

# **The development of robust and internationally consistent approaches for liquidity supervision:**

## **The current state of international initiatives**

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# I. Liquidity risk – supervisory perspective

- Sound management of liquidity risk and liquidity positions is important to reduce the risk of losses to depositors/creditors and limit damage to the financial system
- Liquidity strains can turn into solvency problems
- Liquidity risk is a second-order type of risk
- Ranking of supervisory attention is normally changed by crisis experiences

## 2. Liquidity risk – central bank perspective

- Sound management of liquidity risk is relevant for many central banking functions
  - Smooth functioning of money markets
  - Oversight of payment systems
  - Contribution to financial stability
  - Crisis management
    - **Increased interest** of central banks in banks' management of liquidity risks
    - Specific interest in obtaining **more information on banks' liquidity needs in crisis situations** as a means to better calibrate interventions in the money markets

## 2. Liquidity risk – central bank perspective

An ideal framework for liquidity risk from a central bank perspective would:

- Capture **liquidity risk factors common to all banks** and facilitate cross-border comparison, while acknowledging **institution-specific dimension** of stress tests, liquidity reserves, etc.
- Adopt a **risk-based approach** aimed at limiting moral hazard concerning central banks' role as provider of ELA
- Follow a **proportionality** principle entailing a focus on money centre banks' liquidity risk management, stress testing and contingency funding plans
- Allow central banks to have access to **information** about banks' liquidity situation on an on-going basis

# 3. Policy discussions - international level - BCBS

- **Principles for sound liquidity risk management and supervision (09/2008)**
  - Significantly expanded guidance in a number of key areas taking into account latest market developments and lessons learnt by the turmoil
  - **Banks** required to establish robust liquidity risk management framework and maintain sufficient liquidity to withstand stress events, including the loss or impairment of both unsecured and secured funding sources.
  - Guidance is provided *inter alia* on identification and measurement of the full range of liquidity risks, including contingent liquidity risks; the design and use of severe stress test scenarios and establishment of liquidity buffers; the need for a robust and operational contingency funding plan; public disclosure to promote market discipline
  - **Supervisors** should assess the adequacy of both banks' liquidity risk management framework and liquidity position, and should take prompt action if banks are deficient in either area.
  - Principles stress the importance of supervisory cooperation as well as with other key stakeholders, such as central banks, especially in times of stress.

# 3. Policy discussions - international level - BCBS

- **Ongoing work**

- Development of **internationally consistent metrics to be applied as regulatory standards** for liquidity risk supervision
- Establishment of **minimum levels of liquidity for internationally active banks**, namely through:
  - Liquidity coverage ratio standard
  - A supplementary structural funding standard
- Set-up set of monitoring tools to assist supervisors
- Other issues including
  - Strengthening cross-border supervision of liquidity risk
  - Scope of application
  - Definition of liquid assets

# 3. Policy discussions - EU level - CEBS

- **CEBS Technical advice on Liquidity risk – first part (08/2007)**
  - Updated survey of the regulatory regimes across the EEA
- **CEBS Technical advice on Liquidity risk – second part (09/2008)**
  - **Definitions** of liquidity and liquidity risk
  - **Recommendations for banks**, including on corporate governance issues
  - **Guidance for the supervision of liquidity risk management and internal methodologies**
  - Recommendations in line with BCBS principles
- **CEBS liquidity ID (06/2009)**
  - **Common supervisory language enabling efficient information exchange on liquidity risk**
  - **Set of core information plus set of *à la carte* information**
- **Ongoing CEBS work**
  - Consultation paper on liquidity buffers (07/2009)
    - **definition of liquidity buffers and survival period**
    - **appropriate asset composition of liquidity buffers**



# 3. Policy discussions - EU level - BSC

- **Banking Supervision Committee Report on EU Banks' liquidity stress testing and contingency funding plans (11/2008)**
  - Explores banks' liquidity stress testing and consistency funding plans practices, provides their typology and assesses their adequacy in the light of the financial crisis
  - Proposes concerted rounds of common liquidity stress tests to improve banks' stress testing capabilities and enhance monitoring the liquidity situation of the financial system and its components
- **Ongoing BSC work**
  - Preparatory work on the concrete implementation of concerted rounds of common liquidity stress tests in the event that the ECB decision-making bodies decide to carry out such stress tests

# 3. Policy discussions - EU level - Commission

## Capital Requirements Directive (CRD)

- **CRD I** finalised in 2006 aimed at implementing the Basel II framework in the EU
- **CRD II** approved by the European Parliament in early May 2009
  - Includes a number of housekeeping issues on the original directive
  - Includes new rules on securitisation, large exposures, home-host relationships, hybrids and **liquidity risk management** as result of the lessons learn from the financial crisis
  - Implementation by December 2010
- Changes to liquidity risk management framework included in Annex V and Annex XI to be covered under the supervisory review process.

# 3. Policy discussions - CRD changes

- Changes to **Annex V of CRD** provide **enhanced guiding principles for banks' liquidity risk management**:
  - “adequate levels of liquidity buffers” and “robust strategies, policies, processes and systems” are expected in order to “identify, measure and manage liquidity risk over an appropriate set of time horizons, including intraday”.
  - each bank is requested to adopt strategies and processes proportionate to its complexity and exposure to risk, considering also the bank's systemic relevance in each Member State in which it carries on its business (**new point 14a**).
  - banks are requested to develop a system of limits and appropriate methodologies for “the identification, measurement, management and monitoring of funding positions” (**new Article 15**).
  - The proposal adds to the existing Annex V **points 16 to 22** with specific requirements for banks on pledged and unencumbered assets, liquidity risk mitigation tools, on alternative scenarios and time horizons as well as on implemented and regularly tested contingency plans to address possible liquidity shortfalls.
- **Annex XI of CRD** is amended to **subject these new management requirements to the supervision of competent authorities**
  - Supervisors “shall regularly carry out a comprehensive assessment of the overall liquidity risk management and promote the development of sound internal methodologies” (**new point 1a**)
  - In so doing, they “shall have regard to the role played by the bank in the financial markets and to the potential impact of their decisions on the stability of the financial system in all other Member States”.

# 3. Policy discussions - EU level - Commission

- **CRD III** currently being released proposes
  - Adjustments to the capital requirements for the trading book,
  - Increase in re-securitisation capital requirements,
  - Increase in disclosures on securitisation exposures
  - Restrictions on remuneration policies.
  - Implementation probably by 2011
- **CRD IV** scheduled to be released in October 2009 and likely to include proposals to
  - Include **supplementary measures or metrics for bank capital and liquidity**, as well as to
  - Implement the new leverage ratio currently considered by the Basel Committee
  - Eliminate the remaining national options and discretions
  - Include a framework for counter-cyclical buffers

# 4. Conclusions

- The financial crisis brought to the forefront the pivotal role of liquidity risk for financial stability
- The financial crisis underscored the prominent role of central banks as liquidity providers to the financial system. In this context, strengthened cooperation between supervisors and central banks on an ongoing basis and especially in times of stress, is of utmost importance
- Public authorities' response to the financial crisis was prompt, and already a significant body of work concerning liquidity risk management and supervision has been delivered
- Looking ahead the introduction of regulatory standards at international and EU level should lead to the strengthening of liquidity framework and promote convergence

**Thank you for your attention !**