

In addition, the distinction between insured and uninsured deposits is only relevant in a system where deposit insurance is explicit.

47). Same comments as 41) for wholesale funding, requiring backtesting on the ratio of previous crisis episodes because it could vary according to the type of the crisis, the nature of fundings, and the bank considered (in reference to Northern Rock in mid 2007).

66). The standardised 10% credit commitments (to retail clients) drawdown rate must be backtested by individual banks. They have to consider historical rate of credit lines drawdown during the previous crisis.

70). By excluding from the metric operating costs, regulators suppose that banks take automatically in account these parameters to determine their ability to assume these engagements. In a prudential approach, regulators should not exclude any cost, by using a pro forma amount of operating costs.

77). By considering financial revenues (but not non financial ones which are susceptible to delay in case of crisis), the revenues considered to calculate cash inflows are assessed in a prudent way.

79). and 80). More generally, the discount share of all assets (i.e., the haircut) when they are converted into cash has to be funded with stable fundings (i.e., long term fundings).

81). Similar comments as in 9). and 21).

82). In time of crisis, when liquidity is needed, bank profit (i.e., net income) could also be considered as available liquidity for banks. Indeed, instead of distributing dividends and increasing capital reserves, banks could use their current income to settle their engagements.

III. Monitoring tools

Concentration of fundings

104). Funding concentration has to be balanced with the maturity of assets in order to detect possible maturity mismatch. If it is not the case, transformation risk is inexistent. The problem refers more to the benefits of diversification, insuring better stability of fundings.

105). According to their mission and size, all banks have not similar access to all funding sources. So, regulators have to be careful about bank accessibility to various funding sources without introducing rigidities. Hence, there should be exemption to the 1% limit when the given funding is “stable” under all circumstances.

111). and 116). Fundings denominated in foreign currency do not expose banks to higher risk if they have access to foreign central banks through their local subsidiaries.

Available unencumbered assets

118). Banks have to report the amounts of available unencumbered assets by type and localisation. But, they also should report the amounts of marketable (versus non marketable) unencumbered assets and the breakdown according to asset maturity. Indeed, haircuts are higher if assets are not marketable or with long term maturities.

120). and 121). Frequent reports of unencumbered assets and their collateral value may not capture the risk of haircut increase during crisis. The key question is again the determination of haircuts valid in stress time, backtested whenever possible on previous crisis.

Market related monitoring tools

125). By monitoring financial markets (equity, bond, currency, commodities...), supervisors should try to detect possible asset price bubble build-up, to what extent banks contribute to exacerbate it and how they could limit the trend.

127). Similar comments as in 15). d).

130). and 135). In order to emphasize the importance of systemic risk management and increase protection against moral hazard and accommodative assumptions on liquidity risk valuation models, it is necessary that external auditors confirm the robustness of liquidity risk estimations and backtesting before using them for regulatory purposes.
