ALM – Liquidity Risk

Liquidity risk describes the probability a bank being unable to meet its financial obligations as they come due, amid lack of liquid asset, an inability to liquidate assets or obtain adequate funding.

The so-called funding liquidity risk deals with a bank unable to honor expected or unexpected current or future cash obligations. – Whilst market liquidity risk, on the other hand, describes an institution not able to offset or eliminate a position without significantly affecting market prices because of inadequate market depth or a sudden market disruption.

In maintaining sufficient levels of liquidity, a bank can broadly pursue two types of strategies: Under the liquid assets approach, a bank maintains liquid instruments on its balance sheet which are drawn upon when needed. Such pool of unencumbered assets (usually highly tradable government securities) can be liquidated or used to obtain secured funding through repurchase agreements and other secured facilities. - Under the cash flow matching approach, on the other hand, an institution attempts to match (expected / unexpected) cash outflows against contractual cash inflows across a variety of near-term maturity buckets.

Due to the concept´s complexity, no single metric will in its entirety adequately reflect the actual liquidity risk of a bank. The concept stresses, though, the importance of a pool of widely diversified funding sources: Such should reach across different types of depositors, investors, also products, marketplaces, and currencies, as well as extend to and include relationships with investors, not least when financing and selling assets.

In parallel, a bank must regularly assess its secured and unsecured funding capacity under varying conditions. This is due to liquidity risk possibly arising from sources not necessarily linked to a bank´s strategy: For example, historically constellations were observed, where lack of access to liquidity actually impacted – besides banking - all industry and service sectors, due to frictions in the overall macroeconomic environment or major geopolitical events.

Concerning intraday- and short-term liquidity, a bank will focus on cash flow, its cash position and collateral management. Medium- and long-term an institution will probably take a matrix view on contractual and expected cash flows as well as planned transactions, both in total, across the entire balance sheet, as well as in certain segments, such as in each currency, for instance. Such forecast would not only include future cash flows related to assets and liabilities, but also off-balance sheet positions. Hence, ultimately a bank´s exposure to liquidity risk deals with a potential cash flow mismatch, or liquidity gap, along the entire maturity ladder.

Clustering a bank´s assets based on to their liquidity quality is an important preparatory step: Accordingly, assets can be broken down into such pledgeable (depending on central banks´ and industry criteria), repoable, or securitizable (retail or consumer loans). – Also, securities can be grouped according to their liquidity value, with – for example - high values applied to such eligible to be held by central banks. Other liquidity value criteria include rating and credit quality, market price availability, maturity, type of security, time to settlement or else. – A continuous review of its assets will enable a bank to assess its ability to convert unsecured funding towards a secured basis, not least with a view to optimize funding costs.

Ongoing monitoring of a bank´s liquidity is also relevant in preparation for a potential contingency: Therefore, an institution should have in place an asset reduction plan and a financing strategy for bank-specific and market-related liquidity events. Should a disruption occur, then funding from asset liquidation would be ensured for high-grade paper (in particular, eligible central bank assets), otherwise haircuts (i.e. discounts) be applied depending on liquidity quality. Besides, a bank could also consider utilizing unused credit facilities, such as provided by the central bank or other counterparties: As history has shown though, in a crisis environment interbank lending can disappear quickly.

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DEPENDENCY ON FINANCIAL INSTITUTIONS	$\frac{\text{CASH + SECURITIES + S/T BANKING EXPOSURES}}{\text{SIGNIFICANT RESOURCES FROM FINANCIAL INSTITUTIONS}}$
LIQUIDITY VULNERABILITY	$\frac{\text{EASILY DISPOSABLE ASSETS}}{\text{EASILY WITHDRAWABLE FUNDS}}$
COVERAGE OF LOANS BY DEPOSITS	$\frac{\text{DEPOSITS}}{\text{LOANS}}$
SHORT-TERM LIABILITIES COVERAGE BY LIQUID ASSETS	$\frac{\text{LIQUID ASSETS}}{\text{SHORT TERM LIABILITIES}}$

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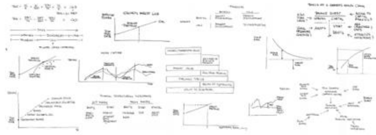

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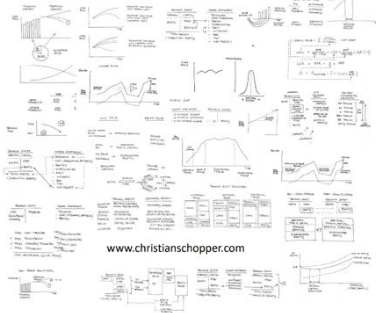

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