

# Financial Services Alert

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## ➤ Basel Committee on Banking Supervision Publishes Summary of Report of Liquidity Working Group

The Basel Committee on Banking Supervision (the “Basel Committee”) published a summary (the “Summary”) of its Working Group on Liquidity’s (“WGL”) principal findings regarding liquidity risk management and national supervisory regimes in light of the current liquidity constrained environment. The Summary presents information on the nature of the challenge of liquidity risk management, features of national liquidity regimes, lessons learned from the current liquidity market and outlines areas for future focus of regulatory supervision of liquidity.

The Summary explains that liquidity risk management has become more challenging, even under benign economic conditions, due to a combination of factors: banks increasingly obtaining funding from potentially volatile capital markets; increased use of securitization and the resulting exposure to financial markets and potential contingent liquidity risk; increased use of financial instruments with complicated liquidity characteristics and short track records; increased use of collateral resulting in increased funding liquidity risk; improvements in payment and settlement systems giving rise to new intra-day liquidity risks; and the increased integration and dependence on international markets and cross-border flows by many financial institutions.

The Summary also provides an overview of national liquidity regimes developed by national banking supervisors and notes that, while the high level objectives of such regimes are generally similar, there is diversity amongst the regimes in terms of approaches to supervision and specific rules and guidelines on liquidity. For example, in the area of stress testing and scenario analysis, some regimes prescribe the types of shocks that should be analyzed, while others leave it to the institutions to decide what to test. The diversity in regimes exist for a variety of reasons, including national policy choices that are outside the scope of the bank supervisory regime, such as insolvency regimes, deposit insurance and central bank policies. The diversity in regimes has implications for competition, supervisory coordination and supervisory reporting/communication by institutions and supervisors operating within a diversity of national liquidity regimes.

The Summary highlights several lessons for liquidity risk management that have arisen from current market conditions. Among the lessons is that stress testing needs to be more rigorous and comprehensive as most stress testing did not test for the type of market-wide and multiple market/currency stress currently being experienced by the financial system. The current conditions also have demonstrated a need to strengthen contingency funding plans and assumptions about sources of funding as well as to have a diverse set of elements in a contingency plan. Reputational risk has also emerged as a liquidity concern as banks have provided support to special purpose vehicles for reputational reasons even when not contractually required to do so. It has also become clear from recent events that liquidity risk management is an important goal, because well capitalized banks can have severe liquidity problems.

The Summary states that the Basel Committee and the WGL will continue to work on strengthening liquidity risk management and supervisory practices. The WGL will be updating the Basel Committee’s February 2000 Sound Practices for Managing Liquidity in Banking Organizations in light of recent market developments. It is expected that the updates will focus on identifying and measuring liquidity risks, stress testing, the role of supervisors in strengthening liquidity risk management, the management of intra-day liquidity risks associated with payments and settlement and foreign currency liquidity risk from cross-border flows.