

Standard & Poor's view on Bank' liquidity and funding

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Agenda

- **1 - How does Standard & Poor's take liquidity into account in its ratings?**
- **2 - Key points in S&P's review of liquidity management.**
- **3 - Is the methodology going to change?**
- **4 - Does S&P think that European banks are strong enough for liquidity risk management ?**

How does Standard & Poor's take liquidity into account in its ratings?

S&P Bank Rating Methodology

A. Economic and industry risk

B. Business profile

- Market position
- Diversification
- Management/Strategy

C. Risk management

- Risk governance
- Credit, market, operational, and **funding/liquidity risks**

D. Financial profile

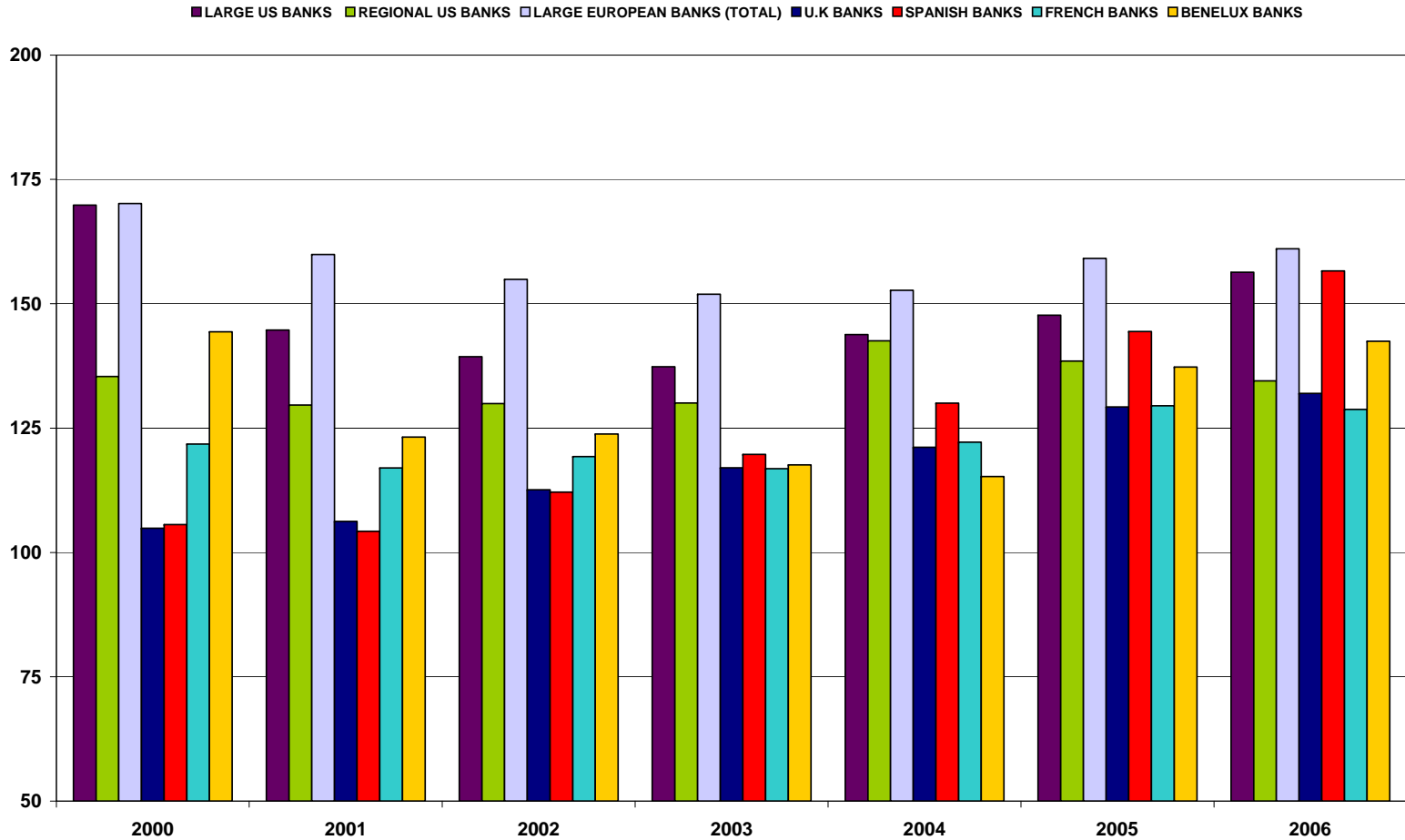
- Credit risk
- Market risk
- **Funding/liquidity risks**
- Earnings
- Capital and financial flexibility

How liquidity is taken into account in our ratings

- **Liquidity risk management has always been a key rating factor for wholesale funded and specialized players;**
- **For universal banks, the focus was more on the funding benefit derived from customer deposits;**
- **But liquidity risk management has become an important topic for universal banks.**

Deterioration in some European loan to deposit ratio

Average total loans/Customer deposits



Retail Deposits

S&P looks favorably on banks with strong retail deposits because:

- **They are typically less credit and interest rate sensitive than wholesale funding;**
- **They are typically cheaper than wholesale funding, especially if there is a large amount of checking accounts;**
- **They are more stable through a stress scenario.**

Assessing funding/liquidity profile is relatively easy

- **Strength of deposit franchise**
 - ❖ Stability and rate sensitivity of balances
 - ❖ Geographic and customer diversity
 - ❖ Concentrations
- **Volume and composition of wholesale funding**
 - ❖ Maturity
 - ❖ Investor type
 - ❖ Product
 - ❖ Currency
- **Liquid asset ratios**
 - ❖ Size and composition of unencumbered liquid asset portfolio

Funding profile can be modified by liquidity management

- **Greater attention on investor diversification, lengthening the liability profile, and managing costs**
 - ❖ Covered bonds
 - ❖ Securitization
 - ❖ US & domestic CP programs
 - ❖ Benchmark and structured MTNs, extendible notes.
- **Closer management of off-balance-sheet commitments**

Key points in Standard & Poor's review of liquidity management

Why does Standard & Poor's review liquidity risk

- **As for any risks, we want to understand senior management's risk appetite and tolerances;**
- **As for any risks, adequacy of risk management to risk profile is key;**
- **More specifically, liquidity risk determines an organization's ability to pursue organic and inorganic business opportunities...**
- **... and maintain its capacity to honor commitments to the market and to customers**

Funding /Liquidity Risk review

Two aspects:

- **Business as usual liquidity management: ability to fund new loans and other business opportunities**
- **Stress liquidity management: ability to survive a market-wide or bank-specific crisis**

S&P asks many different questions as part as our review

- **Understand Governance/Organization :**
 - How is liquidity risk management organized, are risk procedures unified across organization, how centralized is the management of subsidiaries...
- **Understand overall practices:**
 - Do you maintain a portfolio of unencumbered liquid assets to sell or repo in the event of a problem, do you run stress tests, have you fixed some specific limits regarding liquidity management.....?

Understand tools and metrics :

- How are indicators built, what are the assumptions used in stress tests, how do you model customer behaviors....

For us, understanding internal indicators and reports used by banks are key for S&P.

3 - Is the methodology going to change? Future evolutions

How Liquidity is integrated in our two current key programs:

- **Entreprise risk management (ERM)**
 - A key initiative to better formalize and communicate our opinion on banks' overall risk management and to improve our capacity to compare banks.
- **Risk-adjusted capital project**
 - Preliminary decision is to quantify a capital charge to cover Interest Rate Risk in the Banking Book in our model....
 -but not for liquidity risk.
 - This choice is due to technical difficulties but also recognizes that liquidity risk is first a risk management issue that cannot be offset by capital.

4 – How Standard & Poor's sees liquidity risk management for European banks ?

Liquidity management for European banks

- **Liquidity management is overall adequate, with some banks ranking strong;**
- **We see an improving trend, from limited risk and poor risk management, to risk becoming significant and adequate (or strong) risk management;**
- **Stress tests have moved up on the agenda under regulatory pressure, but banks still underestimate the market disruption that would result from a bank-specific or widespread liquidity event;**

- **Capacity of banks to continue to improve their risk management in tandem with their reliance on wholesale funding will become increasingly important in our rating approach.**
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Q & A ?

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