Enterprise Risk Management Mumbai

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Liquidity Risk
Better be 'liquid' to stay afloat

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Agenda

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What is Liquidity Risk Management?

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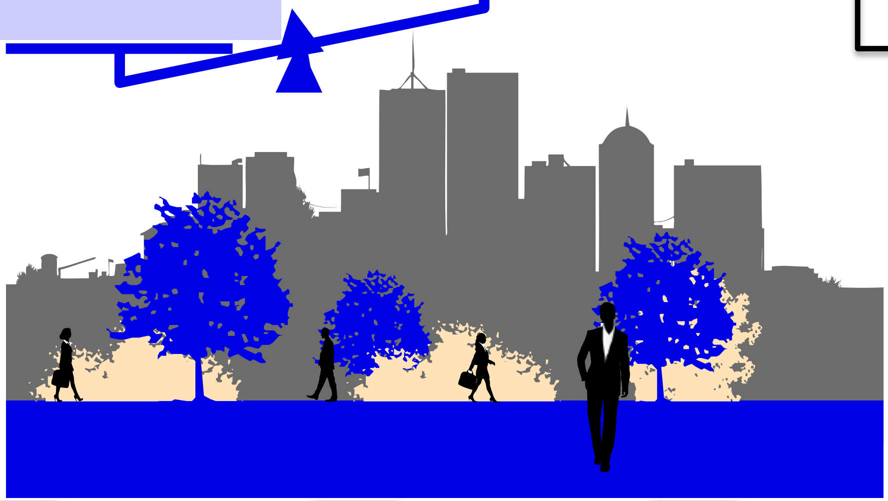
Financial obligations

Liquid assets or funds



Trading Liquidity Risk

Funding Liquidity Risk

Ensuring a healthy threshold of liquid assets which can be liquidated for servicing short term obligations at the same time maintaining an adequate flow of funds (Borrowings/deposits) to offset cash outflows.

Why is Liquidity Risk Management important?

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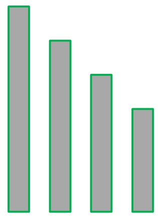
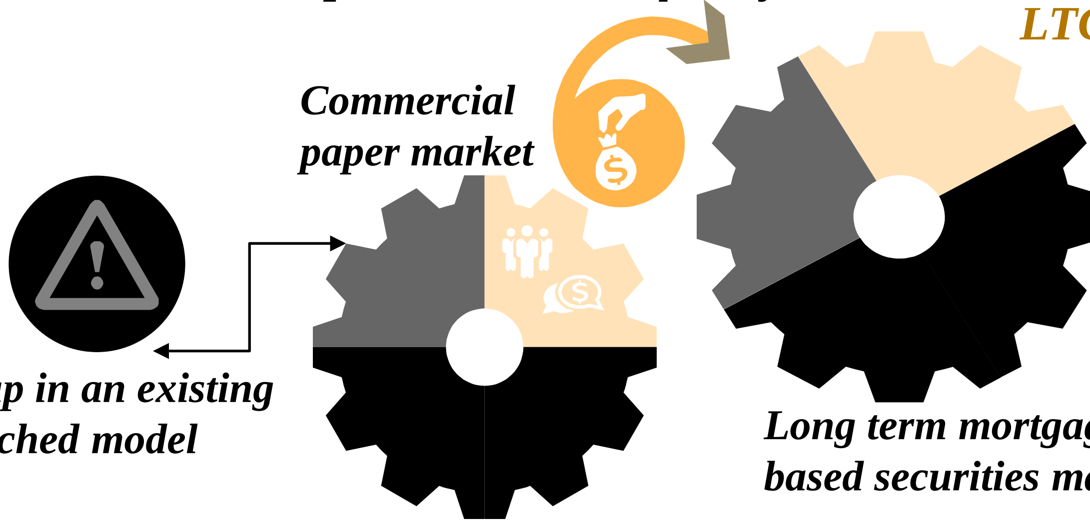
The sub prime crisis – Liquidity crunch



Housing prices plummeted

Liquidity dried up in an existing maturity mismatched model

Commercial paper market



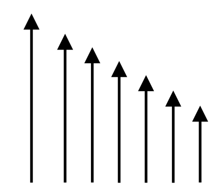
LTCM

BNP Paribas

Northern Rock

Long term mortgage based securities market

Hedge funds terminated withdrawals, Investors lost confidence & bank runs occurred. The spread between the US Tbill rate & LIBOR shot to 4%!



Number of Bank failures due to Liquidity is higher than Number of Bank failures due to Insolvency

Liquidity Crisis – Indian Markets

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44% of NBFC borrowings come from Banks followed by Mutual funds & Insurance companies

Default by IL&FS due to a reliance on maturity mismatch model

No more funding from banks

Credit spreads widened and borrowing cost of NBFCs soared

Evolution of leading practices

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Global leading practices

Sep 2008
BIS - Principles for sound liquidity risk Management and Supervision

Dec 2010
BIS - International framework for liquidity risk measurement, standards and monitoring

Jan 2013
BIS - The liquidity coverage ratio and liquidity risk monitoring tools

Jan 2014
Liquidity coverage ratio: Disclosure standards

Oct 2014
BIS - The net stable funding ratio

Jun 2015
BIS – Net stable funding ratio Disclosure standards

Jan 2016
ECB published for the first time its expectations on ILAAP

Nov 2018
ECB published final guidelines on ILAAP

An Integrated All Inclusive framework on liquidity

RBI

2015

60% LCR for Banks

2019

100% LCR for Banks

60% LCR for NBFCs (Draft)

Leading practices in Liquidity Risk..1

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Governance

In order to integrate the day to day operational aspects and strategic decisions with liquidity risk management a comprehensive governance structure is necessary.

Funding Strategy

FIs should establish a funding strategy with effective diversification in terms of sources and tenor. There should not be over-reliance on a single source. Hence, concentration in sources of funds should be monitored in a regular fashion.

ALCO

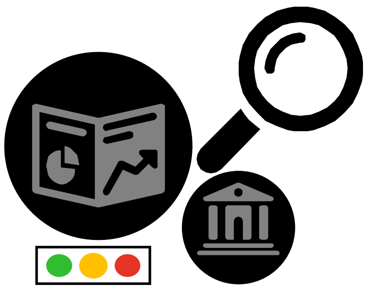
Stock Approach

FIs have to decide on suitable indicators/ ratios pertaining to liquidity risk and then set predefined internal limits upon board approval.. E.g. commercial papers as a percentage of total public funds, total liabilities and total assets, non-convertible debentures (NCDs) (original maturity less than one year) to total assets etc.

Risk Monitoring

FIs have to develop liquidity risk monitoring tools in terms of availability of unencumbered assets as well as market related monitoring tools. E.g. the coupon at which long-term and short-term debts are being raised by them will help to identify risks early. The framework should also include management of liquidity risks relating to certain off-balance sheet exposures on account of SPVs, derivatives etc.

Leading practices in Liquidity Risk..2



Stress tests should be conducted periodically for a set of short-term scenarios comprising of institution specific, general market and combined scenarios. Also, FIs have to develop mechanisms to survive the minimum stress period.

Contingency Funding Plan involves designing suitable approaches to raise funds in case contingencies arise. They have to document trigger points, set of activities, approval matrices, escalation matrices, level of haircuts (in case of asset sale) etc. details for each of the alternative approaches.

Leading practices in Liquidity Risk..3

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Key compliance metrics

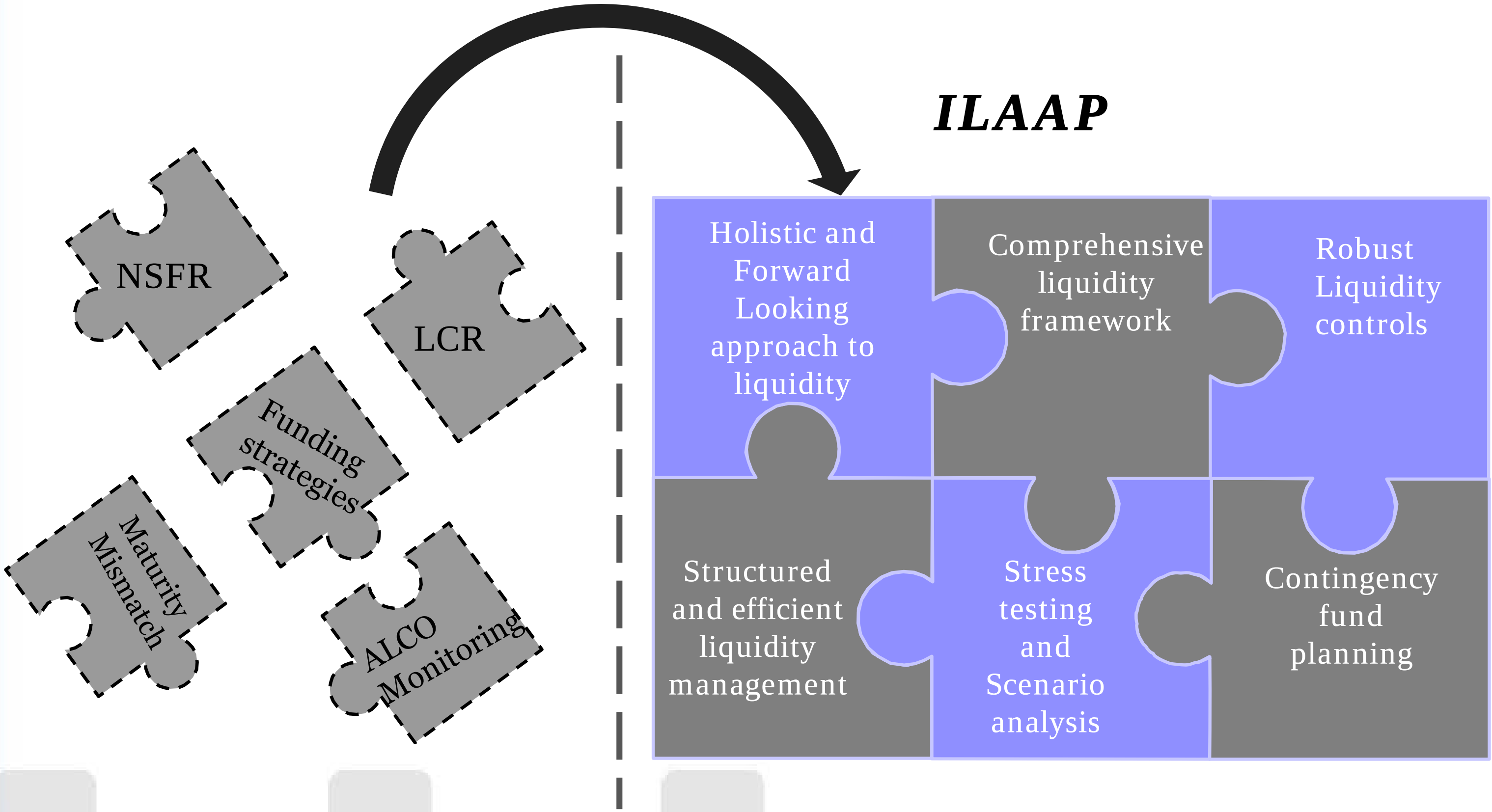
Liquidity Coverage Ratio

Net Stable Funding Ratio

$$\frac{\text{Available Stable Funding}}{\text{Required Stable Funding}}$$

$$\frac{\text{HQLA}}{\text{Net cash outflow in 30 Days}}$$

Leading practices in Liquidity Risk..4

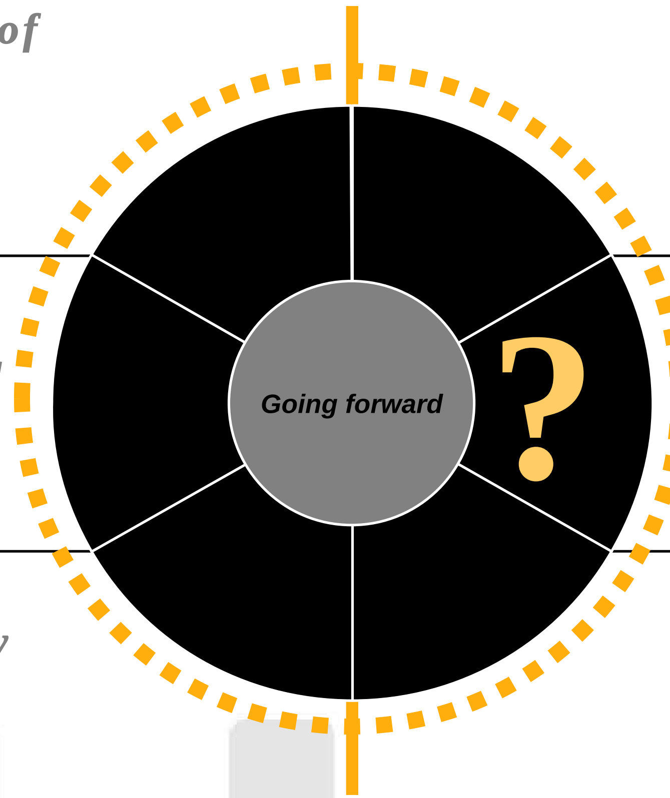


Banks, Insurance companies, NBFCs – Going forward

Application of NSFR for banks

Application of LCR for NBFCs

Liquidity Stress testing



Application of liquidity transfer pricing for banks

Emphasis on Asset liability management

Maintaining & Monitoring liquidity risk dashboards

The way forward offers Risk sophistication however the roadmap is filled with implementation challenges

Thank you

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