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

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Getting a Grip on a Firm’s Liquidity

1. Liquidity Assessment Overview - Thoughts on Market Liquidity
2. Current Industry Liquidity Measurement Practices
3. Liquidity Measurement Challenges
4. Illustrative Cases
5. Concluding Thoughts
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
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)
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
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Illustrative Cases

- Prime Brokerage
  - Multiple inter-connected elements

- Deposit Modelling
  - Not yet mature – especially categorization of “operational” (considered more stable) versus “non-operational” balances
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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
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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