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Thomson Reuters response to CEBS Consultation Paper ‘Second Part of CEBS’s Technical Advice to the European Commission on Liquidity Risk Management’ (Ref: CP19 Liquidity)

Thomson Reuters is the world’s leading source of intelligent information for businesses and professionals. Our financial data is updated on average 60,000 times per second and, at peak times, more than 200,000 times per second. We supply information from over 160 exchanges and OTC markets globally and maintain over 12 million data records.

Thomson Reuters welcomes the opportunity to offer comments to this consultation. Thomson Reuters is the largest provider of risk management software in the world, supplying trade and risk management solutions to over 750 financial institutions globally. With more than 950 risk professionals and more than two decades’ of experience in risk management, Thomson Reuters is pleased to be able to share its expertise with CEBS. We offer comments on the nature and definitions of liquidity risk presented in the Consultation Paper (CP) and some specific comments on its recommendations.

Nature and Definitions of Liquidity Risk

The CP defines liquidity and liquidity risks, outlining the former as the capacity to obtain funding and the latter as the potential threat to generate cash as a counterbalancing capacity against liquidity demand. We broadly agree with this view.

Liquidity not a ‘stand-alone’ risk

However, we note an apparent contradiction in the nature of liquidity risk presented in different parts of the CP. The Executive Summary, point #14, page 6, states:

“while liquidity risk is often triggered by problems in the management of other risk... its management should therefore be embedded in the institution’s overall risk management framework as a stand-alone risk”

whereas Part 1, point #6, page 13 states:

“While liquidity risk often materializes in connection with the failure...of an institution, it can also be triggered by cash flow or reputational difficulties stemming from other risks. Thus in order to understand liquidity risk and the liquidity risk management processes, it is necessary to analyse the relationship between the primary banking risks and their effects on liquidity.”

In our view, liquidity issues derive from mishandling risks related to funding, portfolio and collateral management, counterparties, failed settlements and other operational mismanagements. Failures to anticipate the full impact of adverse market conditions on the various risk factors to which a firm is exposed, expose that firm to liquidity risks. Liquidity risk should therefore be considered as the ultimate operational risk rather than a stand-alone risk.



In consequence, mitigating liquidity risks requires not only preparing liquidity buffers as a counterbalancing capacity, but also initially requires a fundamental review of risk factors and their alignment with the risk policy of the firm. In addition, the actual risk factors to which a firm is exposed may not be immediately visible, especially where securitization and derivatives are involved.

It may be necessary for a firm to map all the assets or risk factors underlying the assets under management to fully understand and visualize the actual risk exposure and potential concentrations. This in-depth review of actual risk factors, their links with the firm's main customers, the sensitivity and concentrations of key assets to those factors, potential correlations among assets, clients and portfolios, are fundamental to defining the appropriate stress scenarios of each firm.

Systemic risks

We see systemic risks in driving entire industry segments to using stress tests of a homogeneous nature, creating liquidity buffers with assets of comparable sensitivities, preparing financial institutions to trigger those buffers in similar market conditions. These remedies to liquidity risks could actually create liquidity holes of exceptional severity.

Our view is that each firm must engineer its own individual response and counterbalancing framework in the context of its own exposure, the exposure of its clients, and the nature of its business and align it with the approved risk policy.

Sources of liquidity risks

Liquidity risks originate mainly from two sources. The first source is the funding and funding costs associated with the lending books, defined in the paper as funding liquidity risk. The second source is the risks that assets held in portfolio or pledged as collateral may be mispriced or simply impossible to sell due to adverse market conditions. This risk is defined as market liquidity risk. The CP highlights links between those two sources originating from the growing practice of pledging securities as collateral for OTC positions or lending books.

However, we also see a third source, which is the liquidity risks related to a counterparty's unfulfilled obligations, missed or past due settlements, which we define as counterparty liquidity risk. Causes may either stem from financial problems with the counterparty, or from connectivity failures or all other business continuity issues and especially from data mismanagement. The latter occurs especially often as all systems for straight through processing linking risk takers with their execution venues, brokers, custodians and administrators usually require complex and frequent database alignment. Failure to process transactions in a timely manner may result in payment failures which, in times of extreme market conditions, can disrupt the firm's liquidity management.

In our view, the proper handling of all liquidity problems and the prevention of liquidity risks, regardless of their source, should involve a very tight monitoring of concentrations. Banks are traditionally structured to monitor and hedge concentrations within their lending books, thus focusing on funding risk. Buy-side firms are normally required and fully equipped to monitor and diversify their concentrations within portfolios, therefore preventing market liquidity risk.

Challenges arise when both the buy-side and the sell-side need to tackle cross-asset concentrations to similar risks, when the concentrations are hidden by the derivative nature of the instruments, when

funding can be disrupted as a result of market movements changing the value of collateral and when all are impacted by their counterparties' failure to handle those risks properly.

It would be difficult to predict all business scenarios that can result in imbalances and disruptions of this nature as they tend to result from unexpected correlation and volatility movements due to unforeseen events. It is possible, however, to tightly monitor exposure concentrations of all kinds, internal and external, as they point out the vulnerabilities of a firm (internal) and even the ones of the entire industry and financial markets (external). Once concentrations have been identified at the very root of financial risks, we suggest using a range of real-time news and data instrument to maintain a predictive surveillance of the markets, in other words trying to avoid bubble burst and its likely impact on market liquidity.

Build up of concentrations and speculative bubbles

There are two kinds of markets. One kind is wealth generating markets such as stock exchanges or real estate, which aggregate liquidity based on the perceived value of the assets traded. The other kind is zero-sum game markets such as futures and options where the gain of an investor's gain matches the losses of another. One macroeconomic role of the former is to absorb or regurgitate liquidity as needed by the economy; the latter is a hedging tool for operators with matching exposures to risk factors such as fluctuations of commodity or currency prices for example.

A vital element to maintaining the balance in wealth generating markets is the different timeframes in which investors operate: what one perceives as a short term opportunity to sell an asset is seen as a long term investment by others. The exposure derived from the various investments leads to hedging with zero-sum game markets such as futures and options. Hedges are always arranged for the short term, or rolling from tenant to tenant, due to the risk profiles and settlements they require. Zero-sum markets do not create or drive trends but can dramatically amplify the short term price fluctuations of the underlying investments from which they are derived.

Speculative bubbles tend to inflate when a large majority of investors trade in a single direction regardless of a timeframe. Risk concentrations form at that point and are particularly likely to trigger liquidity problems as everyone become a short term trader and may exit in panic when the bubble bursts. While it would not be possible to predict where and when the next bubble will be created, there are tools to help monitor risk concentrations build-up and the liquidity risks associated.

Monitoring concentration build-up

The key to understanding a firm's vulnerabilities is to point out the actual risk factors to which it is exposed. For example, a firm holding a portfolio of securities themselves exposed directly or indirectly to commodity prices would get only a partial view of its total risk exposure by running simulations just on equity prices. The potential impact of the underlying commodities on equities should be studied carefully. Arguably, the simulated prices of equities would encapsulate this effect but this relies on many assumptions related to the covariance of the equity versus underlying price returns, the impact on market volatility and liquidity of extreme market movements, correlations within the industry and so on. In other words, considering the impact of liquidity risks requires monitoring risk exposures at their roots, as much as possible.

Each firm should therefore ensure that it identifies all root-risk factors, monitor the concentrations they build up and add radical correlation changes into their scenarios.



Price movement and volumes traded give important indications of potential concentration build-ups as they point out the degree of emotion in which securities or financial instrument are traded. A well-balanced market where buyers meet sellers in steady volume tend to return normally distributed prices and P/L changes, in both the short and medium term. Before a market loses balance and experiences a massive drawdown, some typical distortions are often noticeable, such as directional volumes imbalance, unexpected changes in correlations, unusual standard deviations, and so on. Simultaneously, news releases related to that market tend to increase in volume, new sources of information appear and market sentiment tends to point to a single direction. Even though market liquidity may actually be at its highest at this point, the market gets vulnerable.

Impact of volatility

The impact of volatility and correlations on market liquidity is massive and complex. The unpredictable nature of correlations under stressed conditions makes predictive quantitative models less reliable. The interaction of volatility, liquidity and correlation is three-dimensional and non-linear. Simulations based on history can be misleading too since financial market typically suffer from remedies or structures derived from a previous crisis so the next crisis will necessarily be different from previous ones.

It is possible, however, for analysts to keep tracking the effects that liquidity (expressed in market depth), volatility (implied) and correlation have on each other and relate those observations to news as they break on a real-time basis. For example, one can define several categories of news related to oil prices, set up systems for machine-readable news to automatically trigger records of price changes, volatility, impact on correlations, on credit, credit correlation and so on. It sets the base for an exploratory forward-looking approach that can supplement a quantitative statistic-based analysis.

Counterparty-generated liquidity risks

Similarly, it would be possible to prevent some of the counterparty-generated liquidity risks by monitoring the main transaction flows electronically. All OTC transactions can be documented and categorised. Outstanding amounts, issuers, ratings, geographies, sectors, can be reported in real-time under statuses such as confirmed, cleared and settled. In this way, not only will each firm be in control of their amount at risk, but the regulators can have a direct view of concentration build-ups and may even be in a position to adjust counter-balancing capacities accordingly.

As explained above, connectivity and business continuity infrastructure and recovery plans are nowadays critical to maintaining transaction flows, hence preventing some of the liquidity risks related to operational and technical failures. We believe that each firm should establish a map of their connectivity workflow for each category of business and category of clients they have. It would then be possible to “rate” those networks in terms of business efficiency, scalability and resilience and watch the less efficient ones more closely or allocate trading and position limits accordingly.

Finally, we recommend that financial institutions and regulators consider the implementation of trading and exposure limits based on liquidity risks, assessed quantitatively and qualitatively using the above criteria. A simple hike in regulatory capital would not address the roots of the problems that lead to liquidity holes. In addition, it may lead to a focus on some markets and financial instruments or be an incentive to circumvent the rules with new financial innovations, which would eventually lead to new concentrations and growing risks of bubble burst.



Specific Comments on the Report's Recommendations

In this section, we offer a number of specific comments on some of the recommendations laid out in the CP.

Recommendation 1

The effectiveness of managing liquidity risks depends on the overall competence for managing operational risks associated with the activities of the firm and the complexity of the instruments and markets it chooses to trade or hold.

Recommendation 2

An internal liquidity allocation mechanism relates to the operational risk of asset/liability management. Firms should have a transfer pricing system to assess the value of assets and liabilities taking many factors in consideration. At that stage, liquidity under a range of scenarios should be assessed and factored in.

Recommendation 3

We support this recommendation and also believe the monitoring and provision of liquidity should be segregated and that a unit should be dedicated to providing funds, either externally or cross-department. At a macro-economic level, regulators should also aggregate data and monitor market liquidity and concentration build-ups.

Recommendation 5

Indeed there is no one-size-fits-all solution to this problem. Regulators should be aware that their being too prescriptive and inflexible in this field can contribute to systemic risk.

Recommendation 6

Assessing the liquidity-generating capacity of an asset involves scenarios. Each firm therefore needs to consider the liquidity of its assets under scenarios appropriate to the very context in which they usually do business.

Recommendation 7

In the aftermath of the credit crunch, all netting agreements and collateralisation rules should be reviewed, and adapted to each client, the nature of the market they trade in and the business scenarios they might find themselves in. Special attention should be given to cross-asset agreements.

Recommendation 8

We support this recommendation. "Documentation risk" and risk associated with covenants relates to the "counterparty liquidity risk" we define above.

Recommendation 10



We support this recommendation. This also relates to the counterparty liquidity risk defined above. In addition to the recommended measures, we believe business networks and clients should be categorised and rated based on the time it would take to confirm, clear and settle the transactions.

Recommendation 13

Liquidity monitoring units should be given an enterprise-wide responsibility and remain independent from the business units.

Recommendation 14

In practice it would be difficult to simulate the impact of a business scenario on asset prices that would result from liquidity issues because extreme market conditions tend to create or eliminate correlations and volatility, which has a dramatic and unpredictable impact on prices. Highlighting and monitoring potential vulnerabilities should provide a more realistic approach than quantitative analysis.

Recommendation 16

Regulators must be extremely cautious not unwittingly to create new sources of systemic risks when recommending a methodology for establishing liquidity buffers.

Recommendation 17 and 21

We support these recommendations and believe that monitoring concentrations and trying to prevent liquidity risks from impacting the firm is the best approach. Contingency funding scenarios should be dynamically drafted and actively adapted based on such analysis.

Recommendation 19

Regulators will be in the best position to identify concentrations and risks if they gather information and consolidate it across markets, instruments and countries.

Recommendation 26

Standardised one-size fits all prescriptive regulatory approaches should be discouraged as their inflexibility may lead to systemic risk. We are concerned that this recommendation may contradict recommendations 22 to 24.

Recommendation 29

We support this recommendation and also believe that special attention should be given to cross-border and cross-market implications of liquidity risks and liquidity movements. Bank supervisors should gather in international liquidity watch groups, facilitated by data providers and endorsed by regulators.



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