Managing liquidity risk in a changed and global world

Executive Summary

March 2010

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This white paper seeks to engage you - bank treasury and payments transaction business managers - on the topic of liquidity risk, and how you can help avoid severe implications when lacking control over it.

Many books and papers have been and will be written about the liquidity crisis that started mid 2007, the collapse of Lehman Brothers in September 2008, and its effect on the “real” economy. During the crisis, liquidity in the international transaction system evaporated as a consequence of the complexity of interconnected systems, the difficulty in alignments of operational practices, and trust issues between banks.

Equally, much has been written about the efforts by politicians, central banks and regulators to restore liquidity in the financial system and take measures to avoid such a crisis from happening again. [1]

This paper does not attempt to rewrite that commentary. Instead, we use the financial crisis as a backdrop to the tsunami of regulation that is coming your way, and as motivation to look ahead.

This is a call for action. The banking landscape has changed. The list of banks that failed, were forced into mergers or rescued is long. Equally, many other banks were well prepared and are now ready to capitalize on new opportunities. The question is: where is your bank at, will it survive the next crisis, and what can you do about it?

There are many facets to liquidity risk management.

Managing liquidity risk requires decisions at multiple levels of aggregation (transaction, product, business line, and bank-wide). Funding must be there for all transactions, current and future. Failure to do so could ripple through the entire bank and banking system.

So where to start? Whilst liquidity risk must be tackled top down and calculated bottom-up, we believe there are two dimensions that underpin everything else and that you can address now -
improve your intra-day liquidity visibility, and improve your liquidity forecasting capability:

1. **Improve intra-day liquidity visibility, through better communication flows**
   To obtain and maintain a full, intra-day visibility on your liquidity risk position requires connecting up and gathering position and liquidity information from various internal systems, business lines and divisions within your bank. But you need to go beyond that. As the origins and consequences of the liquidity crisis were global, the actions you need to take, have to reach beyond your bank. To get a true view on exposure, you need to link up branches and subsidiaries, as well as ensuring better communication flows with the ‘external world’ of account holding institutions and agents, systems and market infrastructures.

2. **Improve liquidity forecasting capability, by building a transaction data warehouse**
   The timing of liquidity has increased in importance. Whereas positions were previously considered end-of-day, liquidity risk now needs to be managed intra-day, short term one week out, as well as determining longer term funding requirements, running liquidity stress tests and calculating forward exposure… simultaneously. Reports to management, board, and supervisor include data ranging from intra-day to a three-month perspective. To achieve this, you first need to build a data warehouse of detailed and timed transactions, events and positions across your bank. This data can then feed a calculation engine, be used to generate scenarios and produce reports for decision making.

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[1] A selection of key documents is provided in annex 1.

In this paper, we offer a deeper reflection on liquidity risk management at banks and on these two dimensions in particular. Whilst we do not claim to have ‘all the answers to all questions’, we will suggest possible avenues and actions for improvement.

Our thinking is developed in five thematic steps**:**

1. **The specific nature of liquidity risk** has driven the banking community to
2. **More regulation and best practice**, and this
3. **Changed reality is pointing to gaps in current practice**, into which
4. **Banks need to invest now**, whilst at the same time
5. **Working together, for the benefit of each**.

Indeed, in addition to making improvements at your own organisation, there should be more industry dialogue with a view to developing collaborative solutions.

We hope to stimulate your thinking, gather feedback, engage in dialogue, and evolve this white paper over time to reflect our enhanced collective understanding.

We look forward to your thoughts and opinions.

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This Executive Summary is an extract of the white paper (21 pages). Please contact us by e-mail to receive the full copy.