

Press Points for Chapter 3:
Market and Funding Illiquidity: When Private Risk Becomes Public
Global Financial Stability Report (GFSR), April 2008

Key points

- **Complex linkages between funding and market liquidity pressures have been established during the current crisis. These have compounded on one another to produce a downward spiral of illiquidity.**
- **The benign financial environment of recent years encouraged many financial firms to become complacent about liquidity risk management given their dependence on wholesale funding sources. They “underinsured” against a system-wide illiquidity event and implicitly relied on central bank intervention to meet emergency liquidity requirements.**
- **To address the issue, firms need to take liquidity risk management more seriously. In particular, stress tests need to be increased in severity and supervisors should ensure that large firms are able to survive significant periods without access to wholesale markets.**
- **Central banks have appropriately innovated to improve the distribution of liquidity and the functioning of interbank markets. The crisis has shown the need for central banks to be able to extend liquidity at a range of maturities, to a wide range of counterparties, against a wide range of collateral.**

As the crisis has progressed from a funding problem for SIVs and conduits to a widespread reduction in interbank liquidity, liquidity management within a number of banks has been shown to have been inadequate. Meanwhile, diminished liquidity in funding markets has required unprecedented intervention by some central banks to ease strains in the interbank money market.

Chapter 3 looks at the nexus between market liquidity (the ability to buy and sell an asset with a small associated price change) **and funding liquidity** (the ability of a solvent institution to make agreed-upon payments in a timely fashion). It also examines the policy interventions taken by various central banks. A number of policy implications are drawn from the analysis.

The immediate challenge is to reduce the duration and severity of the crisis. Actions that focus on reducing uncertainty and strengthening confidence in mature market financial systems should be the first priority. Some steps can be accomplished by the private sector

without the need for regulatory changes. Others, where the public nature of the problem precludes a purely private solution, will require official sector involvement.

Areas in which the private sector practice could improve:

- More extreme stress tests need to be undertaken with longer periods of funding illiquidity assumed and improved contingency planning. Greater transparency regarding how liquidity risk is managed within the firm should be available to investors and counterparties, in particular with regard to implicit lending commitments to off-balance sheet entities.
- Institutions should disclose their broad liquidity risk management strategy. For instance, they could state their target period of survival without wholesale market funding and their underlying assumptions.
- Larger holdings of highly liquid assets to use as collateral would allow institutions greater access to funding sources during periods of stress. Firms also need to carefully manage cashflow mismatches and concentrations of funding sources.

Areas in which official sector action should be considered:

- More attention could be paid by supervisors to ensure banks have appropriate liquidity risk management systems and a strong internal governance structure. When supervisors are not satisfied that risk is being appropriately managed, they should insist on greater capital and liquidity buffers.
- Improvements in ensuring progress toward achieving sound practices for liquidity management would help to address shortcomings at some institutions. If progress is insufficient, more traditional means of addressing liquidity risk (e.g. minimum holdings of liquid assets) may be needed.
- Expediency in the crisis has meant that central banks have needed to inject liquidity against a wide range of collateral. However, central banks will need to have well-established collateral pricing policies to avoid incurring undue credit and liquidity risk.
- Central banks should have a wide group of counterparty banks established during normal times which are able to access central bank liquidity during stressful times.
- Central banks should have the flexibility to provide liquidity at a range of maturities.
- Central banks should ensure they have access to sufficient information on individual banks so as to be able to independently judge the health of potential counterparties. Cross-border information sharing and coordination among regulatory bodies should also be strengthened.