



**MENA**  
Financial Regulators' Training Initiative

# Liquidity Risk Management Expectations in a Changing Global Market Place

**Joint Regional Seminar on  
Global Financial Turmoil and the  
Changing Face of Financial Sector Supervision**

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**Office of the Comptroller of the Currency**

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Comptroller of the Currency  
Administrator of National Banks

US Department of the Treasury

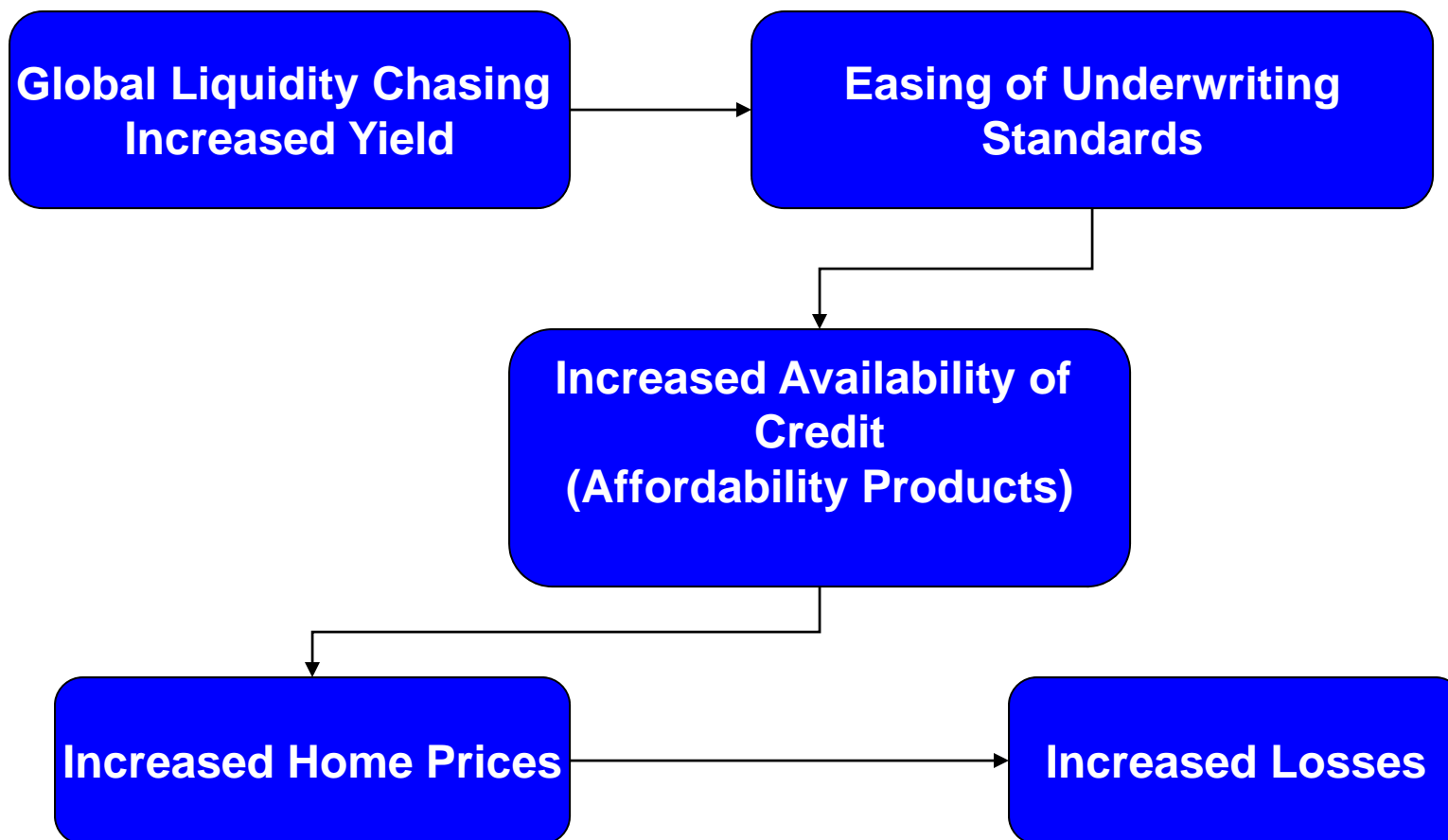
ENSURING A SAFE AND SOUND  
NATIONAL BANKING SYSTEM  
FOR ALL AMERICANS



- Market Disruption – Brief Recap
- International Supervisory Effort
- Lessons Learned
- Overview of the 2008 Basel Liquidity Principles
- Looking Forward: Basel Working Group on Liquidity
- Final Thoughts

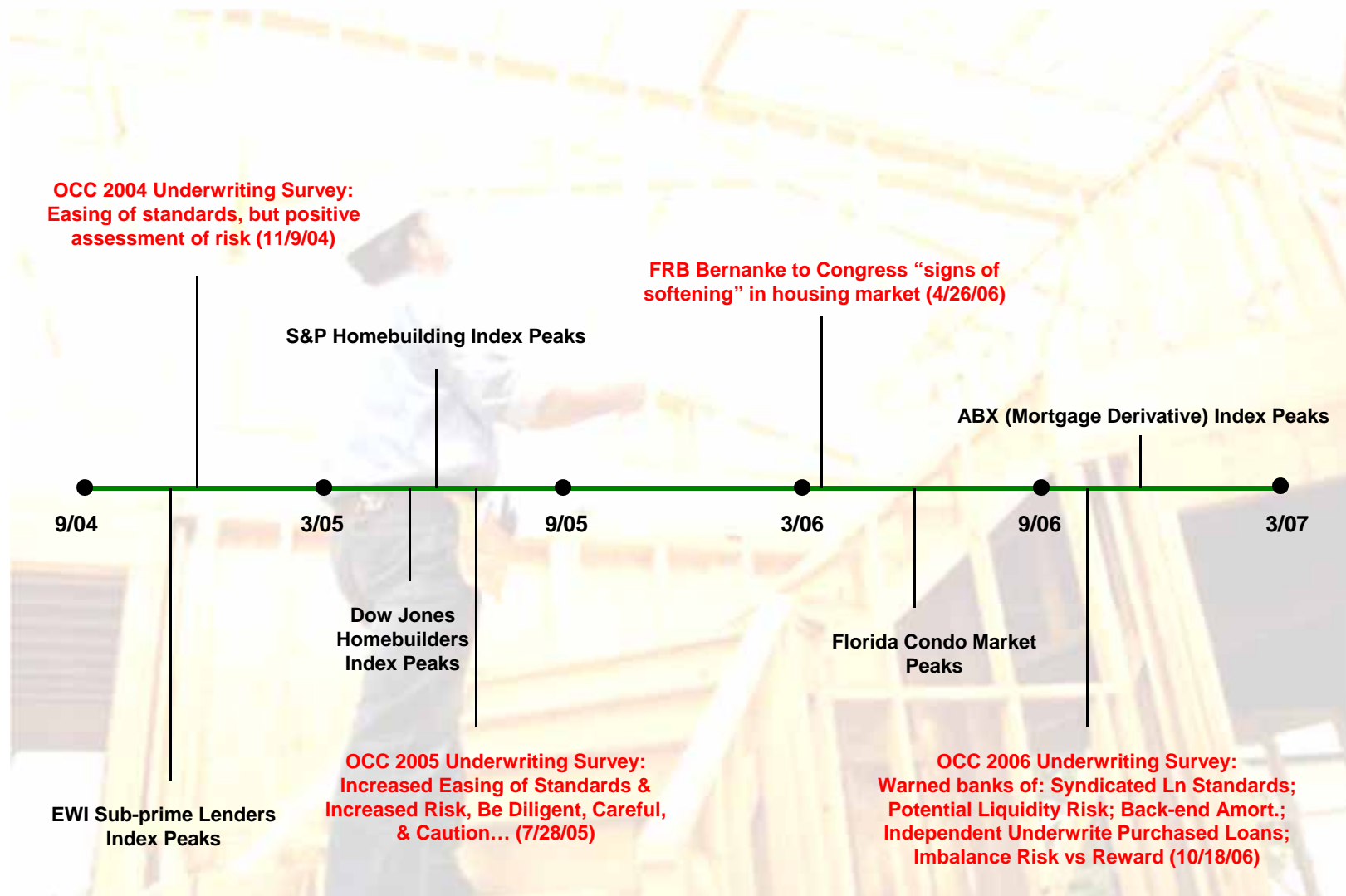


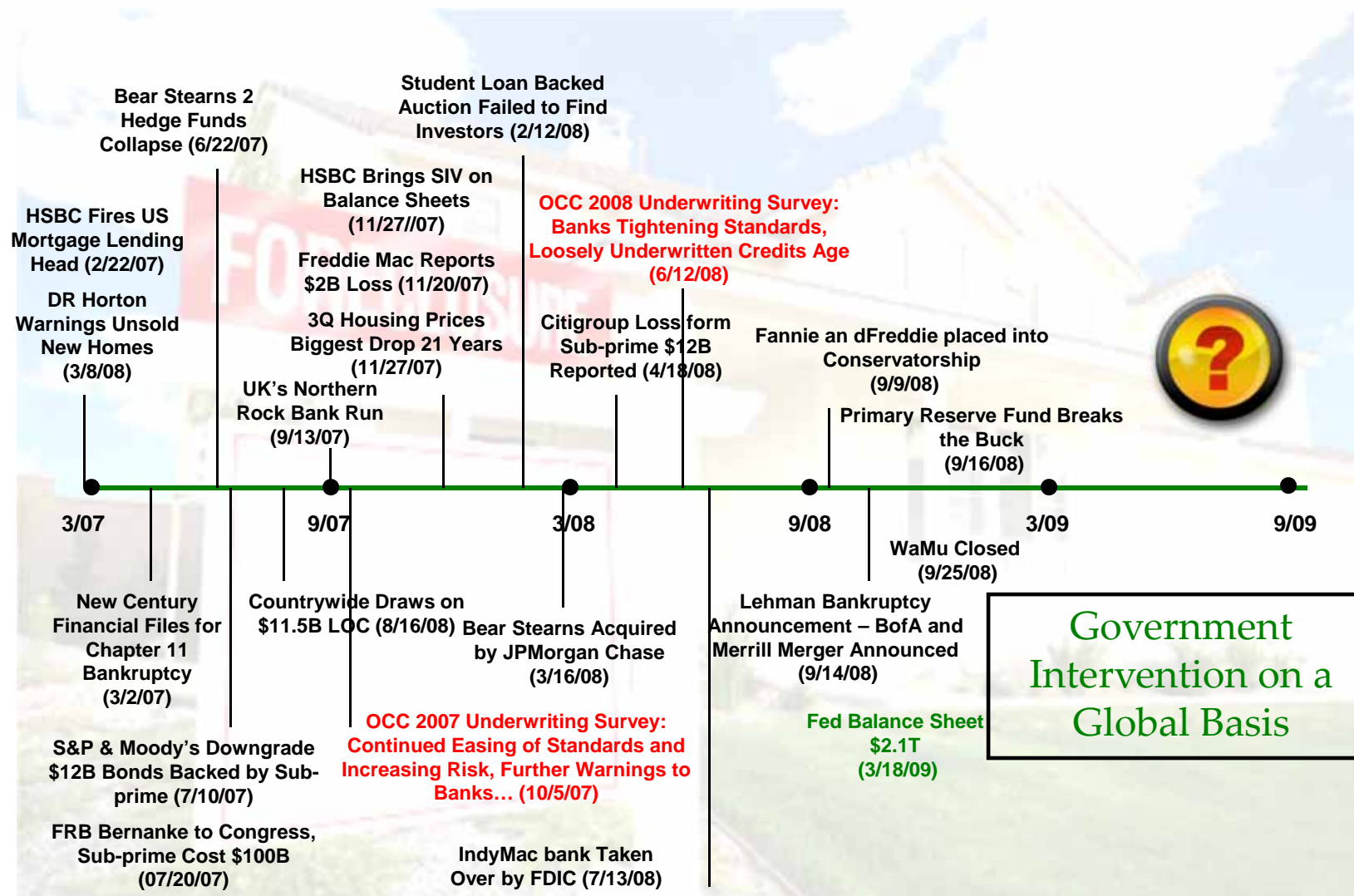
Globally, a surplus of savings over spending caused excess liquidity to seek a return.





- Current market environment was preceded by a prolonged period of:
  - Low interest rates - tough to generate yields
  - Substantial home price appreciation
  - Significant easing of underwriting standards
  - Growth of financial assets in private pools of capital
  - Substantial leveraging in the financial system
  - Long period of no significant problems in the banking system or economy





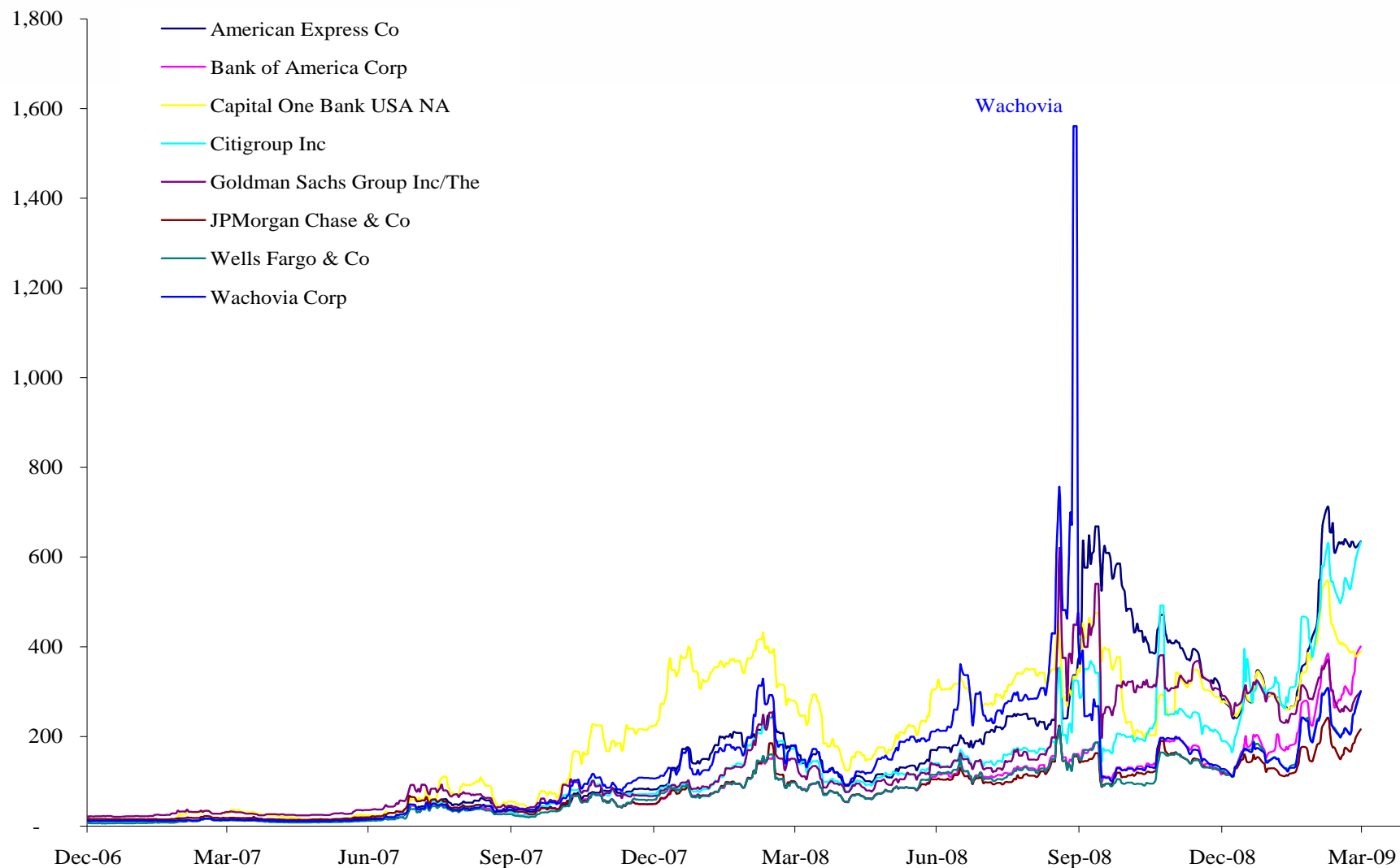


- One can debate the chicken and the egg...
- What we know is that the egg cracked sometime mid-year 2007
- Investors suddenly realized that they were not appropriately compensated for risk
- Intermediaries got stuck with unwanted risk exposures – Originate-to-distribute model cracked
- Risk management weaknesses were rapidly exposed
- Uncertainty damaged confidence of market participants



# Credit Default Swap (CDS) Spreads

Spread, bps

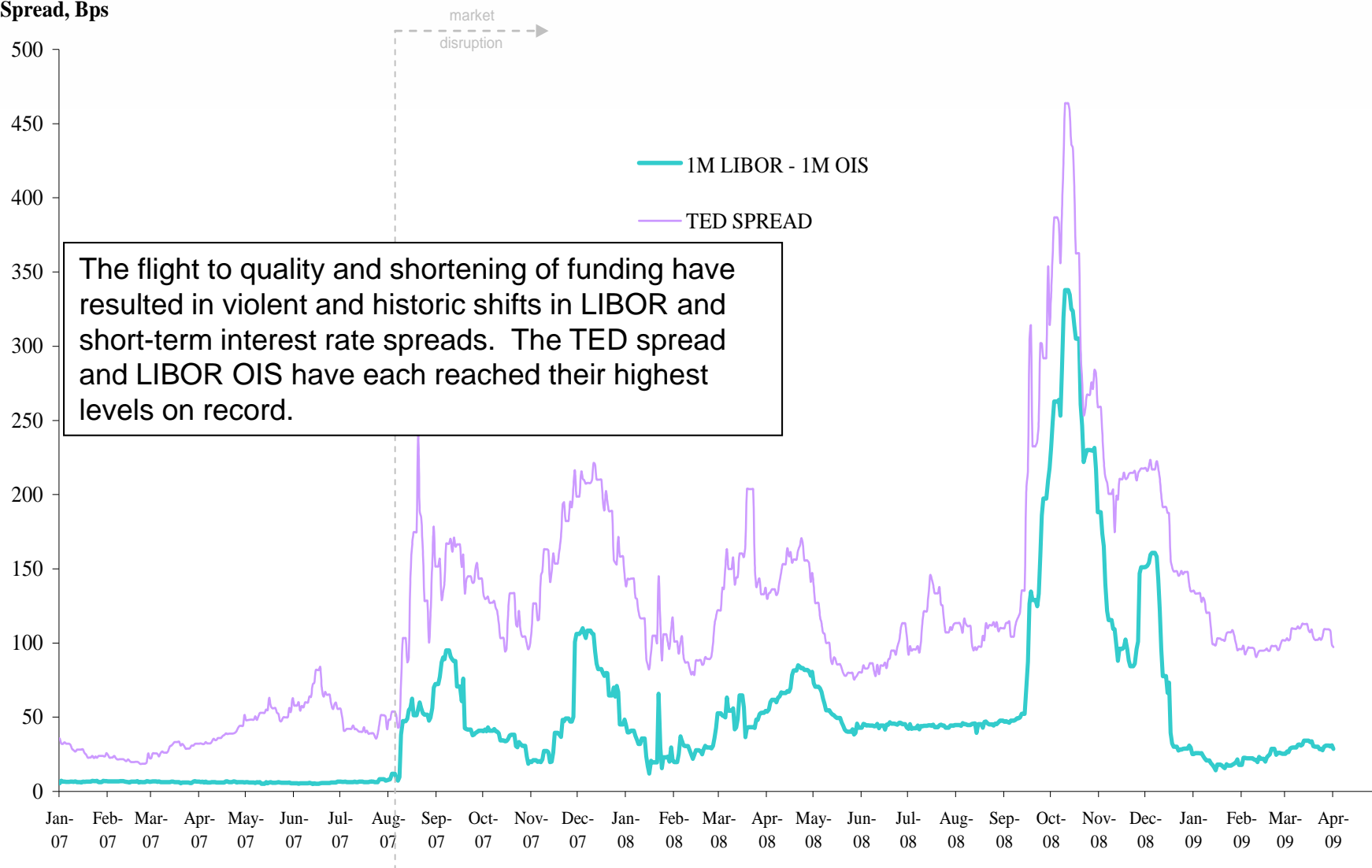






## Money Market Instruments 1M LIBOR versus Overnight Index Swaps & TED Spread

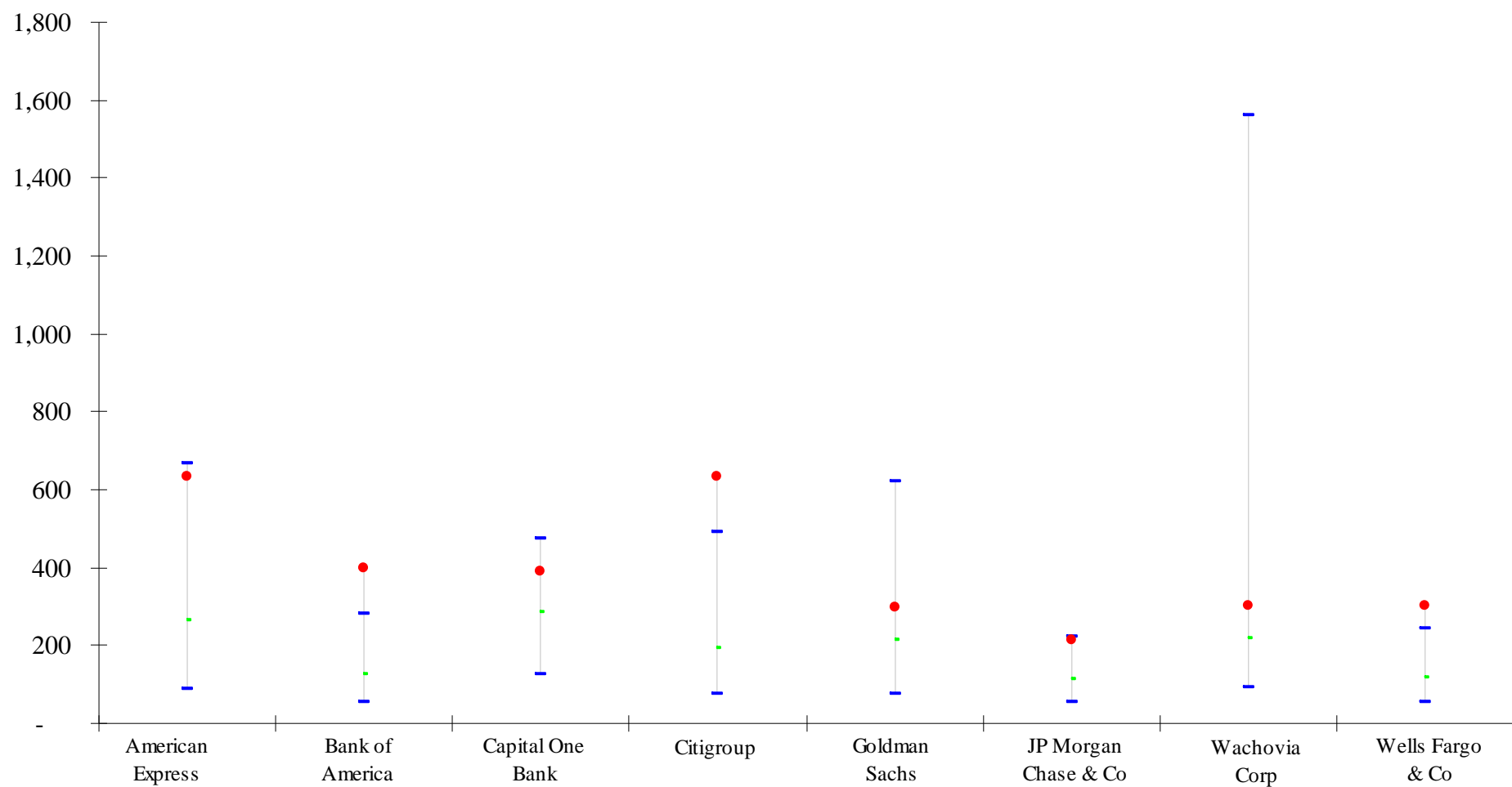
Spread, Bps



The flight to quality and shortening of funding have resulted in violent and historic shifts in LIBOR and short-term interest rate spreads. The TED spread and LIBOR OIS have each reached their highest levels on record.



# Credit Default Swap (CDS) Spreads

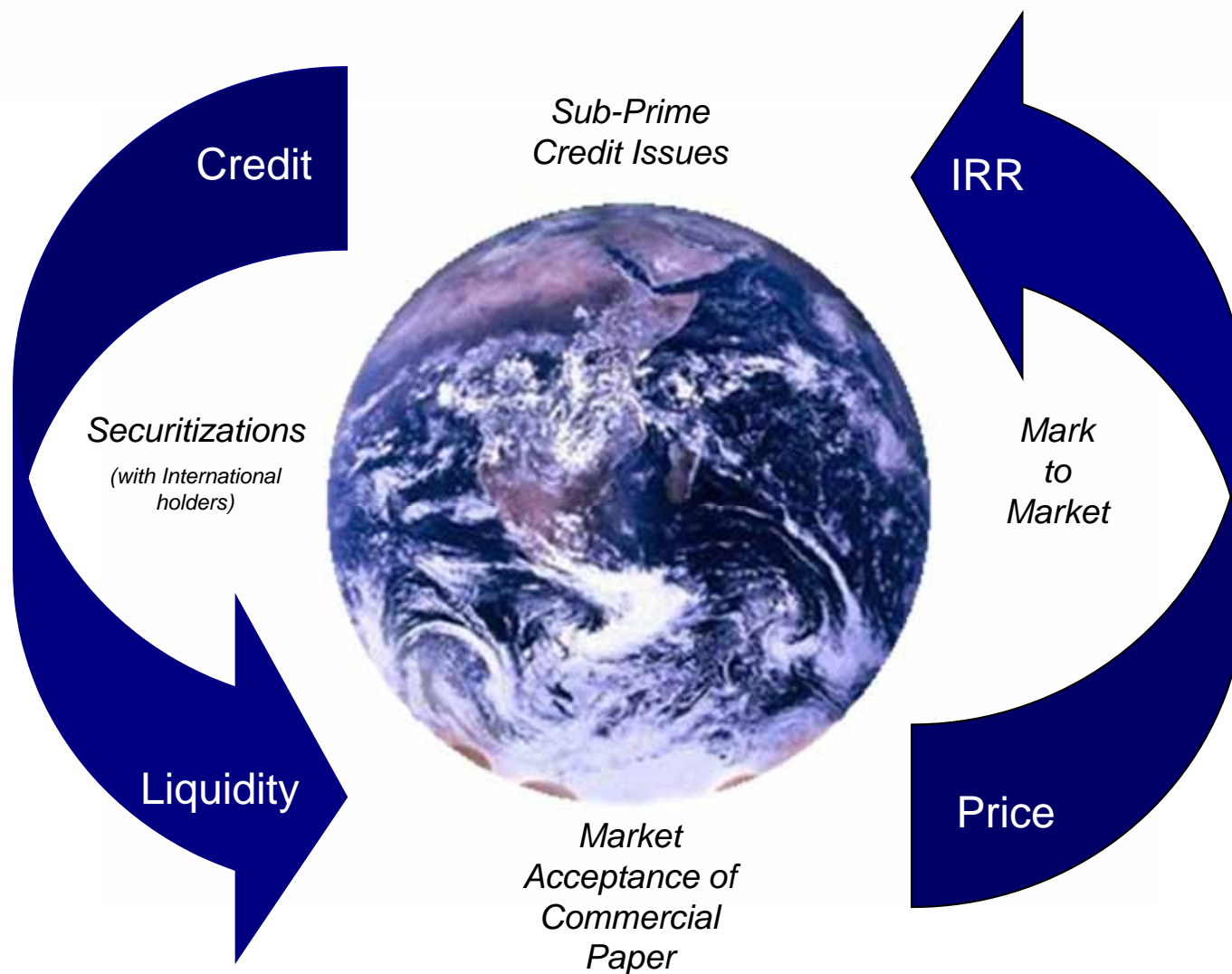




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## It's Global Economy With Interconnecting Risks





- **The President's Working Group (PWG) on Financial Markets, Policy Statement on Financial Market Developments, March 2008**
  - Members: Treasury, Fed Board of Governors, SEC, and Commodity Futures Trading Commission, OCC; FRBNY participates
- **Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence, March 6, 2008**
  - Members: U.S. – Fed Board, FRBNY, OCC, SEC; Other Countries Banking and Financial Authorities included – France, Germany, Switzerland, and the U.K. Group analyzed eleven of the largest banking and securities firms.
- **Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, April 7, 2008**
  - Members: 12 countries banking/finance authorities; and other international organizations (Basel, IMF, World Bank, ECB, etc.)
- **Basel's Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision, September 2008**
  - Committee of banking supervisory authorities established by the central bank Governors of the G10 countries in 1975. Seventeen countries involved in the Working Group on Liquidity.



***Firms that suffered significant losses tended to exhibit the following risk management weaknesses. . .***

- Weak controls over potential balance sheet growth, including ineffective limits on the growth of business lines and poor monitoring of off-balance sheet exposures
- Inadequate communications among senior management, business lines, and risk management functions
- Dependence on a narrow range of risk measures that were based on assumptions that proved erroneous and on measurement processes that were difficult to alter when it became apparent underlying assumptions were wrong
- Insufficient attention to valuation issues, including excessive reliance on credit ratings and inadequate development of models for valuing complex or potentially illiquid securities



### ***Four firm-wide management practices that differentiated performance...***

- Effective firm-wide risk identification, analysis, and planning – shared quantitative and qualitative information; identified sources of significant risk early on, and executed practical risk mitigation plans
- Consistent application of independent and rigorous valuation practices across the firm – including complex or potentially illiquid securities
- Effective management of funding liquidity, capital, and the balance sheet - treasury functions were aligned closely with risk management processes; actively managed contingent liquidity needs
- Adaptive (rather than static) risk measurement processes and systems that could rapidly alter underlying assumptions in risk measures to reflect current circumstances; could customize forward-looking scenario analyses to incorporate management’s best sense of changing market conditions



### Common Themes

- Need strengthened risk management (overall and for capital and liquidity) – by investors, issuers, financial institutions, rating agencies, and regulators
- Enhance transparency and valuation disclosures – for complex structured products, off balance sheet items
- Credit rating agency practices must improve, but users of services must understand the limitations. Investors should conduct risk analysis commensurate with the complexity of the product.
- Stress tests failed to identify institutions' vulnerabilities to system-wide shocks to markets and market participants.



## Common Themes

- Over reliance on wholesale funding.
- Insufficient collateral management.
- Contingency Funding Plans (CFPs) need to include assumptions on off balance sheet items in addition to more significant stresses in the balance sheet and asset liquidity.
  - CFPs failed to anticipate the depth of the turmoil:
    - No expectations of asset illiquidity with assumed unlimited secured funding
    - Firms did not expect balance sheets to grow in a funding crisis
    - Current turmoil far exceeded CFP expectations
    - Stresses from reputation maintenance decisions
    - Generally, did not include market events





- **Overriding Principle**
  - Establish a *robust* liquidity risk management framework
- **Governance of Liquidity Risk Management**
  - Establishment of risk strategy, risk tolerance, risk reporting, and the role of senior management & board.
  - Incorporate liquidity costs and benefits into bank activities.
- **Measurement & Management of Liquidity Risk**
  - Projecting cash flows, stress testing
  - Contingency Funding Planning
  - Liquidity Cushion



- Public Disclosure
  - Describe the liquidity risk management framework.
  - Quantify liquidity position
  - *KEY: Provide market participants with enough information so that they can understand the bank's liquidity position in normal and stressed conditions.*
- Role of Supervisors
  - Determine the quantity of liquidity risk (i.e., adequacy).
  - Assess the quality of liquidity risk management.
  - Monitor the bank's liquidity position and the level of resilience to liquidity stress through internal bank reports, supervisory prepared reports, and market information.
  - Take action when needed to prevent contagion.
  - Communicate with other supervisors, when needed.



- President's Working Group (PWG) on Financial Markets
  - Very active with ongoing projects
- Senior Supervisor's Group (SSG)
  - Second "lessons learned" exercise and self assessment
  - Liquidity risk management, securities lending, money market funds, and brokerage activities - follow-up
- US Interagency Liquidity Guidance – in process



- Basel Working Group of Liquidity – 4 new work streams
  - Stress tests, benchmarks, scenario analysis & metrics
  - Cross border issues & consistency
  - Principles implementation issues – intraday liquidity and disclosure
  - Internal pricing of liquidity risk
- 1<sup>st</sup> half of 2009 focus on developing supervisory metrics and benchmarks.
- Other work streams will be taken up in the 2<sup>nd</sup> half of 2009.



- Current period of market turmoil is not over
- Ability to manage risk comprehensively separates strong performers from weak performers. Banks should:
  - Share quantitative and qualitative information across business lines; avoid silo mentality; do homework on investment purchases
  - Make stress testing, well, stressful! Customize forward-looking scenarios
  - Consider potential systemic impacts
  - Actively manage contingent liquidity needs (this IS impacted by asset quality deterioration)
  - Understand that collateral management is key
  - Get on board - asset liquidity cushion is in vogue
  - Look for concentrations and correlations
  - Address capital needs - capital buffer increases flexibility
- Reassess enterprise-wide risk management with a view toward interconnected risks; consider direct and indirect exposures; incorporate best practices as appropriate



- Monthly collection and analysis of large bank data:
  - Collection began in May 2008 (current liquidity positions; contingent liquidity; projected sources and uses); developing benchmarks.
  - Quarterly collection for midsize banks.
- Outlier metrics distributed quarterly to district analysts and capital markets examiners.
- Ongoing interactions with field examiners to assist with liquidity risk management best practices.
- An Interagency Task Force is working on a liquidity policy statement.
- Staff continues involvement with external groups regarding the market disruption in order to develop best practices and revised liquidity guidance.



- Liquidity handbook revised.
- Interim liquidity guidance for reviews in community banks with CRE concentrations has been drafted. Key areas of focus: rollover risk management; collateral management; contingency funding plans; and legal restrictions with regard to brokered deposits.
- A FY 2009 National Training Initiative will focus on liquidity and funds management.



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# Questions