Risk Reward riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

Q3 – 2009

# The Basel Committee

## A REVIEW OF THEIR ANALYSIS OF THE TRADING BOOK QUANTITATIVE IMPACT STUDY

BANK FOR INTERNATIONAL SETTLEMENTS

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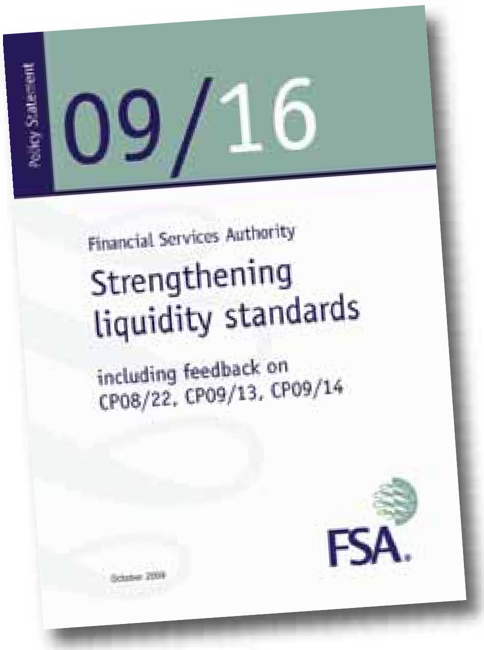
# THE FINANCIAL SERVICES AUTHORITY AND LIQUIDITY RISK

## Introduction

This is of course a Global Risk Update, rather than one focussed on the United Kingdom and its unitary regulator the Financial Services Authority (FSA). The FSA have nonetheless published a detailed response to the liquidity crisis in their policy paper entitled Strengthening Liquidity Standards (Policy statement 09/16) issued in October 2009. We thought you would like to know how we assess the paper and what we feel could be its impact.




## The Issues Identified

The FSA in the UK is not a central bank, instead it is a regulator of financial institutions dealing with both consumer matters and more general supervisory issues. They have identified the following failures of liquidity risk management and are suggesting new mitigation approaches to deal with them. That they are bound to fail and will exacerbate the next set of problems is one of the reasons why we have written his article at this time.

## Issue 1: Liquid Asset Buffers

The FSA state that the first issue related to banks maintaining inadequate quality and quantity of liquid asset buffers, leading to firms' inability to liquidate them in a stress event.

The mitigation (chapter 8) is a new tough definition of liquid assets and risk-based buffer. They are requiring a stock of high-quality government bonds, central bank reserves and bonds issued by multi-lateral development banks to be held.

The new requirements are based on an initial two-week firm-specific and market-wide stress with the wider market-wide stress continuing out to three months. The cash flows need to cover the two week period and then an assessment of the additional buffer requirements will be made.

There is a problem here that should be obvious to everyone, not least of whom is the FSA. What we are to expect is that banks will hold the government securities of their home issuer. What happened when we had the 1999 problems in Russia? At the time when Russia defaulted the value of Russian bonds collapsed and a large number of banks failed. Given that the governments that are issuing the highest quality assets are exactly the governments which are the most indebted and have the greatest likelihood of failure, this concentration is extremely dangerous. To make the issue crystal clear, at exactly the time that the bank will need to realise these assets they will themselves become illiquid. Indeed if the FSA was really considering the risk assessment appropriately and the market correlations they would have required the banks to hold physical commodities, not government securities.

Then we have the idea of the two- week out flow window. We know what happens when a bank goes under stress. It is not just the cash deposits that move out, but the interbank market closes the bank out of the market. Reserve lines get withdrawn and become unavailable. There is more than just a cash outflow – indeed the cash outflow may be the least of their problems. To maintain sufficient cash to deal with this would require cash reserves that are greater than the global economy. Consequently the rules cannot work and will only put an additional cash burden onto the poor consumer.

## Issue 2: Liquidity Risk Management

The next issue identified by the FSA is that banks had poor liquidity risk management capabilities (i.e. inadequate stress testing, contingency funding planning and senior management oversight). This is indeed a correct reading of the situation, which was exacerbated by the Basel Accord choosing to focus on credit, market and operational risk, making stress testing only a requirement for advanced approaches. Indeed this concern has appeared in previous Risk Reward Risk Updates.

The mitigation is that banks should introduce enhanced systems and control requirements based on the BIS paper "Principles for Sound Liquidity Risk Management and Supervision". This 2009 paper draws heavily on the previous February 2000 paper from the BIS. Put at its simplest there is little in the new paper that was not really there in the 2000 paper and, indeed, in papers that have been around for much longer.

## THE FINANCIAL SERVICES AUTHORITY AND LIQUIDITY RISK CONTINUED

Clearly there is nothing wrong with the new BIS paper, nor with the earlier 2000 paper and perhaps this crisis will create the impetus for these basic requirements to be implemented. They are not in themselves sufficient however and most banks will require a much higher level of control and guidance than is suggested in the paper.

**Issue 3: Liquidity risk factors**
The third issue identified by the FSA is:

- Over-reliance on short term credit-sensitive wholesale funding markets;
- Large pipelines of new business with limited or no ability to fund them;
- Over-reliance for funding on securitisation markets;
- Inability to meet significant retail outflows; and
- Firms entering into ratings-based liquidity contracts without valuing the underlying option.

The new quantitative (i.e. value based) requirements include the sound of a stable door being closed. What they also will warn you about is where the next problem will come from.

They are:

- Banks should stress 100% of outflows out to two weeks and limited rollover beyond (is issue 1)
- Banks should consider undrawn commitments and the need to continue lending under the franchise-viability risk driver – which is what they do now
- Banks should diversify their funding base;
- Banks should raise their retail resilience and;
- A requirement to take into account all ratings triggers.

This is not generally very helpful considering the last three parts of the mitigation (chapter 6) and if you look at the requirements these include working out your liquidity based on a closure of the FX markets and various other uncertainties. They believe that retail deposits are stickier than wholesale deposits – whereas we believe the opposite is actually the case. They are not prescriptive, but if the FX markets are closed the diversification required becomes difficult.

If there is a real downturn of the manner suggested, government securities (indeed all securities) collapse in value and commodities increase. Reserve lines actually get withdrawn. Can you imagine being a bank with a reserve line of $1bn being called by a failing bank – would you send it? Of course you would not.

We are not suggesting that no such lines should exist; indeed we would recommend that they be obtained from institutions that are not directly linked to the problem banks economic drivers. However whether any of these can help a bank if the market decides to kill it is a different matter. Beware the curse of Breakfast television – the bad press can kill you by lunchtime.

**Issue 4: Group issues**
The FSA stats that another issue was UK branches and subsidiaries of foreign groups which maintain global liquidity pools that can be disadvantageous to UK deposits. The mitigation here is that principles of adequate liquidity and self sufficiency should be implemented where necessary, together with enhanced home-host regulation.

Given that capital tends to either migrate to the home regulator or become sticky when either a firm or a bank goes under stress, these rules are clearly valid – but will prove hard to implement particularly in branches.

**Issue 5: Data Issues**
The final issue raised by the FSA is that they have insufficient data to assess properly the firms' liquidity positions or to form sector and industry wide views. They are requiring more detailed reporting of liquidity positions.

Of course at the heart of all of this, much of which is welcomed, is a major issue. Liquidity does not tend to go wrong on average, or for the last reasons that we have seen. The next crisis could easily result from a major economy being forced to go to the IMF or defaulting. The rules here, being essentially backward looking, could miss the real issue. What is needed, in addition, is much better behavioural analysis within the banks themselves, together with embedded economic analysis.

The economic analysis is the leading indicator which when combined with appropriate stress testing could actually lead an issue enabling avoiding action to be taken. However take a simple case. Do you have a mortgage? Who were you working for when you took the mortgage out? Have you told the mortgage provider of any of your changing circumstances? In the absence of such basic data the behavioural analysis becomes less effective in predicting the future and consequently cash flow prediction is even more difficult.

This is a long and detailed paper which I commend to all of you to read – where the FSA goes today your regulator may go tomorrow. The FSA have indicated these rules, which will cause a significant burden to banks, will only be implemented once the UK is clearly emerged from recession. That their implementation will probably cause an immediate return to recession, inappropriate banking practices that will exacerbate the next crisis and increased charges to the customer appears not to really matter much.

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