Liquidity Management

An Introduction to the new Regulatory Framework (France)

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Background

Background

- Current French regulation is based on the CRB 88-01 rule: banks (at the legal entity level for French institutions, or at the branch level for foreign institutions) have to comply with a quantitative ratio. The ratio compares receivable and liquid assets to payable, with a one month horizon.
- Banks communicate their ratio to *Commission Bancaire* on a quarterly basis, but they theoretically have to comply with it on every single day.
- Beside the ratio, banks have to regularly run a Contingency Funding Plan, that makes provisions in case of a systemic crisis, and an idiosyncratic crisis

- Contrarily to other prudential aspects of the banking regulation, liquidity regulations are currently not harmonized at the EU level.
- The Basel Committee however has issued (Feb 2000) a paper outlining "The Sound Practices for Managing Liquidity in Banking Organisations", which lays the ground for common practices. These guidelines have been updated in 2008, and the same year, the CEBS issued 30 recommendations on liquidity risk management. On June 22nd this year, the CEBS published its "liquidity identity card" aiming at providing supervisors of European cross-border groups with a single prudential language.
- The European industry (notably the MMLWG) has been pushing for a European harmonization, based on internal models use, in order to favour a level playing field.
- French regulators have taken into account the Basel principles, the CESB recommendations, and the industry wishes, but the global liquidity crisis seems to have put an end to harmonization efforts. Paradoxically, banking regulations tend to re-nationalized.

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Perimeter

Perimeter

- The new regulation will come into force in July 2010
- The regulation will apply to French banks and branches of non-French banks, with the possible exception of EU banks which have a centralized liquidity management, controlled by the local regulator
- Contrarily to the current rule, where the liquidity ratio applies to legal entities, the perimeter managed under the internal models will be defined by each institution. It may differ from the legal entity. It may include non banking subsidiaries such as insurance companies or AM.
- If an entity is excluded from a Group perimeter, it will have to run its own internal models, or to comply with the standard approach.
- A detailed mapping of the perimeter will be required by the CB, including a review of all possible legal or operational obstacles that may limit the transfer of liquidity between the various entities

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General principles

General principles

- Institutions have to implement a liquidity risk management function in order to identify, monitor, measure, analyse the liquidity risk.
- They have to insure they can face their payment obligations (no time horizon given), notably by holding a stock of unencumbered liquid assets
- They regularly have to test their ability to refinance, under stressed circumstances.

- In order to measure their liquidity risk, institutions can opt for the standard approach, or the advanced approach. It is strongly recommended by the CB that large banks opt for the advanced approach.
- Nevertheless, the main component of the standard approach, i.e. the standard ratio, will have to be provided to the CB under the advanced approach. However in that case, the ratio will be given for information only, and will not be a regulatory constraint.

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The standard approach

The standard approach

- Institutions have to comply with a quantitative one month ratio, at any time. The ratio is produced by accounting (from BO tools) and sent to the CB on a monthly basis.
- A new requirement is introduced under the standard approach, consisting of a 0 to 7 days liquidity forecast, both in Euro and in foreign currencies.
- The 7 days forecast can be elaborated from FO tools. It must be consolidated at the global perimeter level
- Assumptions made for the forecast of cash inflows and outflows have to be documented and communicated to the CB
- The 7 days forecast will have to be completed by an analysis of the stock of unencumbered eligible assets, and a review of the existing “refinancing agreement”

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The standard approach (cont.)

The "new" one month quantitative ratio introduces some major changes compared to current measure:

- Regarding customers term deposits statistical behaviour, it differentiates:
  - Retail deposits (70% stable)
  - Corporate deposits (50%)
  - Inter-bank deposits (0%)
- It increases the stability of sight deposits (notably after a study of the Northern Rock case), from 80% to 90%
- It improves and harmonises the treatment of European government securities (but still differentiates for non EU govies, incl US & Japan), and fully takes into account the liquidity arising from the ECB pledged pool of assets.
- It differentiates off balance sheet commitments:
  - To retail customers (3% weighting)
  - To corporate (15%)
  - To SPV (30%)
  - To banks (100%)

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The advanced approach

The advanced approach/ General principles and governance

- In order to be authorized to use internal models, institutions have to define global liquidity policies, procedures, and limits.
- They also have to set up administration tools, IT systems
- Define a proper governance of the liquidity risk management. The bank executive committee, its board, and its permanent control unit must be involved
- The board defines the general policies, the level of risk acceptance, the perimeter to which it applies, the processes, and the limits.
- The audit committee reviews regularly the internal methodologies and the stress case assumptions

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The advanced approach/ General principles and governance

- Liquidity management covers short term (incl intraday) and long term horizon.
- It takes into account the nature of the banks business, its development plans, and its risk profile
- It is declined in each currency where the bank has a significant level of activity. It takes into account local regulatory constraints regarding liquidity transfers.
- It includes measures of the liquidity cost (long term and short term)
- It measures precisely the stock of unencumbered eligible/liquid assets
- Liquidity rules must be set at global and local level. Possibly, at business lines level.

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The advanced approach/ Indicators & limits

- Internal methodologies measure the cumulative outflows, according to prudent assumptions. Both static and dynamic approach have to be run. In each relevant currency.
- Internal models include a measure of the bank's funding cost. An internal transfer price policy has to be defined accordingly.
- In order to reduce its liquidity risk, the bank has to 1/hold a portfolio of unencumbered liquid assets, at any time. 2/ diversify its liquidity sources and market access; 3/ establish plans to access additional funding, under stressed circumstances.
- The liquidity of unencumbered assets must be quantified, taking into account operational aspects (e.g. ability to access the central bank, haircut,..)
- The diversification of liquidity sources has to be quantified

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The advanced approach/ Indicators & limits

- Institutions have to define liquidity limits on liquidity gaps, for each relevant currency, and for the relevant time horizons (1 week, 1 month, and 3 months gaps are a must)
- Global limits have to be declined by local entities, and business lines
- Procedures in case of limit breach have to be defined
- The Commission Bancaire will choose some of the limits that have been set, and consider them as a regulatory constraint
- Change of regulatory limits (or of the methodology used to measure the limit usage) are subject to prior agreement of the Commission Bancaire

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The advanced approach/ Contingency Funding Plan

- Institutions have to assess their liquidity situation under stressed scenario. The following stress cases have to be reviewed:
  - Systemic liquidity crisis
  - Idiosyncratic crisis (Calyon name event))
  - A combination of the two previous scenario
- Specific stress cases could be made for local places or business lines.
- Assumption used for the computation of CFP have to be documented
- Stress scenario must be updated on a regular basis
- The CFP defines:
  - The terms that trigger its activation
  - The CFP task force
  - Role and responsibilities of task force members
  - Alternative solutions to access funding
  - The internal and external communication plan

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Possible implications

Possible implications?

- The new framework will clearly strengthen the control on (French) banks liquidity management. Internal models in no way means a loosening of the regulation
- The use of internal model, however, will make the control much more accurate compared to the current situation
- Having a more reliable measure of liquidity positions will help some institutions, and globally moderate market behaviours. Including OMO participations.
- It has positive implications for retail banks
- It limits the expansion of investment banks (notably regarding conduits)
- The lack of EU harmonization could generate significant discrepancies regarding the profitability of institutions. More than ever, liquidity leveraging is a considerable source of revenues.

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