

**THE FINANCIAL CRISIS
AND NEW DIMENSIONS OF THE LIQUIDITY RISK:
RETHINKING PRUDENTIAL REGULATION
AND SUPERVISION**

Bergamo, 23 gennaio 2009

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Main research questions

- New and more complex dimensions of the liquidity risks
 - Closer nexus between credit, market and liquidity risk
- How structural changes in the financial systems - financial innovation process and the OTD intermediation model - have increased the operators' vulnerability to liquidity risks
- What went wrong in the prevention of the liquidity crisis and the reduction of the contagion effect
- What lessons can the regulators and supervisors draw from the role played by liquidity risk in the current financial crisis

Evolution of liquidity concept

Historically the concept of liquidity changes in response to modifications in the structure and functioning of the financial system

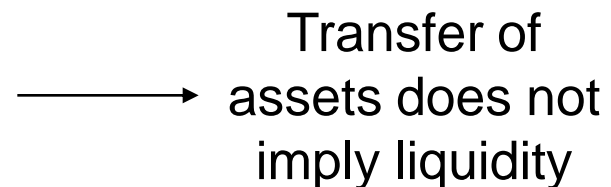
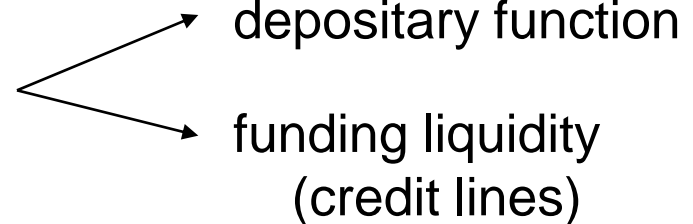
from banking liquidity



*Securitisation and OTD
model*



to market liquidity



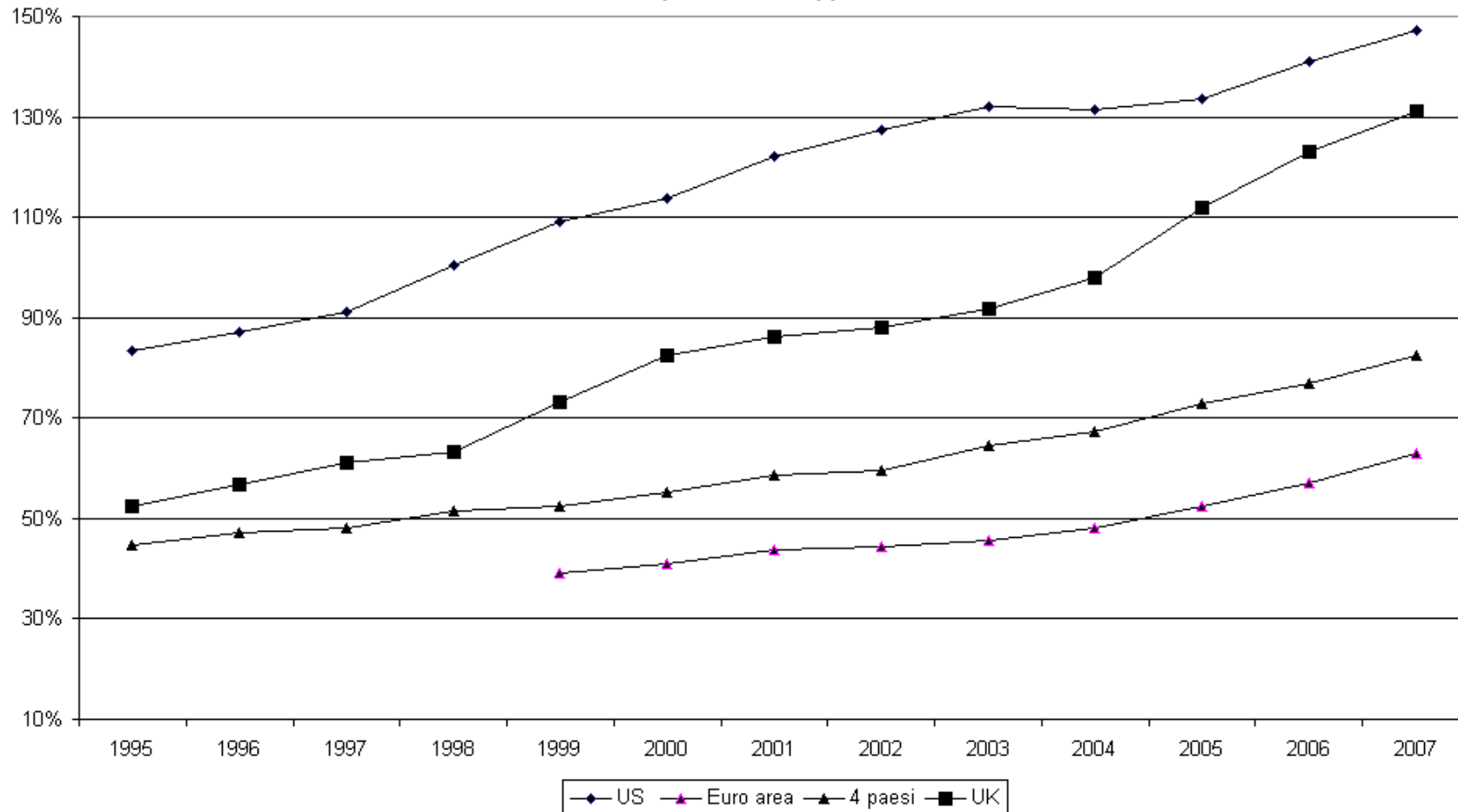
Transformations of financial intermediation



- Financial innovation (CRT products) and the new intermediation model (OTD) have made banks and non monetary financial institutions more reliant on financial markets
 - ...but not on liquid markets
- The growing interconnection of the intermediation levels has made periods of flight to quality more complex and risky, enhancing the systemic liquidity risk
- MFI and OFI adopt similar business models, their activities are more interrelated and the value of the assets have become more correlated thus accentuating the systemic component of financial risk

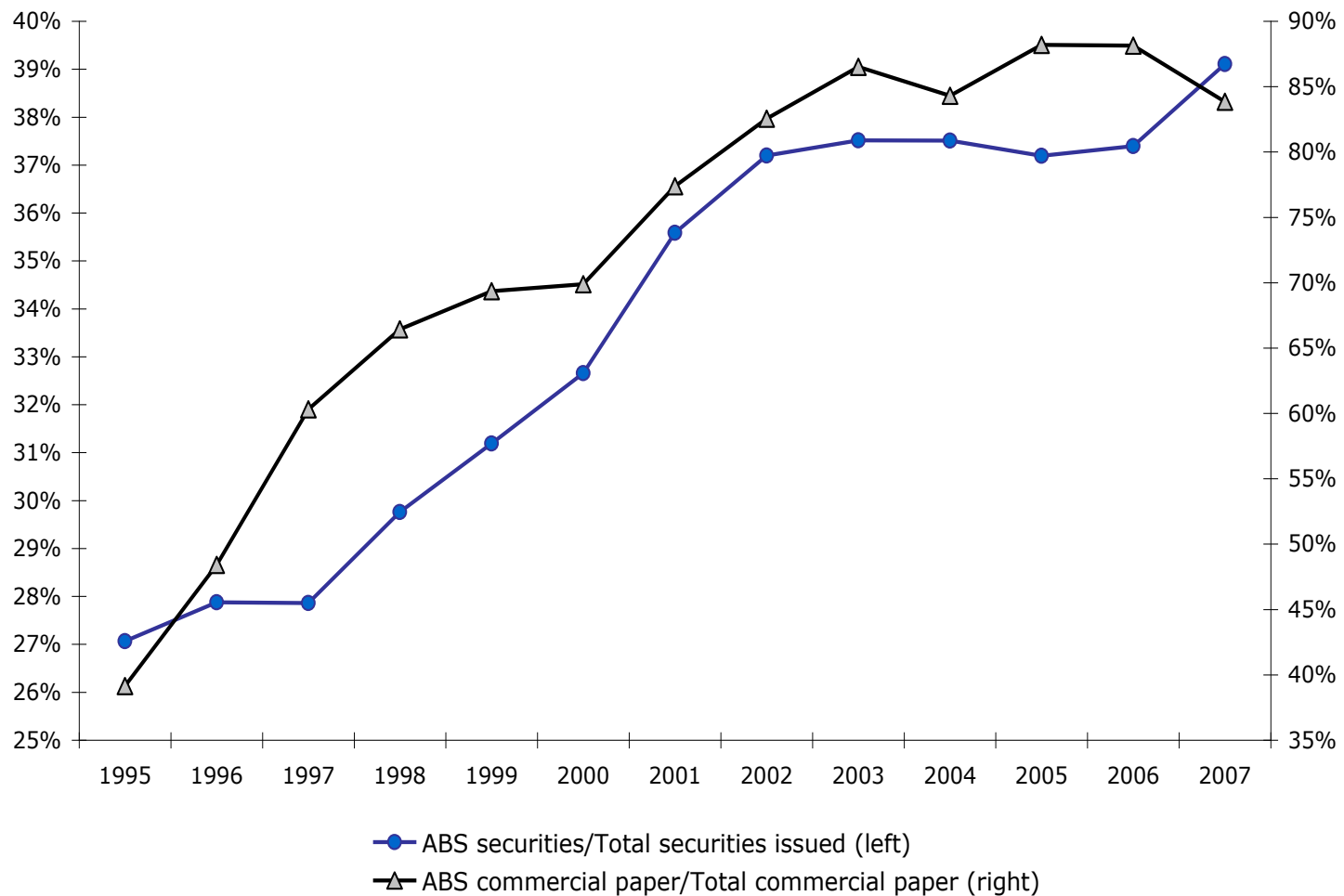
Increasing role of securities' markets

Issued securities of private sector
(as a % of Gdp)



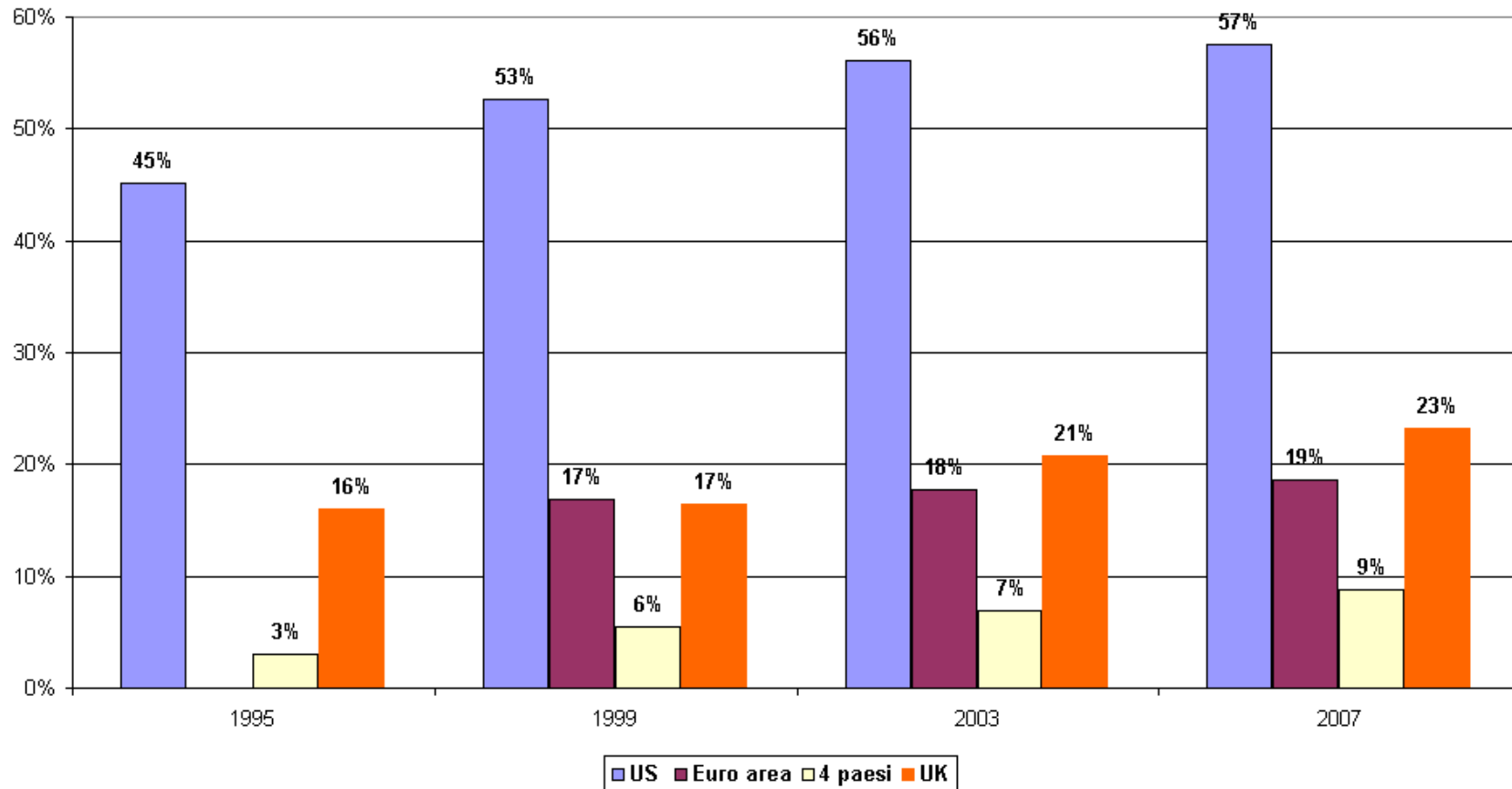
CRT products' growth...

Securities and ABS commercial paper in the US



...sustained by a parallel non-banking circuit

Financial assets other FI
(as a percentage of fin assets MFI and Other FI)



Risk spiral: credit, market and liquidity risk



The lessons for financial regulation and supervision



The characteristics of the recent financial crisis motivate a systemic vision of financial risks

- Integration of risk management procedures
 - Solvency and liquidity as integrated aspects of financial stability (adjustments to Basel 2)
 - Promoting more comprehensive management procedures
- Improving market liquidity
 - Increase transparency and liquidity of the markets on which risk credit transfer instruments are negotiated
- Crucial role of lender of last resort (LLR) in the management of the systemic implications of funding liquidity risk

Nexus between solvency and liquidity: rethinking Basel 2



- if Basel 2 had already been in place, especially in the USA, the crisis, even if not avoided, could have been less severe
 - Basel II is not a liquidity regulatory standard but:
 - capital position can affect banks' ability to obtain liquidity
 - banks have to evaluate the adequacy of their capital in the context of both their liquidity profile and the liquidity of the markets in which they operate (Pillar 2)
 - it strengthens the regulatory capital treatment of securitization and therefore can limit the CRT process which was one of the main causes of the spread of low liquidity structured products
- Basel Committee is working on liquidity issue by developing guidelines

Basel 2

- The final adjustments to and implementation of Basel 2 should address the issue of liquidity risk
 - Pillar 1: banks should be required to apply higher weightings to the liquidity lines extended to securitization vehicles, thus increasing the level of capital required
 - Pillar 2: coordination of the actions envisaged by Pillar 2 through internationally accepted guidelines on supervisory activities and liquidity risk management practices
 - Pillar 3: the present provisions do not adequately address transparency in relation to structured products, off-balance sheet vehicles and conduits. The BCBS is working to strengthen disclosure requirements in these fields

Liquidity management

- Different liquidity regimes have developed along national lines with different quantitative and qualitative rules
- Increasing supervisory emphasis on qualitative approaches (stress tests and contingency fund plans)
 - these tests omitted critical linkages and were mainly focused on idiosyncratic shocks
 - contingency funding plans were insufficiently robust
 - inclusion of liquidity sources that proved to be unavailable in generalized stress situation
- The task for supervisory authorities is to promote stress testing more standardized, rigorous, comprehensive and more integrated with contingency plans

Market liquidity risk and organized exchanges



- The liquidity of CRT instruments has been aggravated by the fact that those instruments are traded in OTC markets, and not in organized exchanges
 - introduction of organized exchanges for specific kind of financial instruments
 - participants to hold margins in order to maintain positions
 - an equivalent of capital requirement is set for non-bank participants
 - while the provision of a clearinghouse reduces the counterparty risk

Supervision and LLO

- When financial instruments are no longer backed by liquidity and there is an increasing funding liquidity risk, the role of lender of last resort (LLR) played by Central Banks becomes crucial
- Main issues: scale and scope of the LLR function with the widening of collaterals and of counterparts
- The monetary policy authorities should adopt eligibility rules capable of providing incentives for banks to engage in less risky speculative lending activity and to hold “high quality” paper as collateral for credit and liquidity risk

The main lesson of the current financial turmoil

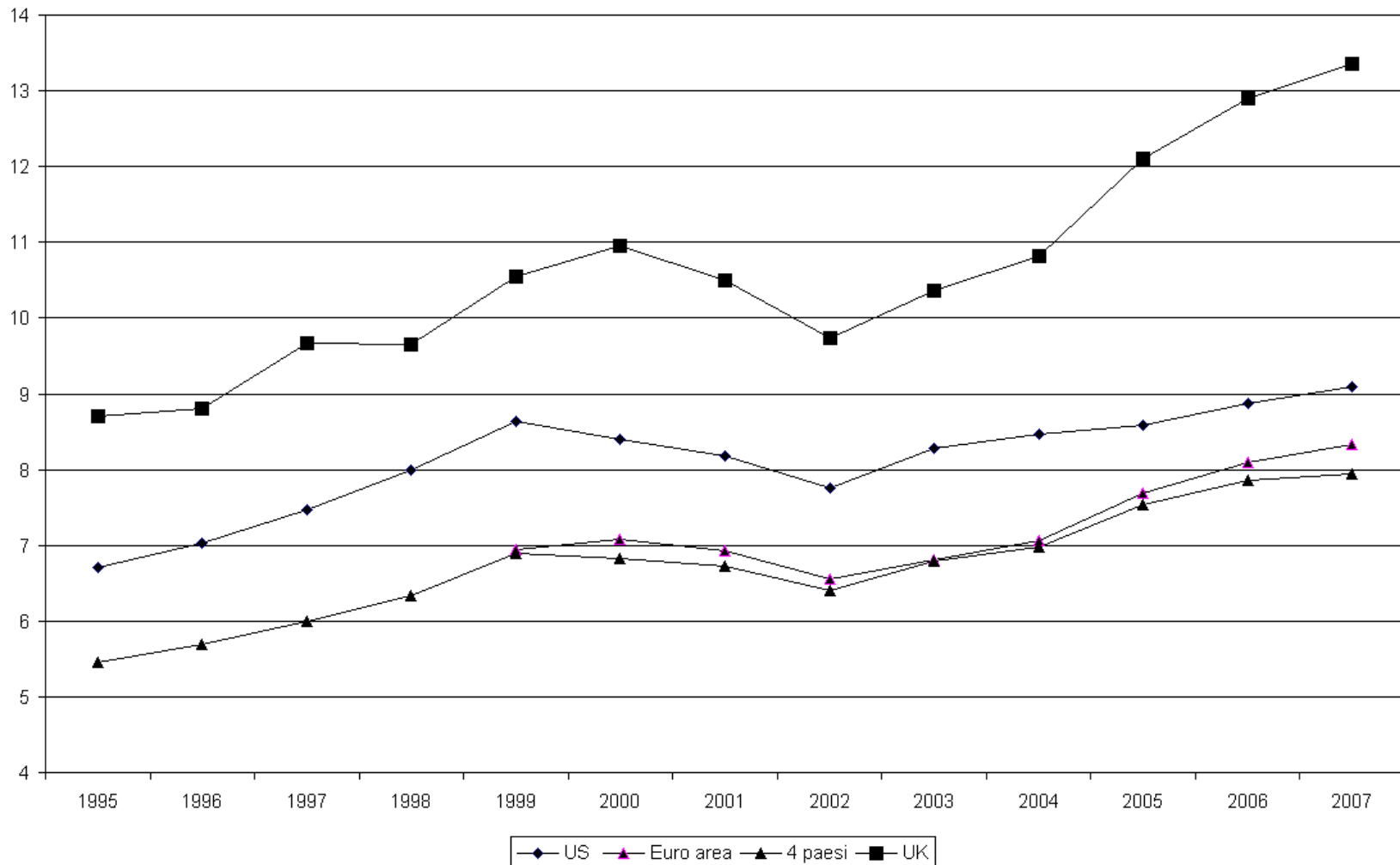


- Liquidity risk is once again a central topic for the stability of the financial system
 - Increase transparency and liquidity of the markets on which risk credit transfer instruments are negotiated
 - Adjustments to and implementation of Basel 2 to address the liquidity risk also via regulation of securitization and international guidelines on liquidity management regimes
 - Scale and scope of the LLR function with the widening of collaterals and of counterparts, and the enlargement of the area of regulation
 - Rethink of the design of regulation and supervision

BACK UP

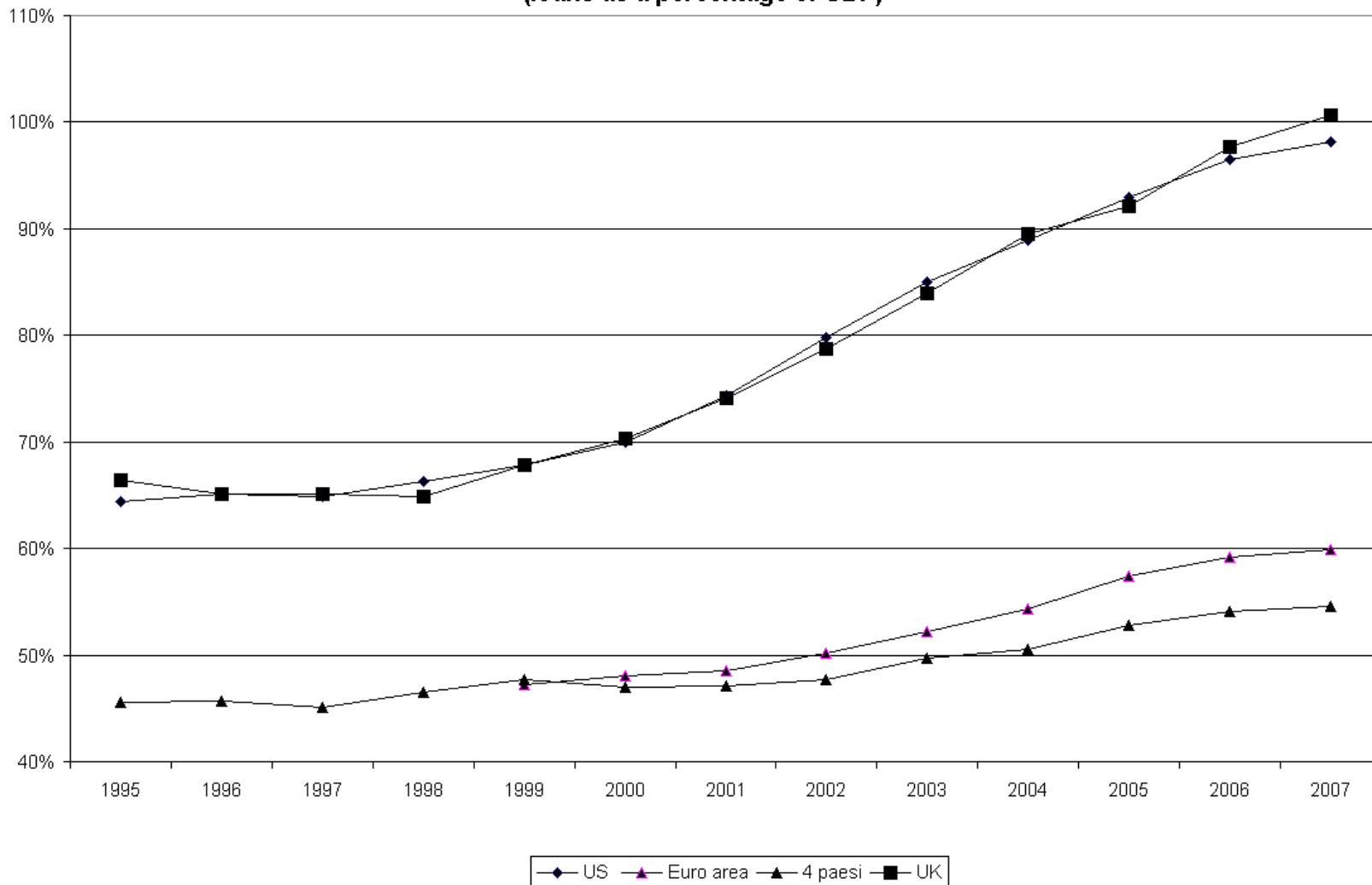
Transformations of financial systems: financial deepening...

Total financial assets/GDP
– Excluding rest of the world –



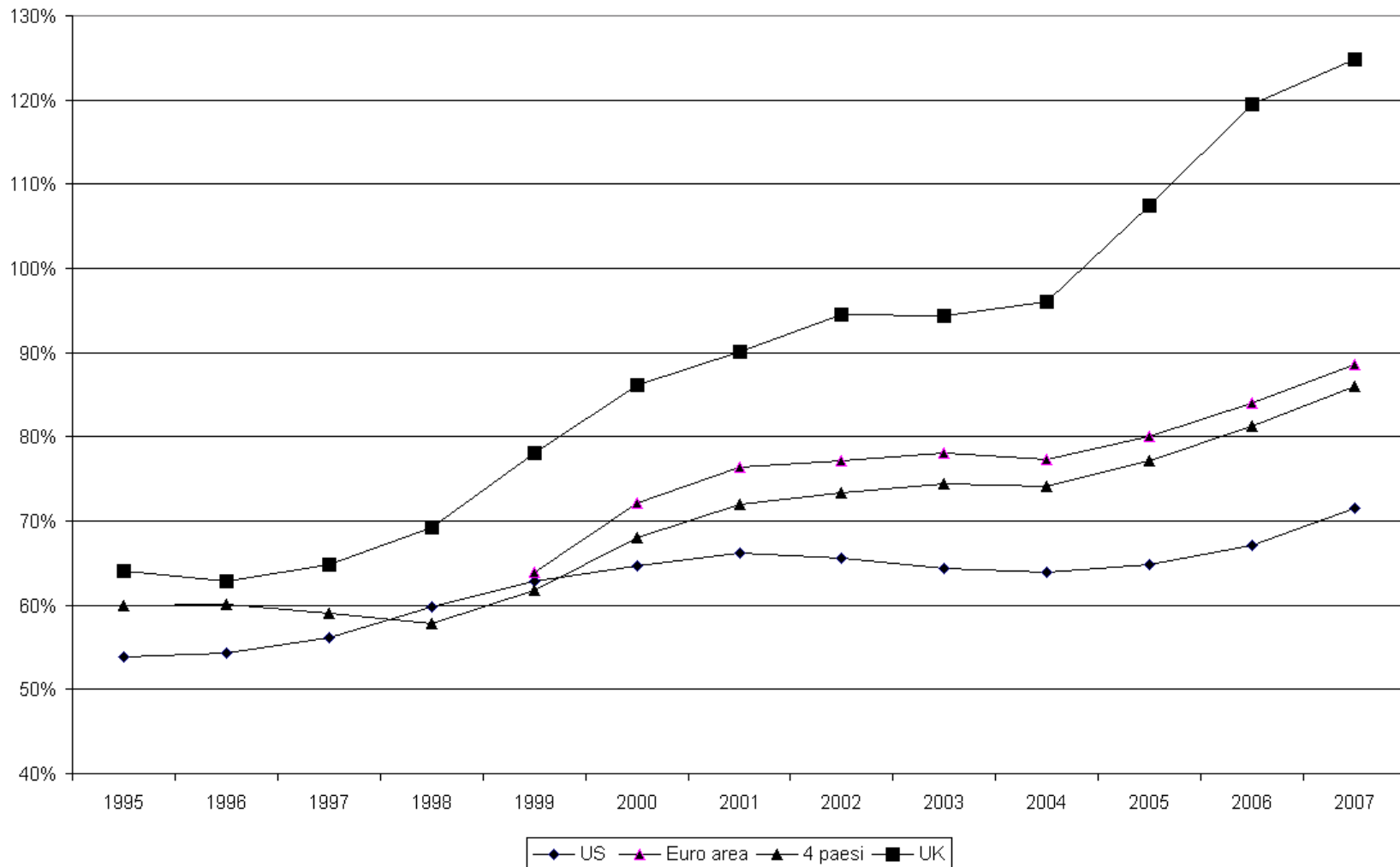
...related to the debt growth of households...

Credit to households sector (loans as a percentage of GDP)



...as well as of non-financial companies

Credit to non fin. companies
(loans plus securities as a percentage of GDP)



From deposit to securities funding

