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Thomson Reuters response to BCBS draft ‘Principles for Sound Liquidity Risk Management and Supervision’

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Thomson Reuters welcomes the opportunity to offer comments to this consultation. Thomson Reuters is the largest provider of risk management software in the world, supplying trade and risk management solutions to over 750 financial institutions globally. With more than 950 risk professionals and more than two decades’ of experience in risk management, Thomson Reuters is pleased to be able to share its expertise with the Basel Committee on Banking Supervision (BCBS). We offer some general comments and recommendations on liquidity risk management, followed by specific views on each of the BCBS’s draft principles.

General Comments on Liquidity Risk Management

We understand that the financial market turmoil, which began in 2007 and led to liquidity management issues across several segments of the financial industry, has driven the BCBS to review the 2000 recommendations on sound management practices for liquidity risk. While we generally agree that it is critical for banks to establish a liquidity risk management framework involving exposure monitoring and contingency plans, we would like to recommend caution on the following two aspects.

Firstly, the origin and amplitude of liquidity issues are unpredictable by nature. Therefore, the business scenarios that would be necessary to anticipate and evaluate the exposure to liquidity risks will require multiple assumptions on correlations, liquidity and volatility of the underlying asset classes. For these reasons we recommend an open approach in which risk managers consider the impact of risk factors from markets to which they themselves may not be directly exposed, but nevertheless have indirect exposure through their customers, custodians, funding partners and all other third parties.

Secondly, regulators must be cautious when recommending methodologies for contingency funding and collateralisation. Under adverse market conditions, uniform hedging tactics can lead to a flight to quality which, if excessively focused on a small amount of “riskless” collateral, can itself lead to additional liquidity issues and systemic risk.

In our view, the proper handling of all liquidity problems and the prevention of liquidity risks, regardless of their source, should involve a very tight monitoring of concentrations. Banks are traditionally structured to monitor and hedge concentrations within their lending books, thus focusing on funding risk. Buy-side firms are normally required and fully equipped to monitor and diversify their concentrations within portfolios, therefore preventing market liquidity risk. Challenges arise when both the buy-side and the sell-side need to tackle cross-asset concentrations to similar risks, when the concentrations are hidden by the derivative nature of the instruments, when funding can be

disrupted as a result of market movements changing the value of collateral and when all are impacted by their counterparties' failure to handle those risks properly.

It would be difficult to predict all business scenarios that can result in imbalances and disruptions of this nature as they tend to result from unexpected correlation and volatility movements due to unforeseen events. It is possible, however, to tightly monitor exposure concentrations of all kinds, internal and external, as they point out the vulnerabilities of a firm (internal) and even the ones of the entire industry and financial markets (external).

Thomson Reuters recommendations

- 1) Each firm should dynamically monitor exposure concentrations to risk factors that can directly or indirectly impact their positions, their clients or counterparties. In addition, firms should have a pre-emptive approach to the impact of correlations and volatility changes.
- 2) Each firm should rate business activities, business networks and counterparties based on business efficiency, resilience and transparency with regard to confirming, clearing and settlement of transactions.
- 3) The creation of a liquidity data workgroup gathering industry-wide data regarding exposure concentrations, correlations, and all news and data that may let anticipate particular areas of vulnerabilities or potential changes in funding conditions.

Specific Comments on the Draft Principles

Principle 1

While we agree with the concept of “cushion” we believe a stronger emphasis should be made on prevention and exposure monitoring as the cornerstone of a liquidity risk management framework.

Principle 2

Liquidity risks should indeed be considered and aligned with the overall risk policy of a bank when making decisions such as entering a new market or embarking on new strategies.

Principle 3

Liquidity requirements must be estimated on a daily basis and not only based on internal measurements but also on external factors such as cross-industry business outlook, cross-market correlations, counterparties' own funding needs, business continuity and connectivity of the network related to each business activity.

Principle 4

Banks should remain free to pass on funding costs or not to their customers. Strong directives in this field may lead to the abandonment of some products and a shift to unregulated markets or products.

Principle 5

Projecting cash-flows arising from assets, liabilities and off-balance sheet items and aggregating them under a broad range of business scenarios is central to managing funding requirements. To assess liquidity risks, the scenarios would have to be cross-asset and cross-industry, involving correlation changes and unprecedented volatility swings in particular. A realistic scenario on liquidity risk would need to take into consideration many qualitative criteria such as the price transparency of the assets, the probable reactions of customers or counterparties to similar market moves and the availability of prices and data under extreme market conditions.

Principle 6

It is indeed critical to maintain a very broad view across industry, regions and legal frameworks.

Principle 7

Regulators should be extremely cautious not to drive entire segments of the industry toward uniform tactics and funding strategies. There could be systemic risk in doing so.

Principle 8

We see difficulty in considering “stressed conditions” in the case of liquidity risk. There could be danger in relying on a commonly-accepted definition, as liquidity issues tend to occur in unexpected times and conditions. It is precisely because they are widely unexpected that issues come to be of exceptional severity, leading to changes in behaviour and tactical decisions that trigger liquidity holes.

Principle 9

This recommendation may prove difficult to implement in extreme market conditions. Liquidity dries out when securities previously known as unencumbered become encumbered. If a market turns illiquid progressively as participants lose interest and shift to more profitable activities, then firms have enough time and margin of manoeuvre to re-assess pledges and shift toward collateral with satisfactory depth, transparency and resilience. Liquidity crises, however, typically strike because unexpected effects or turns of event take everyone by surprise.

Principle 10

Adapting contingency plans based on stress scenarios is a wise and pre-emptive approach of a type that we recommend. The difficulty arises in defining what “stress” means, how it applies not only to the bank’s exposure but also its effects on the bank’s clients, what could be the unexpected, as yet unseen, correlations of the future and what could be the effect on all other counterparties including external providers of pricing services. Banks should endeavour continuously to refine and adapt those scenarios and avoid relying on a false sense of safety.

Principle 11

The means of addressing liquidity shortfalls in emergency situation should not derive from an overarching strategy, but is rather a series of tactical emergency actions. The ability to take such actions effectively requires flexibility and adaptability. It should not be thought of as a ‘strategy’ to be implemented with well-established processes within the boundaries of discipline and escalation procedures, as this may impede the agility of a firm’s response.

Principle 12

We recommend that the regulators maintain an aggregated view of the unencumbered assets used as collateral for the cushions as there are risks of building new concentrations if all adopt a homogenous methodology across segments and regions.

Principle 13:

We support this principle. Furthermore, financial institutions should be rated for their overall capabilities to address liquidity issues within specific market activities.

Principle 14

We support this principle. Furthermore, supervisors involved in liquidity management should be involved in product and marketing strategies before a financial institution enters a new market or activity.

Principle 15

Market information related to concentration risks and potential liquidity issues is scarce at this time. Thomson Reuters is in a position to help industry groups, professional associations, national regulators and supra-national regulators to gather, aggregate and redistribute news and data that would help to set up heat maps and alerts.

Principle 16

If this is deemed a necessary measure, we would advise against driving entire segments to taking similar decisions under similar conditions.

Principle 17

We suggest the creation of an industry-wide liquidity risk data workgroup to support this effort and to provide an effective means of conveying the information back to the supervisors for any follow-up action.

Contact details

Philippe Carrel
Executive Vice President
Thomson Reuters

+41 583 065 409

philippe.carrel@thomsonreuters.com