


Liquidity risk management



Is your solvency being properly monitored and protected?

“Liquidity always comes first; without it a bank doesn’t open its doors; with it, a bank may have time to solve its basic problems.”

Donald Howard,
Citicorp CFO (1977)

Until recently, managing liquidity risk was rarely seen as a high priority by most banks and financial institutions.

Now, as a consequence of the credit crunch, banks are putting new measures in place to monitor and protect their solvency, forming part of a trend that is likely to continue.

As technology specialists in risk management, banking and trading, we understand that too much liquidity risk leads to the possibility of insolvency, while too little risk will result in opportunity costs.

We provide liquidity risk management solutions that help you ensure your organisation is properly risk informed and that your appetite for liquidity risk is defined and realised.

By reviewing your processes, systems, reporting and analytics, we ensure that awareness of your liquidity risk is disseminated enterprise-wide. At the same time, regulatory compliance with the latest BIS and domestic reporting requirements can be demonstrated.

Understanding liquidity risk

Common problems and misconceptions

Liquidity risk is one of the least understood and most underestimated risks that financial markets participants are exposed to.

Reasons for this include:

- Under normal market conditions, liquidity problems are not observed
- Liquidity risk does not lend itself to readily usable measures
- Despite specific BIS recommendations, liquidity risk management is left out of capital adequacy calculations due to a lack of control and regulation
- 'Liquidity management' is often confused with 'liquidity risk management'
- Market and credit risk management focus on assets, while liquidity risk can stem from liabilities as well

Liquidity risk is also different in nature to market and credit risk and needs to be thought of differently;

- Normal markets analyses (expected or going-concern situations) are insufficient; liquidity risk can only be understood with scenario-based stress testing
- Historical measures of liquidity are irrelevant; prospective views are essential
- Liquidity risk cannot be readily hedged, and can only be mitigated against through rigorous monitoring and controls
- The pricing of many instruments does not properly charge for liquidity

“Supervisors should assess the adequacy of both a bank’s liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system.”

Basel II (Principle 1)

Liquidity risk management

Achieving best practice

Managing liquidity risk is often about applied common sense. Like operational risk, it requires a firm-wide approach and this places a high demand on the right processes and procedures.

Any management information system used to mitigate liquidity risk should be:

Accurate

The best way of encouraging accuracy is to keep reporting simple

Communicative

Reports and information should speak plainly

Regular

Timely reporting allows managers to judge changes in the market and their organisation's liquidity profile

Comprehensive

Must reflect your organisational reality, such as different entities, jurisdictions and regulations

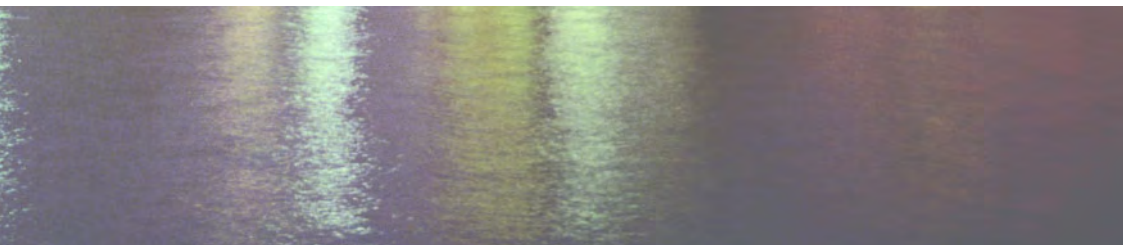
Realistic

Scenarios must be rigorous if risk is to be identified in real situations

We provide 'health check' reviews of your organisation and benchmark your liquidity risk management processes alongside your peers.

This is achieved by reviewing and developing:

- Cashflow-based liquidity gap analysis (including behavioural adjustments)
- Scenario-based analysis, liability modelling and stress testing
- Liquidity risk bearing analysis (the ability to counterbalance detrimental liquidity situations)
- Limits systems
- Funding resources diversification
- Liquidity status reporting
- Contingency funding plan
- Liquidity policy that identifies the methodology, processes and responsibilities



Beyond professional services

Our liquidity management solutions

With years of risk management experience, we advise and help our clients to quantify, examine, communicate, control and mitigate their liquidity risk. Tools to meet BIS and domestic reporting requirements include:

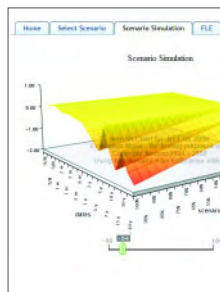


Forward Liquidity Exposure (FLE)

Computing the profile of a Forward Liquidity Exposure allows banks to answer the question ‘will we be solvent in the future?’, set limits and identify weak points. Expected cashflows are categorised as either deterministic (contractual) or non-deterministic and can be modelled as either floating, virtual or hypothetical cashflows.

Creating risk measures

To help you understand your liquidity profiles, we create risk measures that are readily familiar to risk practitioners. These include Cashflow-at-Risk (CFaR) to quantify the upper and lower bounds of your non-deterministic cash flows; Expected Liquidity-at-Risk (ELaR) which gives a minimum net cash position at a future time; and Value Liquidity-at-Risk (VLaR). The modelling behind these measures is a valuable building block to a comprehensive understanding of your liquidity.



“Our reporting proposals expect firms to have systems in place which will enable them to report daily in a crisis situation for key data items.”

FSA consultation paper -
Strengthening Liquidity Standards

Counter Balancing Capacity

Measuring downside risk is one thing; quantifying the risk exposure that a bank can bear is another. We build and integrate solutions that can model and simulate your bank’s funding mechanism and enable you to quantify the likelihood of insolvency for a given funding requirement.

Start managing your liquidity risk

To talk to a specialist, call **+44 (0)20 7489 2900** or email **risk@riskcare.com**.
For more about our approach, visit **www.riskcare.com/risk**