

Initiatives in the field of liquidity risk management

State of play

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Frankfurt am Main, 27 May 2008

Overview

- **Ongoing initiatives in the field of liquidity risk management**
 - **Basel Committee on Banking Supervision (BCBS)**
 - **Financial Stability Forum (FSF)**
 - **EU Commission**
 - **ECOFIN roadmap**
 - **Committee of European Banking Supervisors (CEBS)**
 - **ESCB Banking Supervision Committee (BSC)**
- **Regulatory framework in the EU**

Basel Committee on Banking Supervision

- In December 2006, the Basel Committee on Banking Supervision (BCBS) established the Working Group on Liquidity (WGL) with the mandate to:
 - take stock of liquidity supervision across member countries
 - evaluate the type of approaches and tools used by supervisors to evaluate liquidity risk and banks' management of liquidity risks arising from financial market developments
- In response to the market events starting in mid-2007, the original mandate was expanded to
 - provide initial observations on the strengths and weaknesses of liquidity risk management in times of difficulty

Basel Committee on Banking Supervision

- **In February 2008 BCBS published a summary of the WGL key findings financial market developments that affect liquidity risk management**
 - national supervisory regimes and their components
 - initial observations from the current period of stress
 - potential future work related to liquidity risk management and supervision
- **WGL is currently conducting a fundamental review of the BCBS “Sound practices for managing liquidity risk in banking organisations” published in 2000**
- **WGL will also continue its work on evaluating the reasons for and implications of the diversity in national liquidity supervision regimes**

Basel Committee on Banking Supervision

- BCBS will issue for consultation sound practice guidance on the management and supervision of liquidity by July 2008 covering the following areas:
 - the **identification and measurement** of the full range of liquidity risks, including contingent liquidity risk associated with off-balance sheet vehicles;
 - **stress tests**, including greater emphasis on market-wide stresses and the linkage of stress tests to contingency funding plans;
 - the **role of supervisors**, including communication and cooperation between supervisors, in strengthening liquidity risk management practices;
 - the **management of intra-day liquidity risks** arising from payment and settlement obligations both domestically and across borders;
 - **cross-border flows** and the management of foreign currency liquidity risk; and
 - the **role of disclosure and market discipline** in promoting improved liquidity risk management practices.

Financial Stability Forum

- On 11 April 2008, the Financial Stability Forum (FSF) presented to the G7 Finance Ministers and Central Bank Governors a report making recommendations for enhancing the resilience of markets and financial institutions.
- The recommended actions are in five areas:
 - **Strengthened prudential oversight of capital, liquidity and risk management**
 - Enhancing transparency and valuation
 - Changes in the role and uses of credit ratings
 - Strengthening the authorities' responsiveness to risks
 - Robust arrangements for dealing with stress in the financial system

FSF on Liquidity Management

- The turmoil demonstrated the **central importance that effective liquidity risk management practices and high liquidity buffers** play in maintaining institutional and systemic resilience in the face of shocks.
- National supervisors should **closely check banks' implementation of the updated guidance** by the Basel Committee as part of their regular supervision. If banks' implementation of the guidance is inadequate, supervisors will take more prescriptive action to improve practices.
- Supervisors and central banks will **examine the scope for additional steps to promote more robust and internationally consistent liquidity approaches for cross-border banks**. This will include the scope for more convergence around liquidity supervision as well as central bank liquidity operations.

EU level

- At its meeting on 9 October, the European Council adopted conclusions on a series of initiatives to be followed in response to weaknesses identified in the financial system. These combine actions of both a regulatory and non-regulatory nature around four main objectives:
 - improving transparency in the market, notably as concerns banks' exposures relating to securitisation and off-balance sheet items;
 - upgrading valuation standards to respond in particular to problems arising from the valuation of illiquid assets;
 - **strengthening the EU's prudential framework for the banking sector**, e.g. with respect to the treatment of large exposures, banks' exposures to securitisation as well as liquidity risk management; and
 - investigating issues such as the role played by credit rating agencies.

EU level

- **Roadmap agreed by ECOFIN on 9 October 2007 (last updated in May 2008) requests by September 2008**
 - **Enhance liquidity risk assessment and management by banks by agreeing on robust minimum standards for banks to withstand stressed market conditions (at EU-level: ECB/BSC and Commission, in coordination with CEBS; at global level: BCBS)**

EU Commission

- **On 5 March 2007, the European Commission issued a Call for Advice (CfA) (no. 8) asking the Committee of European Banking Supervisors (CEBS) to provide technical advice on liquidity risk management at credit institutions and investment firms.**
- **The Call for Advice was split into two parts:**
 1. **an updated survey of the regulatory regimes across the EEA;**
 2. **an in-depth analysis of the variables that may significantly affect liquidity risk management, the interaction of funding liquidity risk and market liquidity risk, the use of internal methodologies by sophisticated firms and by credit rating agencies as well as the impact of payment and settlements systems design and relevant increased interdependencies.**
- **CEBS was also asked to identify any other areas and problems that appear not to be adequately addressed by the current regulatory framework at EU level.**

Committee of European Banking Supervisors

- In terms of **regulatory frameworks**:
 - Only a few countries have made major changes to their regimes since the first survey
 - Although there are significant variations in detail, there is a considerable degree of commonality in respect of to qualitative expectations.
- In relation to **quantitative requirements**:
 - there appears on the face of it a one third/two thirds split in approaches.
 - The main distinction appears to be between those countries which are prepared to place more reliance on the outcome of internal methodologies while other countries apply supervisory limits based on predetermined methodologies (=> quantitative and qualitative approaches as part of a continuum)
- In relation to the **aims of liquidity supervision**:
 - there appears to be broad agreement at both the micro and macro supervisory levels.

Committee of European Banking Supervisors

- **The focus of CEBS work has moved to the second part of the CfA received from the Commission. These issues, which are also discussed within the Basel Committee, have been intensely discussed, as well as the interaction of liquidity risk with other risks, such as credit, market or reputation risk.**
- **The Commission also invited CEBS to identify any other issue that would not be adequately addressed at EU level**
 - **CEBS will issue by mid-June its answer to this second part of the CfA in the form of a stand-alone report, including lessons from the crisis and recommendations both for firms and supervisors.**
 - **A public hearing is foreseen for the 4 July 2008.**

ESCB Banking Supervision Committee

- The Banking Supervision Committee (BSC) started its work on the topic of banking sector liquidity in November 2005 by considering the challenges faced by the current regulatory framework in the medium to long term
- BSC identified four topics that deserved further attention:
 - the international dimension of liquidity management
 - the potential problems posed by regulatory fragmentation
 - the industry's appetite for the recognition of internal liquidity models and
 - the role played by stress testing.
- The chapter entitled “**Liquidity Risk Management of Cross-Border Banking Groups in the EU**” in the “EU Banking Structures Report for the Year 2006” provides an overview of liquidity risk management practices in EU cross-border banks in the context of different regulatory practices and other structural developments in the EU

ESCB Banking Supervision Committee

In Autumn 2007, the BSC mandated a Task Force on Liquidity Stress Testing & Contingency Funding Plans to address the following questions:

1. What is the **typology of EU banks' liquidity stress testing techniques and contingency funding plans?**
2. **Do banks' liquidity stress tests and contingency funding plans seem adequate as regards the absorption of liquidity shocks?** In particular, how did banks' liquidity stress tests perform during the recent liquidity shocks that hit major money markets? What were the implications of shortcomings in banks' liquidity stress tests and contingency funding plans for counterparties and money markets more generally?

Regulatory framework in the EU

- Purpose of Directives 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast), and 2006/49/EC on the capital adequacy of investment firms and credit institutions of 14 June 2006 (i.e. the **Capital Requirements Directive (CRD)**)
 - To ensure the financial soundness of credit institutions ("banks") and investment firms and
 - To provide the very backbone of day to day prudential supervision of these institutions
- The EU Commission is consulting the public on possible improvements of the CRD.
 - The consultation takes place in the context of on-going work related to the CRD at various supervisory and industry fora. The review of the CRD is, in part, also a response to the recent recommendations of the G-7 Financial Stability Forum.
 - Stakeholders are invited to respond to consultations (for most current consultation see: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm)

Regulatory framework in the EU: liquidity risk

- European banks are subject to the regulatory guidelines as indicated in Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), which requires banks to adopt **appropriate measures to develop a sound internal process for liquidity risk management**.
 - See Annex V (14), which also includes the requirement to have in place stress testing techniques and contingency funding plans.
- EU supervisors will assess and monitor the adequate implementation of these guidelines within the scope of the **Supervisory Review Process**.
 - See Annex XI I(e) : the review and evaluation performed by competent authorities shall inter alia include the exposure to and management of liquidity risk by the credit institutions.
- In addition to these guidelines, almost **all EU countries have some additional form of regulation or monitoring addressing liquidity risk**, although the range of national options varies widely.