

Basel Committee
on Banking Supervision

Working Group on Liquidity
Bank for International Settlements

Comments:
Principles for Sound
Liquidity Risk
Management and
Supervision

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by

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Comments:

Principles for Sound Liquidity Risk Management and Supervision

Introduction

4. We believe that the Basel Committee has conducted in this paper a fundamental and thorough review of its 2 000 Sound Practices for Managing Liquidity in Banking Organisations. As noted, guidance has been significantly expanded in nine key areas. Our own work, Boussanni et al. (2007, 2008) examined the informational content and usefulness of financial groups' liquidity financial disclosure. The results of the study are based on an in-depth content analysis of the annual reports (2004) published by twenty-one of Europe's largest financial groups using the key liquidity risk management factors (KLF) proposed by the BCBS and its Joint Forum (2003, 2006). The results of the study revealed that the level and extent of financial disclosures were found to be the least complete and the least substantive in the following three KLFs: contingency planning, internal controls for liquidity management, and explaining and illustrating the role of public disclosure in improving liquidity. In most aspects, these results lend support to the principles formulated in the present BCBS paper.

5. We also note the fact that the Basel Committee's report has augmented substantially the guidance it provides to supervisors. The report's principles also stress the importance of effective cooperation between supervisors and other key stakeholders, such as central banks especially in times of stress. Our own work, Fortin and Préfontaine (2008), supports the view that supervisors should take robust preventive measures in order to better inform, educate and protect depositors as well as other financial consumers in order to mitigate the impact of potential sources of liquidity risk and all other risks to banks individually and to the financial system as a whole.

Fundamental principle for the management and supervision of liquidity risk

Principle 1: Comments

Principle 1: Comments are underlined

We believe that it should be stated in the formulation of the fundamental principle that supervisors should communicate and coordinate their actions with other supervisors such as central banks, deposit insurers and financial consumers' information, education and protection agencies.

Governance of liquidity risk management

Principles 2, 3 and 4: Comments

Principle 2: No comment

Principle 3: Comments are underlined

Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure through appropriate internal reporting and controls that the bank maintains sufficient liquidity... 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 through appropriate internal reporting and controls that senior management manages liquidity risk effectively.

Principle 4: No comment

Measurement and management of liquidity risk

Principles 5, 6, 7, 8, 9, 10, 11 and 12: Comments

Principle 5: No comment

Principle 6: No comment

Principle 7: Comments

No major comment; except to say that paragraph 72 on identifying alternative sources of funding is very complete.

Principle 8: Comments

No major comment; except to say that paragraphs 78 to 83 clearly identify the six operational elements to be included in a bank's strategy to achieve its intraday liquidity management objectives.

Principle 9: No comment

Principle 10: Comments

No major comment; except to say that paragraph 97 provides a useful guide to the design of stress tests and the choice of scenarios and shocks to be used. All told, six possibilities are considered. Similarly, paragraph 101 discusses points to be considered when setting stress testing assumptions. The list is informative since seventeen different assumptions are considered.

Principle 11: No comment

Principle 12: Comments

No major comment; except to say that the arguments presented in paragraph 124 on the marketability of individual assets can also be used to support the formulation of Principle 13 on public disclosure. In fact, paragraph 124 states: "Nevertheless, there are some general characteristics which tend to increase the liquidity of a given asset including: transparency of its structure and risk characteristics; ease and certainty of valuation..."

Public disclosure

Principle 13: Comments

Principle 13: Comments are underlined.

The beginning of paragraph 126 could be reformulated to say: "Public disclosure improves transparency, reduces uncertainty in the markets, facilitates valuations and strengthens market discipline.

Paragraph 128 states that: "As part of its periodic financial reporting, a bank should provide quantitative information about its liquidity position as well as qualitative information about its liquidity management framework". Further on, paragraph 129 adds: "Qualitative disclosures should serve to provide a context for the quantitative information that is disclosed".

Recent empirical work by the BCBS and the Joint Forum support the view that the level and extent of financial groups' liquidity risk management public disclosure are not satisfactory. Our research, Boussanni et al. (2007, 2008) examined the informational content and the usefulness of financial groups' liquidity financial disclosure. The results of the study are based on an in-depth content analysis of the annual reports (2004) published by twenty-one of Europe's largest financial groups using the key liquidity risk management factors (KLF) proposed by the BCBS and its Joint Forum (2003, 2006). The results of the study revealed a wide disparity in the level and extent of liquidity risk financial disclosures between financial groups from the same or different European countries. For most of the ten KLFs, the scores obtained on the level and extent of qualitative discussions were higher than those relating to quantitative illustrations of the same KLF. The most complete qualitative discussions and the most substantive quantitative illustrations were provided for the three following KLFs: measuring and monitoring net funding requirements (KLF 2) and foreign currency liquidity management (KLF 5) as well as coverage of the origins of cash flows (KLF 9). Conversely, the level and extent of financial disclosures were found to be the least complete and the least substantive in the following three KLFs: contingency planning (KLF 4), internal controls for liquidity management (KLF 6) and explaining and illustrating the role of public disclosure in improving liquidity (KLF 7). Finally, the results of the study showed that financial groups that have earned a relatively high (low) credit rating category were also the institutions that made the most (least) complete and extensive, both qualitative and quantitative, liquidity risk management financial disclosures.

Paragraph 128 could provide further examples of quantitative disclosures like risk metrics currently disclosed by some, but not all, banks:

- The detailed composition of deposit liabilities, domestic and foreign, core (retail) or wholesale deposits.
- Expected net funding requirements over various funding horizons under a business as usual scenario.
- Expected number of days of survival (cash self-sufficiency) under a severe liquidity shock stress testing scenario.

Paragraph 129 could provide further examples of qualitative disclosures currently disclosed by some, but not all, banks:

- The present short-term credit ratings by major credit rating agencies.
- The present medium-term and long-term credit ratings by major credit rating agencies.
- A discussion explaining the bank's target level for its various credit ratings, and how they are to be retained or obtained in the future.
- "The frequency and type of internal liquidity controls and reporting requirements to senior management, and by senior management to the board of directors; including processes for additional controls and reporting requirements in times of market stress."

The Role of Supervisors

Principles 14, 15, 16 and 17: Comments

Principle 14: No comment

Principle 15: No comment

Principle 16: Comments

No major comment; except to say that paragraph 140 explains clearly the range of supervisory responses and remedial actions to be taken by a bank with liquidity risk management weaknesses or excessive risk.

Principle 17: Comments are underlined

Supervisors should communicate with other relevant supervisors and public authorities, such as central banks, deposit insurance agencies, financial consumers' information-education and protection agencies, ...

Also, paragraph 142 could be made more complete by saying: "Cooperation and information sharing among relevant public authorities, including bank supervisors, central banks, securities regulators, deposit insurance and financial consumers' information-education and protection agencies, ...

On line nine of paragraph 142, just before: "Information on market conditions...", the following sentence could be inserted: "Furthermore, financial consumers' information-education and protection agencies, as well as deposit insurance agencies, may inform bank supervisors, central banks and securities regulators of increased levels of complaints and breaches to consumer suitability requirements in the retail sale of financial products and services. Such events could have a firm-specific impact on its liquidity risk financial position; if they are more generalized, the same events could even impact the soundness and stability of the financial system. Unfortunately, credit products sold by banks in retail settings were not part of a recent Joint Forum (April, 2008) review of customer suitability in the retail sale of investment products and services. Recently, Mishkin (February, 2008) and Bernanke (April, 2008) have reiterated the importance of economic education and financial literacy to financial system soundness and stability. Still more recently, Kroszner (June, 2008) discussed the relevance to bank supervisors of protecting consumers in the credit marketplace. Along with the increased complexity of retail mortgage loans and credit cards, for example, there has been growing concern on the part of bank supervisors about the need for more effective disclosure and increased consumer protection in these financial transactions.

In paragraph 144, another type of event "...which suggest the need for heightened communication include, but are not limited to:

- a significant weakening of a bank's financial condition"
- an important downgrading, by two notches or more, of a bank's credit rating

Conclusion

We believe that the Basel Committee on Banking Supervision and its working group on liquidity have conducted in this paper a fundamental and thorough review of its year 2000 Sound Practices for Managing Liquidity in Banking Organisations. As a result of theoretical advances and empirical lessons learned, guidance has been significantly expanded in nine key areas. In most aspects, the fundamental and more applied literature we reviewed provides strong support to the formulation of “Principles for Sound Liquidity Risk Management and Supervision”.

Our comments on Principle 1 suggest more intense communication and coordination between supervisors, central banks, deposit insurers and financial consumers' information-education and protection agencies. For Principle 3, we suggest more detailed and frequent internal reporting and controls to senior management and the board of directors. On Public disclosure, we suggested in Principle 13 that public disclosure also facilitates valuations. Based on BCBS and Joint Forum historical reports, and our own research findings, Boussanni et al. (2007, 2008), we suggested that public disclosure of banks' liquidity risk management be made less opaque by increasing the level and extent of qualitative and quantitative disclosed information. Consequently, we made suggestions on possible quantitative disclosures in paragraph 128, and possible qualitative disclosures in paragraph 129. Finally, we also formulated comments on the Role of Supervisors. On Principle 17, we reiterated the need for regular and more intense communication, coordination and cooperation between supervisors, central banks, deposit insurers and financial consumers' information-education and protection agencies. We presented arguments and expert opinions which indicate that major breaches to financial customer suitability requirements in the retail sale of financial products and services are to be considered as relevant events to supervisors. Such events could have a bank-specific impact on its liquidity risk financial position; if they become more generalized, the same events could even impact the soundness and stability of the financial system.

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