The ultimate risk – Flawed liquidity risk management

As the global financial services industry digests Dodd-Frank, Basel III, European bank stress tests and the inexplicable 'flash crash' that downed Dow Jones 700 points in minutes, the question is where to now? Dr Raj Nathan, Executive Vice President & Chief Marketing Officer, Worldwide Marketing and Business Solutions Operations, Sybase, an SAP company, addresses this and other important issues

To answer the question of 'where to now?' it bears looking at what industry insiders think is important. A useful guide may be the industry's major recent seminars and training events. Assuming they were crafted in response to changes to make the global industry safer, more alert to excessive risk-taking and less needy of taxpayer bailouts, these events, if not predictive, reflect issues that are mostly likely to gain traction in coming months.

Here is a random sample:

- *Enterprise Risk Management: Establishing Confidence as the Financial Crisis Continues*, New York, Milan, London, Frankfurt, Singapore, Hong Kong, Sydney and Tokyo
- *New Beginnings, Bank Systems & Technology Executive Summit*, San Diego
- *The Future of Finance*, New York
- *Credit Risk Summit*, London
- *The Trading Desk of the Future*, Naples, Florida
- *Risk USA*, New York
- *Risk Management and Operational Risk*, Bahrain.

The common word here is 'risk'. It is in the titles of four of the seven events and managing liquidity risk is on the agendas of the other three.

In 2007, a presentation on managing liquidity risk would probably not have filled even a small room at any one of these events. In that year, Northern Rock collapsed, however, followed by Bear Stearns. And, even though they were profitable and well capitalised, their failure to manage liquidity risk was a major cause of their ultimate collapse. The lessons learned from those debacles have brought liquidity risk front and centre today. Reducing it, as some have already noted, is the new imperative. One good reason is the need to restore public trust and hold on to revenues and profitability as governments intentionally withdraw stimulus and liquidity support.

"Liquidity risk is currently one of the hottest topics, not only in risk management but banking in general. In view of limited resources, general uncertainty and economical slowdown, precise measurement and management of the liquidity risk is a must for any modern bank," says Iva Dropulic, department head of the European Erste & Steiermärkische Bank.

The liquidity crisis is creating a library of books, television documentaries, and scientific and academic papers, with more coming. Emerging as a financial bestseller is *Stress Testing for Financial Institutions*, edited by Daniel Rosch. It coincides neatly with July's results of the pan-European bank stress tests in which a reassuring 92.3% of banks – 84 of 91 – passed, to the apparent relief of stock markets everywhere. And, in time for seasonal gift giving will be *Rethinking Risk Measurement and Reporting*, by Klaus Blocker.

Blaming the financial liquidity crisis that began in 2007 on a single thing is like apportioning responsibility for creating a Category 5 hurricane to the sweep of a butterfly's wings. But, in February 2008, a perpetrator was clearly identified by the Basel Committee on Banking Supervision in its *Liquidity Risk: Management and Supervisory Challenges* report. It declared that too many banks failed to consider several basic principles of liquidity risk management when there was plenty of liquidity to go around (when liquidity didn't seem to matter).

The Basel Committee defines liquidity as "the ability of a bank (or other financial organisation) to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses". Liquidity risk, therefore, is the risk of not being able to fund assets or repay liabilities. Managing liquidity requires bankers to monitor and project cash flows every day to ensure and maintain adequate liquidity.

"In a banking environment, that liquidity may be needed to fund customer transfers and settlements or to meet other demands generated by the bank's business with its clients (advances, letters of credit, commitments and other business transactions that banks undertake)," writes Stanley Epstein, principal associate and director of Citadel Advantage, a former liquidity risk manager.

'Risk on/risk off' fluctuations change the investment landscape

Rebuilding investor trust at this time, when even the interbank lending rate has risen is not going to happen without an intense effort from the industry, say the wiser voices. This effort must start with organisations stepping up to produce enterprise-wide and business-specific views of liquidity positions and exposures covering intraday and projections of asset/liability type, currency, location and business entity.

Making an already difficult situation more difficult, however, is that frequent risk on/risk off fluctuations in investor sentiment are here to stay, according to co-authors Richard Clarida and Mohamed El-Erian in an August 3, 2010 *Financial Times* article.

"With declining confidence in a reliable set of investing rules, markets have become more susceptible to overreactions to daily news and are, therefore, more volatile," say Pimco's Clarida, executive vice-president, and El-Erian, chief executive officer and co-chief investment officer.

Further complicating things, says John Jay, senior research analyst at Aite Group, is that integrating home-grown systems into a liquidity risk management architecture is very difficult. "A lot of liquidity risk management is still done on spreadsheets and it is really sort of frightening," he said, quoting from the results of a Sybase Aite Group study, *Leveraging Technology to Shape the Future of Liquidity Risk Management*.

According to the report, 60% of liquidity risk management data is gathered manually on spreadsheets, while 35% comes from automated and manual processing combined, and a mere 5% is automated.

"Financial institutions must adopt a comprehensive approach reflecting the significance of liquidity risk management to the organisation's success," says Jay.

The problem for many organisations is that their mostly manual processes will strain to keep up with a number of new liquidity guidelines from a variety of regulators and committees, including the UK's Financial Services Authority, the US Securities and Exchange Commission, the European Basel III Committee and the US Federal Reserve, to name a few. Furthermore, guidelines from these sources will continue to emerge, in the case of Basel III at least until 2018, requiring flexible and agile systems to respond.

The reason liquidity risk management is the poor relative of the financial services industry is due to a number of reasons, says Jay. To begin with, three functions – analytics, cash management and collateral – intersect where liquidity risk management is. As several regulator investigations into the Wall Street crunch have concluded that silos traditionally walled off this trio of specialties within organisations, not only harming them in a crisis, but the industry as a whole, and, ultimately, the world economy.

This is largely how we got to the ultimate risk – flawed liquidity risk management, explains Douglas Hubbard, author of *The Failure of Risk Management*.

Rectifying it will require up to three years building the systems once corporations overcome the inevitable turf battles over ownership. "Corporate culture is a big obstacle to changing the way liquidity risk management is run at companies," says Jay. He noted that it is hard to change the way firms have analysed risk for the past two decades. Many are reluctant to make drastic changes to risk systems today because risk metrics mostly worked in the past. The notable exception was in the build-up to the Great Recession.

"The single most consistent and significant challenge identified by practitioners is that of gathering information from disparate systems," says Sinan Baskan, senior director of business development, financial services at Sybase. "Lack of timely and accurate visibility into all components influencing bank liquidity hinders a financial institution's ability to manage liquidity risk – for many large banks, the number of systems containing liquidity information is upwards of 25."

A second significant obstacle is cost. There is no doubt developing and implementing adequate liquidity risk management is expensive, perhaps prohibitively so, for tier II banks. Smaller banks are looking for off-the-shelf product technology providers, such as Sybase, SunGard, SmartStream and Wall Street Systems, says Jay. Larger tier I organisations generally opt to build their own liquidity risk management systems. The trade-off is in the longer time it takes.

"The time element is critical," says Jay. "The sooner you get a robust liquidity risk management system in place, the faster you lower your firm's risk exposures."

Enhancing its commitment to risk management and providing the tools to do so, Sybase acquired the assets of Aleri earlier in 2010 to enhance its position as the market leader in complex event processing and liquidity risk management solutions.

Designed to support day-to-day liquidity management and funding operations, LMS also provides a complete and consistent view of future liquidity exposures under business-as-usual and stressed conditions. The solution is dedicated to the management of liquidity and liquidity risk and, as a result, includes functionality to support efficient, cost-effective, unobtrusive integration into the existing processing infrastructure of the institution.

With trade volumes and values at unprecedented levels occurring in nanoseconds, Sybase is in a position to work with the capital markets culture to undertake the necessary changes in the times and provide the tools needed to detect and avert risky trades, dangerous market movements and illicit market abuse.

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