

The Work of the Committee of European Banking Supervisors (CEBS) about Liquidity Risk

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CEBS

Committee of European
Banking Supervisors

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II - First key findings : results of the stock-take

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The CEBS Liquidity Task Force

a two-fold mandate :

- follow-up to the **CEBS December 2006 meeting decision to work out on** « *principles-based approach to liquidity supervision developed through a non-legislative initiative* » and « *high-level principles that give room for the use of internal models...by large banks and simpler approaches for smaller institutions* »
- answer to the **8th Call for Advice issued by the European Commission** on 5 March 2007, covering two sets of issues:
 - an up-dated survey of the regulatory frameworks adopted by European countries (for July 2007)
 - a deepened analysis on diverse issues from concentration of funding sources to payment and settlement design (in course)

The CEBS Liquidity Task Force

organisation of the LiqTF:

- TF composed of 15 members from 12 countries
- referring to the Groupe de Contact and then to CEBS where 30 countries are represented (27 from European Union and 3 from EEA members)
- 12 meetings until 15 March 2007, i.e. almost one per month (+ conference calls)
- general approach : to build on other work done in other fora (BCBS, Joint Forum, BSC) and add specificities of the European market (via members surveys and meetings with the industry, notably with the Industry Expert Group on Liquidity, stemming from CEBS industry panel)

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First key findings : results of the stock-take

context : the regulatory framework for liquidity risk in the EEA

- liquidity risk is one of the risks to be managed by institutions in the framework of the Pillar 2 (cf Annex V of Capital Requirement Directive)
- most national authorities have had long-established individual frameworks for supervising liquidity, with no harmonised regulation and no agreed guidelines within EEA covering this risk
- liquidity risk is an exception to the European home-host cooperation framework as host countries remain responsible for the liquidity risk supervision of branches (different from solvency regulation)

First key findings : results of the stock-take

approaches : commonalities behind the range of regulatory practices

➤ **no harmonised definition but common broad aims** (*= to ensure at a micro-level that institutions have an adequate liquidity risk management (LRM) which enables them to meet their payment obligations when they fall due at any time at reasonable cost; and at a macro-level, that financial stability is not put in jeopardy by the inadequacy of the LRM of credit institutions*)

➤ **one third of countries have only qualitative regimes when two third prefer quantitative standards but:**

- most of countries with quantitative also use qualitative
- those with qualitative only, do in fact collect liquidity data, monitor profiles and would challenge/intervene if necessary
- those with quantitative regimes sometimes accept behavioural adjustments based on own institutions assumptions

First key findings : results of the stock-take

findings about level of application and scope of liquidity regimes

- majority of countries applying liquidity requirements regimes at the **solo level only**, but considering both consolidated and solo levels in one way or another; one country supervises liquidity only at the consolidated level
- a clear majority of countries applying the same supervisory requirements to all credit institutions irrespective of **size and type**
- **investment firms** are subject to the same requirements in one third of the countries, different (=alleviate) in others and sometimes to none liquidity requirements
- **foreign currencies** exposures are generally not subject to specific requirements within liquidity regimes, even if one third of countries treat foreign currencies exposures differently when calculating ratios

recent changes introduced in liquidity regimes

- only a few countries have made recent and significant changes to their regimes, which consisted of :
 - the introduction of a liberation clause from quantitative ratio for institutions able to demonstrate the adequacy and superiority of their internal methodologies
 - the introduction/up-dating of quantitative ratios, while sometimes allowing banks to use outputs from their own models for calculating them
 - the updating of reporting schemes with the option of consolidating credit institutions to report internal management information

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Liquidity risk management during recent market events :

Overview of the turmoil and its channels of transmission

Experience differs significantly across European countries

- Differences in local banking markets
- Difference of institutions' business structures, e.g.
 - reliance on wholesale funding (and flexibility to access additional funding)
 - exposures to the subprime sector
 - contingent liquidity commitments

Liquidity risk management during recent market events :

Some features of banks' liquidity risk management

Raising liquidity buffers was considered a priority:

- secure access to additional central bank money
- raise additional money from existing or new providers of funding

Very limited reductions of retail activity were observed at end-October 2007

Other measures included:

- enhanced monitoring of market trends
- additional internal resources allocated to liquidity management
- more detailed assessment of certain liquidity risks

Liquidity risk management during recent market events :

Supervisory action and adequacy of supervisory tools

None of the regimes, be it qualitative, quantitative or both, enabled the supervisor to foresee the events

Netheless, existing supervisory regimes proved useful in:

- minimizing the effects of the events (e.g. minimum liquidity buffers in place when the crisis broke out, funding diversification etc.)
 - providing adequate information to supervisors
- an enhanced monitoring was organized in many jurisdictions (for the entire banking system, large banks or specific institutions which faced liquidity difficulties)

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Work in progress and next steps

The LiqTF is currently finalising its report for CEBS endorsement.

1) It will include answers to the second part of the European Commission Call for Advice who asked CEBS to conduct a deepened analysis of a list of issues:

- impact of variables affecting liquidity risk management :
 - collateral (use and management);
 - covenants (impact on net liquidity positions);
 - netting agreements;
 - distinction between banking book and trading book (relevance of the distinction for liquidity risk management purposes?);
- interaction of funding liquidity risk and market liquidity risk (funding liquidity risk is linked to the individual net position of the firm and the subject of interest for supervisors but market liquidity risk has to be taken into account as it interferes with this individual position and with funding capacities of the firm)

Work in progress and next steps

- internal methodologies used by sophisticated firms and by credit rating agencies (what lies behind internal methodologies used by firms? what are the commonalities, is it possible to identify best practices? stress-tests and contingency funding plans participate in these internal methodologies)

- impact of payment and settlements systems design and relevant increased interdependencies (how the changes in payment and settlement systems impact the liquidity management of firms in terms of time horizon, needs and management of collateral...)

Work in progress and next steps

2) This report will go beyond this list of issues and would include lessons and recommendations addressed to both European institutions and supervisors.

Parts of the report would probably be used by the European Commission for the review of the Capital Requirement Directive (2006/48).

A public consultation period will be organised in the next weeks.

Work in progress and next steps

Overview of some elements in the report

Importance of requiring liquidity buffers

Necessity to thoroughly assess internal methodologies and possibility to rely on it

Macro stress-test scenarios could be useful

Critical role of disclosure

Work in progress and next steps

Overview of some elements in the report

No prescription about the operational organisation of liquidity risk management but necessity of group-wide overview **and** of taking into account of liquidity flows constraints (be they regulatory at any time or due to market conditions in stress-time)

Stress testing is a key element of liquidity crisis prevention and scenarios need to be more elaborated

➤ Extreme hypotheses need to be considered (even though the current turmoil could not be accommodated by stress approaches alone)