

CHALLENGES TO RIGHT SIZING AN INDIVIDUAL FIRM'S LIQUIDITY RISK COVERAGE

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Getting a Grip on a Firm's Liquidity

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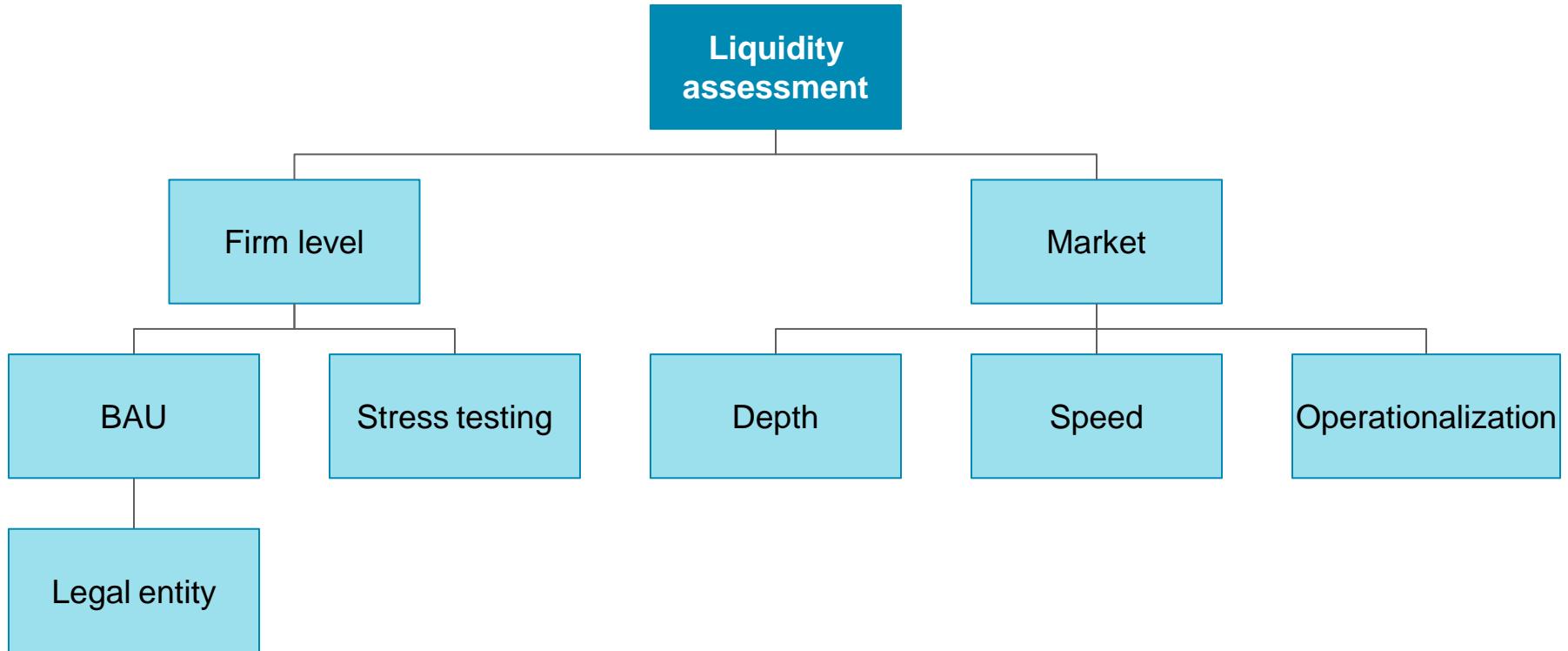
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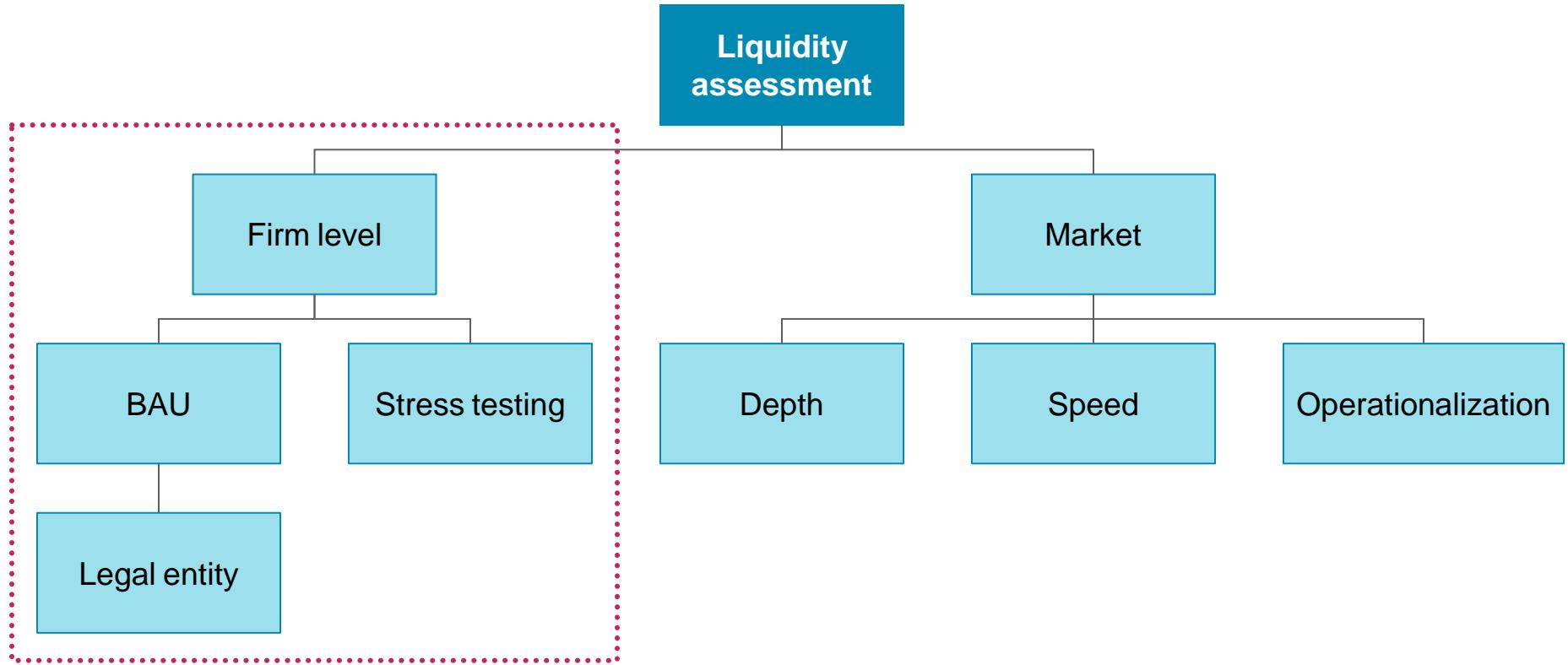
Getting a Grip On a Firm's Liquidity...market liquidity assessment is critical

- Doing otherwise could lead to a false sense of comfort and surprise when least desirable
- Basel and US rules allow up to 40% of liquidity pool assets to be held in non-sovereign securities, e.g. corporate bonds and Russell 1,000 equity securities
- Expectations are for conversion to cash “at little or no loss of value in private markets”



Getting a Grip On A Firm's Liquidity...focus of this section will be on considerations around firm level assessment

- Consolidated level analysis is insufficient
- Stress testing must incorporate a variety of scenarios and time horizons
- Intra-company risks must also be considered especially for firms with global operations



Getting a Grip On A Firm's Liquidity...liquidity measurement

Current industry practices



- Firms have largely adopted cash flow measures
 - Regulatory driven (innovative thinking shifting to creation of new products)
 - Material legal entities typically are now captured
- Continuous learning from peer (and own) shocks and incorporation into stress testing
 - Post mortems on stress situations and relevant considerations taken on board



- More traditional measures (e.g. short term coverage ratio at bank entities), no longer focus items
 - Financial crisis highlighted weaknesses, e.g. off balance sheet and contingent liabilities not captured



- Market stress testing is limited
 - Regulatory defined high quality assets are assumed
 - Efforts to prove market liquidity for assets not defined in regulatory guidance largely abandoned
 - Official sector preparedness and LOLR access have to be assumed in firm specific and systemic shock given concentrations in certain asset classes, e.g. US Treasuries

Getting a Grip On A Firm's Liquidity...liquidity measurement challenges (1/2)

Source of uncertainty in robustness of assessments



- Data Availability
 - Historical time series over a business cycle and incorporating stress events not generally available



- Data Quality challenges when data is “available”
 - Data aggregation and level of granularity still being addressed by industry



- Calibration of stress elements
 - Judgmental approach (firms' or regulators') for key parameters due to data challenges
 - Impact of official sector intervention on data is difficult to isolate



- Risk Capture – completeness
 - Significant strides have been made in addressing business unit and corporate risk management objectives (which are not necessarily aligned)

Getting a Grip On A Firm's Liquidity...liquidity measurement challenges (2/2)

Source of uncertainty in robustness of assessments



- Organizational/Corporate structure and staffing
 - Risk management oversight and effective challenge by independent team



- Systemic inter-connectedness not fully factored in
 - Assets held by large firms (aggregating over \$1.5 TN), are largely the same
 - Uncertainty on market depth, valuation and assumed ability to monetize

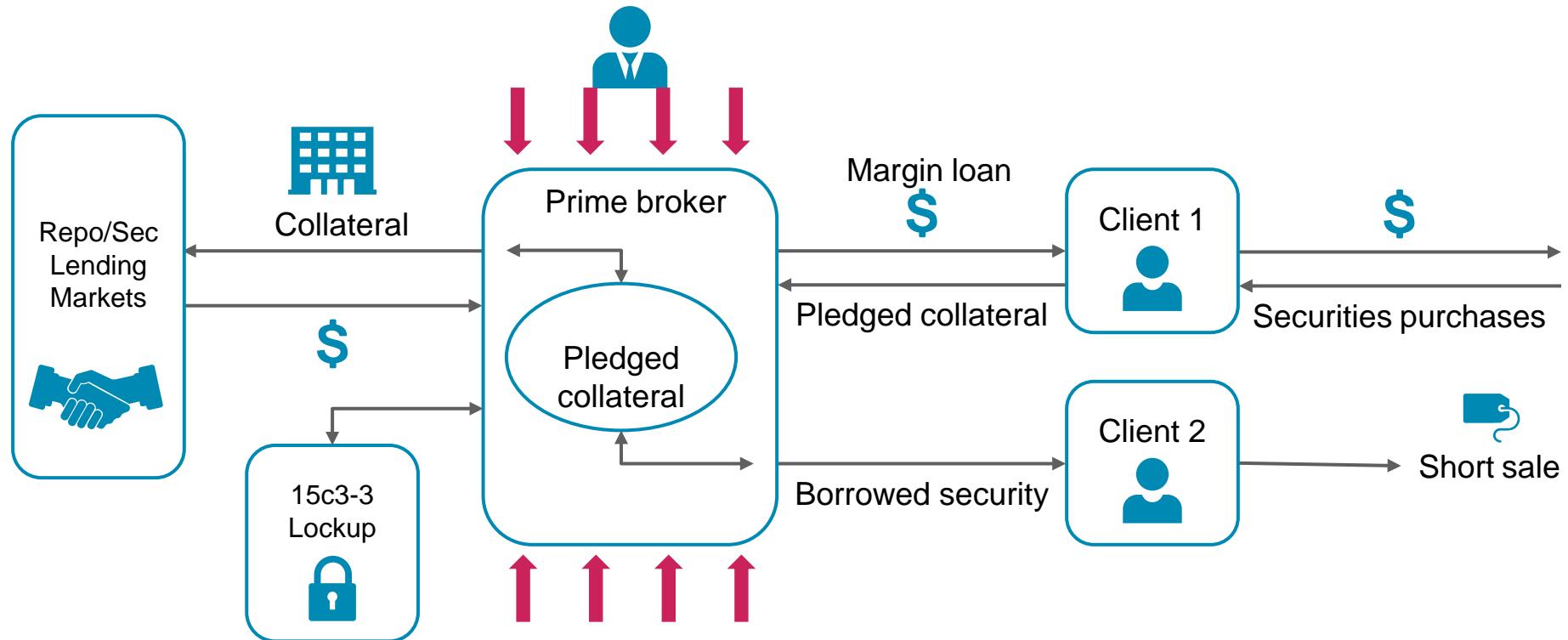
Getting a Grip On A Firm's Liquidity... liquidity measurement challenges

Illustrative Cases

- Prime Brokerage
 - Multiple inter-connected elements
- Deposit Modelling
 - Not yet mature – especially categorization of “operational” (considered more stable) versus “non-operational” balances

Getting a Grip On A Firm's Liquidity... liquidity measurement challenges

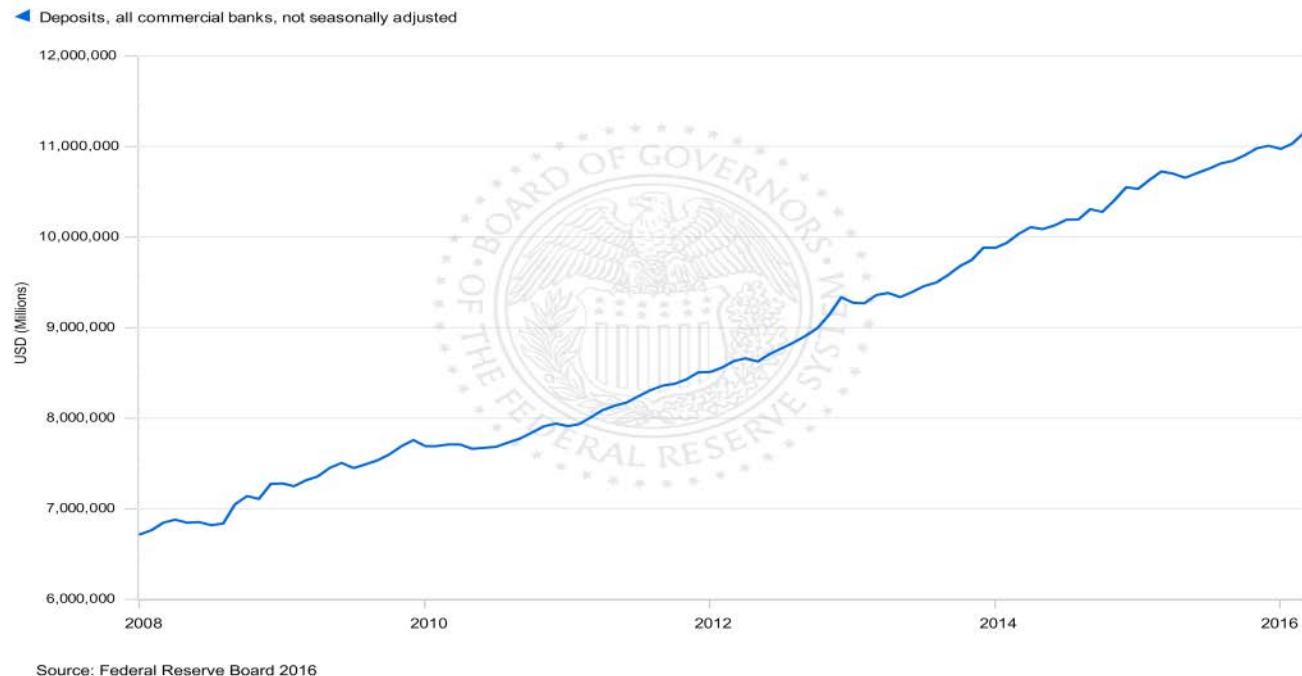
Illustrative case: Prime brokerage



- Behavioral assumptions required for multiple clients
- Highly inter-dependent flows
- Cross border complications when clients are in different jurisdictions
- Quantification of frictions uncertain at best

Getting a Grip On A Firm's Liquidity... liquidity measurement challenges

Illustrative case: Deposits



- tremendous increase in so called “surge deposits” – how stable will these be?
- significant room for error in liquidity modeling

Getting a Grip On A Firm's Liquidity... concluding thoughts

- Firms' liquidity risk measurement approaches are converging around regulatory defined cash flow approaches
- The ability to monetize assets in private markets in a systemic shock remains to be tested
- Calibration uncertainties exist around risk modelling parameters

Notwithstanding the challenges, the resilience of the financial system has without question been significantly enhanced compared to the pre-crisis state

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