

Taking liquidity stress testing to a higher level

Offering highly secure, high-availability software solutions that meet the trading industry's needs for intensive transaction processing, advanced analytics and modelling, Sybase provides some perspective on the importance of liquidity stress testing and outlines how institutions can be better prepared for future stress scenarios

While liquidity stress testing is not unheard of, nor uncommon in the financial community, events over the past couple of years have placed more emphasis on stress testing – and the need to take it to a higher level.

In the UK, the Financial Services Authority (FSA) rapidly responded to the 2008 financial crisis by requesting key information from banks and financial institutions on what particular assets and liabilities they were holding. Although, as of yet, no exact number has been placed on the amount of liquidity that should be held – nor the type of stress tests that should be conducted on this liquidity – it is clear that those institutions that do not satisfy the FSA could be heavily penalised by having greater capital requirements put upon them.

In the US, stress testing became paramount during March 2010, when the *Interagency Policy Statement on Funding and Liquidity Risk Management* was released. This was collectively issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration in conjunction with the Conference of State Bank Supervisors. The policy statement's purpose was to provide consistent interagency expectations on sound practices for managing funding and liquidity risk. In short, financial institutions should have processes that identify, measure, monitor and, as a result, be able to control their funding and liquidity risk. The policy was also, where appropriate, aligned with the international statement issued by the Basel Committee on Banking Supervision, titled *Principles for Sound Liquidity Risk Management and Supervision*.

In May 2010, the European Commission proposed that the European Union (EU) establish "an EU network of bank resolution funds to ensure that future bank failures are not at the cost of the taxpayer or destabilise the financial system". The thinking here is to apply a levy on the banks and use those funds to prevent a future financial crisis. This would theoretically ensure that any future bank failures would be better managed without disrupting the financial system. These resolution funds would not be used for bailouts or to rescue failing banks.

Thus, while proposals are plentiful, actual formalisation and endorsement of these plans have yet to progress. Given the attention from both the public and regulatory entities, financial institutions are keenly aware of scrutiny, and most claim to already manage and stress test their liquidity. Whether these efforts through the collection of data and thorough stress testing will be sufficient in the face of another crisis, no-one will know until it happens.

So how can the institutions better prepare themselves?

Data is the key to knowing intraday and future liquidity positions.

While institutions may have raw intraday data within their establishments, the liquidity-specific data from both internal and external sources – including current and forecast cash flows, availability and cost of funds, valuation of liquid and non-cash assets and liabilities – is not always readily available. Being able to gather this information into a single, composite view, representative in any reporting or stress scenarios, is of primary importance. Many institutions cannot categorically confirm they have such an enterprise-wide view and, while there are those that can, most probably derive the data using a mix of automated and manual processes, thus not guaranteeing the integrity of the data.

In addition to intraday data, historical data is useful too, such that analytics on past cash flows and trends can be seen as models for future events or, at the very least, act as substantiating evidence for a regulator as to why certain stress scenarios may have been applied for existing liquidity positions. Each scenario may have varying parameters and no single parameter will necessarily suit each stress event, neither will the parameters meet the expected or advised stress levels by a regulating body. But, by providing data-substantive rationale for the parameters used during the stress testing, this confirms to the regulators that more realistic scenarios were applied as opposed to 'guesstimating' what may happen.

Finally, sound management and contingency planning must be in place alongside any liquidity stress testing as part of any risk management process. The stress testing gives management the tools to see a variety of credible scenarios, but management also needs to play an active role and have in place an active plan. This plan must be reviewed regularly, to ensure that any probability of liquidity problems are recognised swiftly and addressed promptly to prevent a catastrophe as serious as insolvency.



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