

Post GFC Liquidity Risk

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RISKS & RESOLUTIONS**

New Horizons for Risk Management: Shifting Rules, Shifting Strategies

Post GFC Regulation

March 2010 Interagency Guidance

- Good qualitative information
- Currently ignored or barely noticed by many US banks who are buried under Dodd-Frank and other more pressing regulatory demands
- Too few bankers and examiners pay attention to mere guidance

CCAR and DFA Capital Stress Tests

- Focus on credit risk and capital – liquidity risk largely ignored

Basel III and Proposed Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Are Bank Liquidity Stress Tests Serious and/or Helpful?

- Stress testing is misunderstood.
 - We are not concerned with probabilities. We are looking for vulnerabilities. Uncertainty not just risk.
- Liquidity risk is under resourced.
 - Unscientific survey: In the spring of 2011, I asked large US and Canadian banks to tell me how many people they had working in IRR and how many in liquidity risk. The answer was close to 3:1. (By comparison, European banks reported close to 2:1.)

Are Banks Using Liquidity Stress Tests?

- Few banks appear to be connecting stress test results to either contingency planning or strategic management of vulnerabilities.
- Liquidity risk is treated as a compliance chore.
 - Anecdote: In mid-2011, I visited one of the 50 largest banks in the US. The person responsible for liquidity risk had yet to read the interagency guidance published in March 2010.

Is Basel III The Answer?

- Fixes unintended consequences of Basel II
 - Liquidity was in Pillar 2 and ICAAP but capital is no protection against liquidity risk
 - Capital arbitrage for credit risk capital increased liquidity risk.
- Rigid and Constrained Scope
 - Just two, very similar stress scenarios
 - Just two time horizons
 - Some assumptions are ridiculously severe (e.g. off balance sheet)
 - Some assumptions are naïve and mild
- Attempts to avoid intra-period gaming by requiring “continuous” calculation. How many banks have fresh data each day?

Basel III: New Unintended Consequences

- HQLA and the obvious sovereign problem
 - Converting liquidity risk to credit risk
 - Adding market risk and reliance on discount window
- HQLA and the resulting diminution of lending
 - macroeconomic consequences
- Deposit gaming: “stable and less stable” ; “operational relationships”
- Off balance sheet gaming: liquidity facilities versus credit facilities.