

Liquidity Risk: Improved Management Strategies and Controlling Exposure

Basel III and other regulations address liquidity risk as never before. What kind of liquidity buffer will the bank of the future need?

The GARP Breakfast Briefing on Liquidity Risk: Improved Management Strategies and Controlling Exposure, held in London on June 7, 2010, featured a panel discussion on how the credit crisis quickly became a liquidity crisis and what international regulators are proposing to prevent a repeat occurrence. Hosted by IBM Business Analytics, a new division of IBM Software that delivers clear, immediate and actionable insights into current performance and the ability to predict future outcomes, the briefing featured Selwyn Blair-Ford, Head of Global Regulatory Policy, with consulting firm FRSGlobal; Moorad Choudhry, Visiting Professor of Economics, London Metropolitan University; Tomas Hazleton, Director of Risk Management—Europe, with investment management firm AllianceBernstein; and Laurence Trigwell, IBM Worldwide Financial Services Executive. All are London-based. Christopher Donohue, Managing Director of GARP and Head of the GARP Research Center, moderated.

The More Things Change...

Liquidity risk, the main focus of the forthcoming regulatory standards known as Basel III, received scant attention in the past decade. And yet, Donohue noted, “We’ve been there before.” He cited a document published more than 10 years ago by the Basel Committee on Banking Supervision, “Sound Practices for Managing Liquidity in Banking Organizations,” which he said is “very similar to what they said in [the crisis of] 2008 and what they are saying today.” The difference was that past guidelines were “more principles-based,” whereas today the regulators advocate “specific exercises.”

The expert panel discussed some of the key principles espoused by the Basel Committee in 2000 and mostly gave the banking industry a failing grade when asked to rate the industry on the following four principles.

A subset of liquidity principles the Basel Committee espoused in 2000:

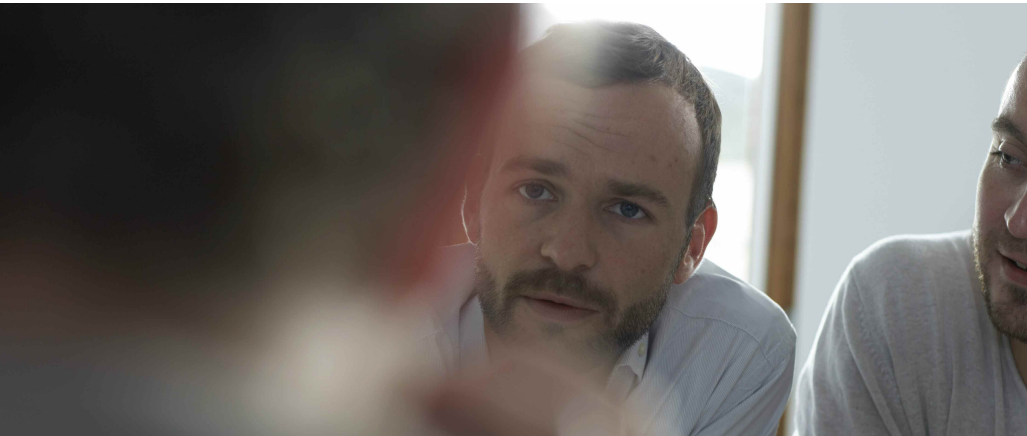
- Each bank should have an agreed strategy for day-to-day management of liquidity.
- Boards of directors should approve the strategy and significant policies regarding the management of liquidity.
- A bank must have adequate information systems for measuring, monitoring, controlling and reporting liquidity risk.
- Banks should analyze liquidity using a variety of “what-if” scenarios [stress tests].

Choudhry said that asset-liability committees “failed utterly” to flag problems to top managers. They, in turn, fell into the trap of believing that cheap sources of funds, which they leveraged to the maximum, would last forever. And yet, he asked, “Correct liquidity, that is the art of banking, isn’t it?”

Once the credit crunch hit, even assets believed to be liquid, proved themselves not to be, Choudhry add-ed. “At EuropeArab bank (Choudhry’s last industry post, where he was Head

“At EuropeArab bank, after Lehman Brothers failed, our liquidity buffer wasn’t liquid. Double A-rated securities—we couldn’t repo them, we couldn’t sell them.”

—Moorad Choudhry, London Metropolitan University



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Board Performance

Bank board members were another weak link in the risk prevention chain. Questioning whether some bank directors, or even top executives coming from other fields such as retailing, could “understand something as basic as liquidity,” Choudhry told of a jokey e-mail circulating in Britain at the height of the crisis. The joke was set up as a spot-the-odd-man-out scenario. It listed a Who’s Who of top British bankers, such as Sir Fred Goodwin, former Chief Executive of Royal Bank of Scotland (which, in 2009, had the biggest loss in Britain’s corporate history), and Andy Hornby, former CEO of HBOS (the troubled bank holding company acquired by Lloyds Banking Group). Among them was a well-known broadcaster, Terry Wogan. One would expect the people running banks and on their boards to have for-

mal training in banking. In fact Choudhry said, “It turned out [that entertainer] Terry Wogan was the only one with a banking qualification.”

Even assuming boards were competent, Hazleton questioned whether they would have heeded warnings of the impending crisis, given how unimaginable were many of the events that unfolded. Taking one factor in the demise of Lehman Brothers, the fact that it was allegedly asked by one of its creditors to come up with billions of dollars in extra cash collateral within days, Hazleton remarked, “I’ve brought less extreme scenarios to the board and been laughed out of the room.”

He gave another example of how the operating environment can change radically and unpredictably, in the case of General Motors. Although U.S. bankruptcy law had long provided for a firm’s creditors to be given an opportunity to restructure the company, “In the crisis,” Hazleton said, “that rule of law went out the window” and creditors, like shareholder-
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Current Hot Spot

“Liquidity is the risk class of the moment,” said IBM’s Trigwell, but, he and other panelists suggested, if there isn’t quick agreement on the content and timing of new, international standards, then intended improvements may never occur.

Trigwell predicted that within days of the June 7 briefing bankers would issue a document through the Institute of International Finance, largely lobbying against the latest liquidity standards proposed by The Basel Committee. The IIF argues that such requirements would cost so much as to delay worldwide economic recovery.

The proposed December 2012 deadline for implementing the Basel III standards is “incredibly short,” Trigwell asserted. Standards, once agreed, take a long time to “operationalize,” he said.

Choudhry of London Metropolitan University added that deadlines for larger banks already are being pushed back further than those for small banks.

Lack of agreement among governments asserting their respective national interests also causes delays, observed AllianceBernstein’s Hazleton. Governments also have conflict, he said, in that any reductions in bank profits will reduce tax revenue.

On the diversity of nations’ regulatory perspectives, FRSGlobal’s Blair-Ford suggested, “We could end up with a regulatory environment as different or more different than it is today.” He added, “There’s a real danger that we run out of political will before the changes come to fruition.”

Also expressing doubts, Choudhry said, “If I was to bet, in 10 years time we’ll again have banks lending 125% LTV [loan to value] mortgages, etc. That’s why forums like this are important.”

ers, lost their money. That's why, he added, "As a practicing risk manager, the number one risk I face is government uncertainty."

How Much is too Much?

Hazleton and Choudhry took opposite ends of the argument on how much additional regulation will help.

Hazleton identified the risk that the industry will "over react" and "over regulate." Guidelines are being tailored to unfathomable, "doomsday" scenarios, he said, whereas, "We need some sense of normality."

Hazleton predicted that there will be a growing divergence between economic capital—the amount a business actually needs to stay afloat—and regulatory capital, the amount regulators want it to keep in reserve.

Choudhry argued for the extensive regulation proposed: "To say it's over prescriptive 90% of the time won't cover you the other 10% of the time."

Speakers agreed, however, that banks' computer systems today often can't facilitate immediate, company-wide views of their risk. Choudhry noted, "RBS [Royal Bank of Scotland] senior managers were not able to tell their exact exposure the weekend they were being acquired because they had so many legacy systems from different acquisitions."

Choudhry advocated that banks work towards intraday reports, but Hazleton disagreed, saying that intraday reports are prohibitively costly—if even possible to produce. "Illiquid assets don't have good, real-time feeds," so valuations require "guessti-

mates" and obtaining broker quotes to supplement pricing models, he said.

Make Banking Boring

Choudhry, meanwhile, called for "a sustainable business model" of typical, risk-adjusted returns.

Besides a couple of firms, such as Goldman Sachs, and J.P. Morgan, which he described as "a cut above" the rest, he warned any firm yielding much beyond the long term average returns of major indices, such as the Dow, that it is likely to lose it all back. He told of his old employer KBC Bank, being uninterested in his proposal for a 15% return with no added risk, because it was earning 24% on other trades. "Fast forward three or four years and KBC is being nationalized by the Belgian government," he said.

"There has to be a change in culture," he added. "Yes, the cost of business will go up, so get used to it."

Echoing this, Blair-Ford said, "The return on capital and liquidity will be lowered."

Trigwell added that "Moving to less profitable lines of businesses... is the real pain," but he urged the industry to focus on how new regulations might make their businesses more profitable, and not confine themselves to bare compliance.

Choudhry declared himself "very much in favor" of liquidity proposals in Basel III and from the U.K.'s Financial Services Authority. He summarized this "much more conservative approach" to strengthening liquidity as: a call for a liquidity buffer, a review of board competence, "building up

capital in good times, lengthening the duration of your liabilities, aiming to be self sufficient in funding." No more should the wholesale bank be trading on capital twice that of the retail bank, he said.

Choudhry praised HSBC and Standard Chartered as "very good examples" in liquidity management, adding "They probably will find that they don't have any extra work to do to implement Basel III." Canadian and Australian banks are also exemplary, he said.

Everyone agreed on the need to "make banking boring again," anticipating a separation or "ring-fencing" of different lines of business as the most likely way to ensure that.

Conclusion

Liquidity risk is high on the regulatory agenda since the recent crisis, when the credit risk of 2007 quickly degenerated into the liquidity risk of 2008, participants said. A so-called "liquidity buffer" is one of the means by which regulators will require reserves that increasingly exceed economic capital. Many of the ideas are not new, panelists agreed, but the trend now is towards establishing rules for banks to follow in place of guiding principles. Achieving international agreement on those rules will be very difficult—so much so that the momentum to make positive change may be lost—but panelists agreed that it is in each bank's interest to use the issues regulators are raising to reassess their approach to funding so as to emerge stronger from this crisis.

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