# Government Regulation and the Impact on Liquidity Risk Practices

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***Disclosure: The opinions, thoughts and ideas expressed in this presentation are those of the speaker and author only and should not be attributed to the OTS.***

# Background

- BIS 2000 Principles
- U.S. Liquidity Risk Guidance
- IIF Principles and Recommendations
- Working Group on Liquidity

# New Guidance Forthcoming

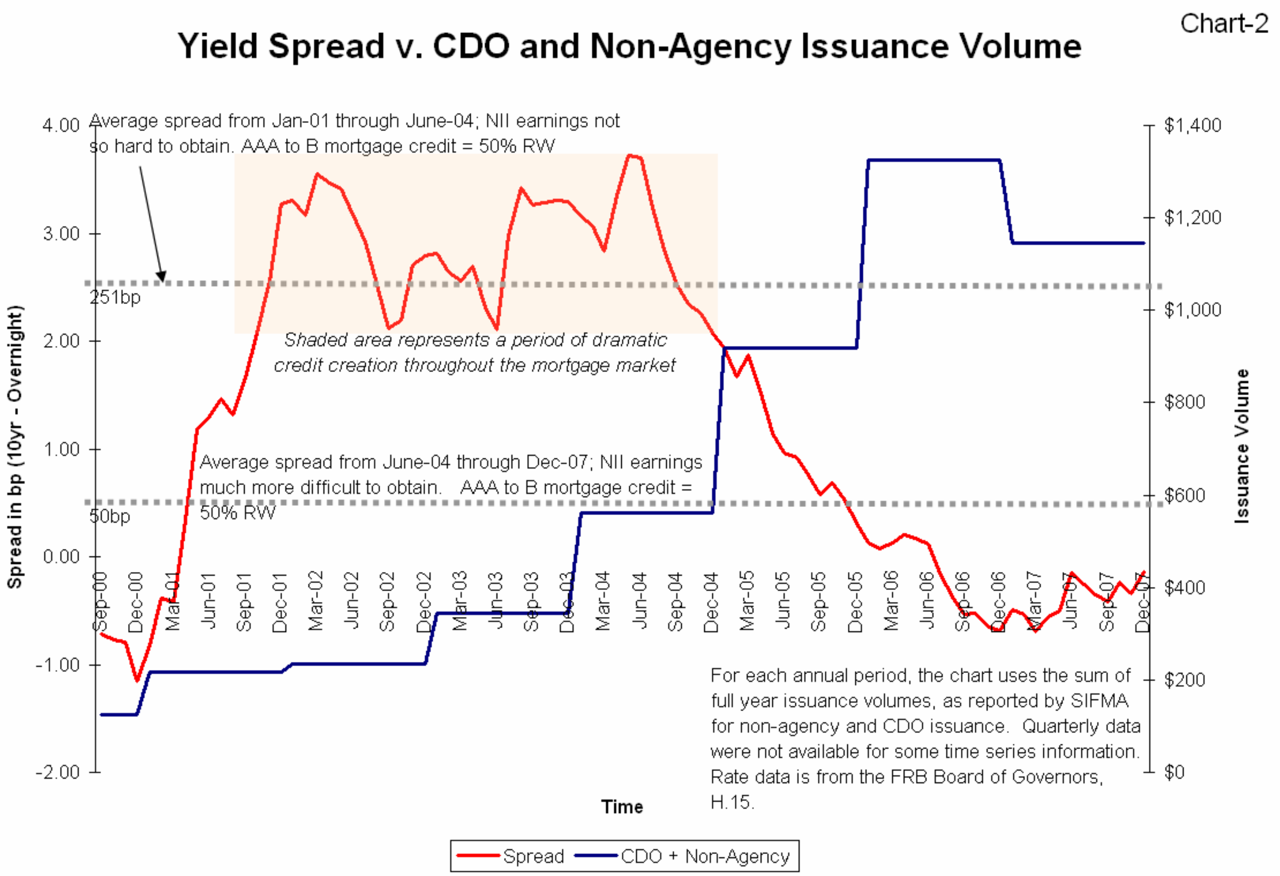
- Stronger tone and higher expectations

- Heightened focus on:
  1. Comprehensive LRM Governance
  2. Counterbalancing capacity and “buffer”
  3. Assignment of costs, benefits and risks for liquidity
  4. Intra-day LRM
  5. Stress-testing
  6. Disclosure

# Impact on U.S. Practice

- U.S. Interagency Guidance
- Working Group Continuing Efforts
- Impact of Current Turbulence
  - Capital versus Liquidity
  - Market Liquidity
- Greater Emphasis is Required

# Causes of the Crisis?




- Over this period, secularly low credit spreads and volatilities
- Glut in global “liquidity”, but in different “shape” than prior periods

# Over this Period…

- Rapid growth in new funding vehicles

- Rapid growth in new on-balance sheet products

- Incentives not aligned with risk
  - *Grow earnings to remain competitive (e.g., “volume” for volume’s sake)*

- Increase in system leverage not transparent
  - e.g., “shadow” system

***See: The 4Q07 Review of IRR posted on the OTS website for more detail***

*[http://www.ots.treas.gov/](http://www.ots.treas.gov/) - Feature article: Liquidity Risk Management*

# Major Lessons Learned

1. Need for effective firm-wide risk identification and analysis
   – Consistent with SSG recent observations
   – With regard to LRM, need a “buffer” of “scenario specific” highly liquid, unencumbered assets

2. Differences between “pricing” and “valuation”. Firms should have strong practices in place

3. Contractual and Non-contractual commitments are critical inputs

4. There needs to be a “tie-in” to pricing and performance management systems

# 1 - Firm-wide LRM Practices

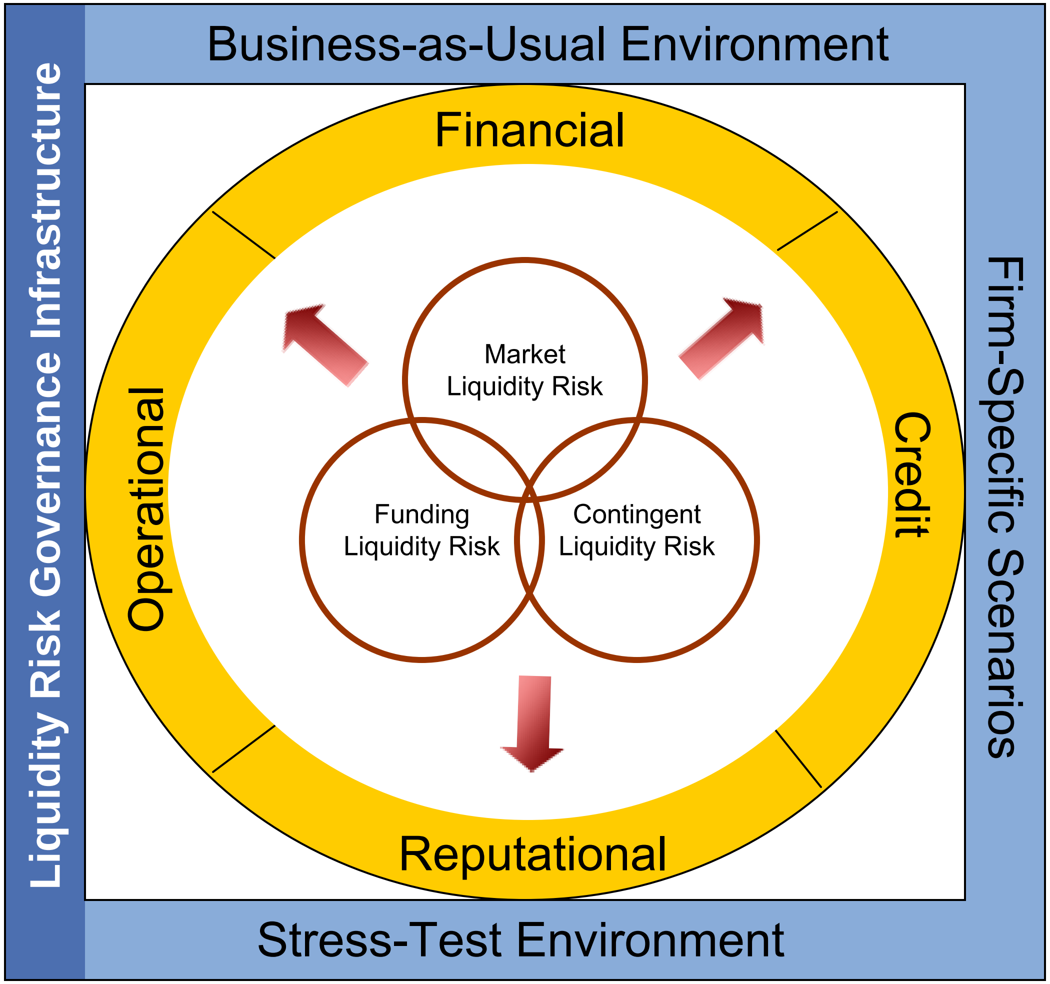
- Firms should review and update their LRM policies, practices and governance structures

  *Goal: Much more "active" management of liquidity risk(s)*

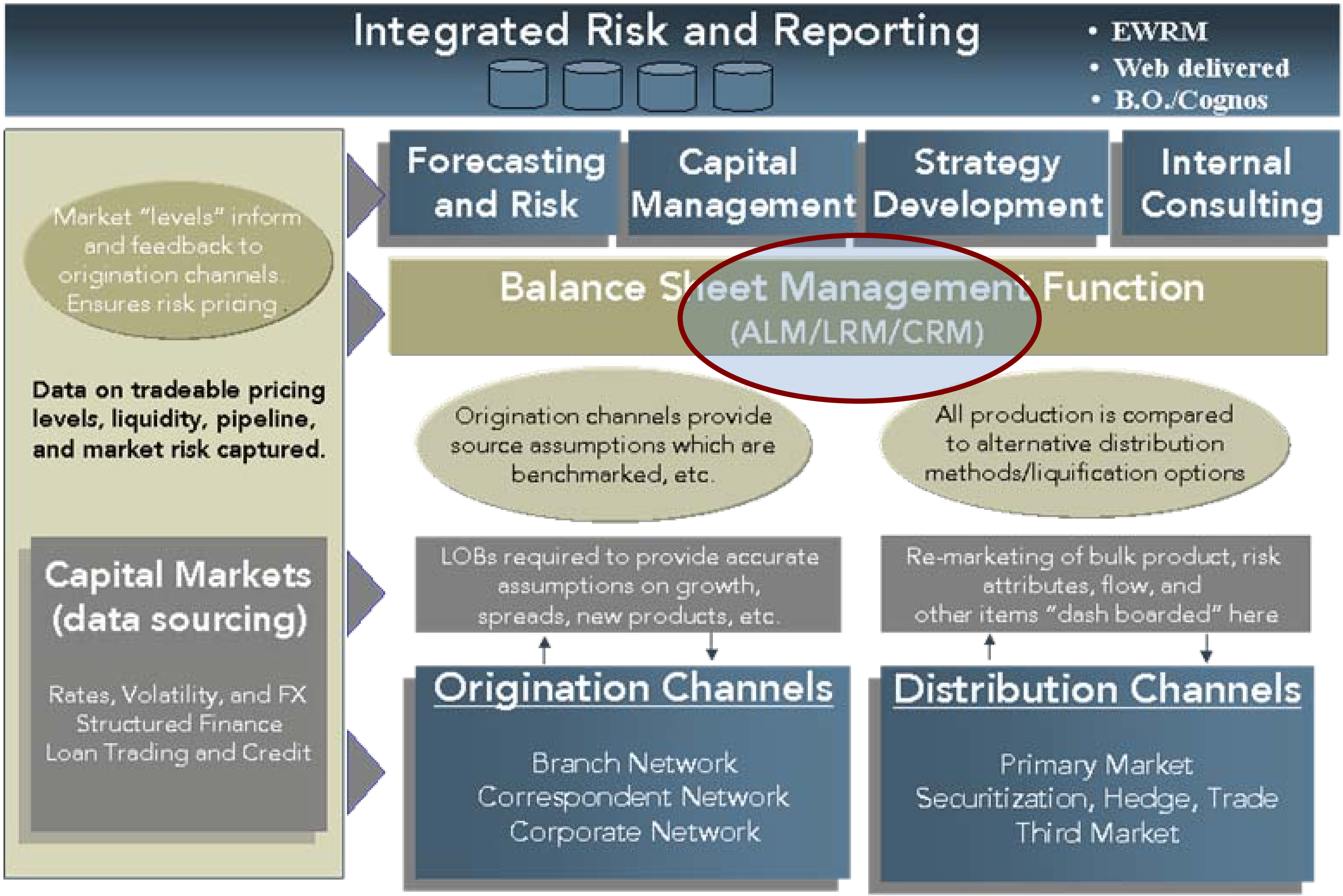
- Action:
  - Daily liquidity needs v. stress-needs
  - Counter-balancing capacities
    - Contractual and non-contractual
    - Secured and unsecured
  - Consider market liquidity impact(s) in times of stress
  - Capital ≠ Liquidity
  - Improvement in prospective and contingency measures
  - Establishing a firm-wide risk tolerance

# Effective Liquidity Risk Management Requires a Holistic Perspective

Effective liquidity risk management begins with the establishment of a comprehensive and strong internal governance process for identifying, measuring and controlling liquidity risk exposure. The LRM infrastructure naturally considers business-as-usual, firm-specific scenarios and stress-test environments. The LRM process considers not only market and funding risks, but how risks are interconnected and can "compound" in ways that create elevated levels of risk and potential exposure. Measures of liquidity risk must be based on both structural condition and prospective (i.e., forward-looking) cash-flow measures.



# Active and Integrated Balance Sheet Management



# 2 - Pricing versus Valuation

- Price and Value are two distinct things
  - Often not recognized
  - Credit is as much a part of effective BSM as NPV and IRR
    - Credit dominates liquidity risk concern(s)

- “Risk” is more complicated than “Price”
  - But the two areas are complimentary

- Pricing practice should emphasize a MTM discipline
  - Independence of pricing is key
  - Skeptical of ratings
  - Inquisitive, able to challenge, disciplined, comprehensive, supported by executives

# Price versus Valuation

- Actions:
  - – Ensure that FAS 107 is more than a naïve internal accounting exercise
  - – Place reasonable prices on products within HFI banking books, not just AFS and trading positions
    - Be able to defend prices that are not “observable” (i.e., know intimately your level II and level III positions)
    - An OAS and *credit-adjusted* OAS process is desirable
  - – Develop ALM/BSM “independent” sources of pricing
    - Don’t overly rely on traders, portfolio managers
    - Have a “view”
  - – Consider pricing in your stress-scenarios
    - Spread widening; counterparty impacts; collateral impacts

# 3 – Contractual v. Non-Contractual

- SIV exposures
- Reputational risks
- Backstop liquidity facilities
  - ABCP programs
- Other contingent commitments
  - Some contractual
  - Some non-contractual

# Contractual v Non-contractual

- Contingency funding plans in place, however…
- Not calibrated to such extreme low-probability, high-impact outcomes
  - What if: "…the mortgage market freezes-up?"
    - Prior to July 2007, risk manager may have been shown the door
- Need to consider all exposures – on and off-balance sheet
  - Allow for "creative exploration of possible tail events"
  - Allow for a non-quantitative approach, as models can and do fail to account for the full "real-world" distribution (whatever that might look like)

# 4 – Costs, Benefits and Risks of Liquidity

- New principle in the upcoming consultative paper on sound LRM practices
- Assign costs, benefits and risks to all material business units
- Should tie into performance management and profitability systems
- Consistent with IIF Recommendation #11

# Conclusion

- Comment period on Consultative Paper is short
  - Will end by 1st of August
- Need to be active in this process
- Will have a connection to Pillar 2 of Basel II
- Will live with us for a while (8-years was the prior paper)
  - This one will be better "enforced"

# Thank You!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