



cutting through complexity

FINANCIAL SERVICES

The global challenge of liquidity

Compliance to business advantage

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Although much attention has focused on Basel III's strengthened capital adequacy requirements, the forthcoming global standards for managing liquidity risk are likely to pose an even greater challenge for banks than the capital ratios. The liquidity challenge is likely to be so tough that banks will need to reassess the entire way they do business. In May 2012, KPMG highlighted the urgent need for banks to focus on liquidity. In this new report, we examine why liquidity¹ is so challenging and the steps banks around the world will need to take, not just to survive but to gain a competitive advantage.



A chance to **reappraise strategy**, funding and profits can create a **business advantage**. Second, an **improvement of liquidity management** is a necessary but not sufficient condition of **success**.

Two points stand out from this analysis. First, mere compliance is scarcely an option. The costs and challenges of compliance with the forthcoming liquidity requirements are already so great that banks should see the new rules as an opportunity, rather than a game-changing threat. A chance to reappraise strategy, funding and profits can create a business advantage. Second, an improvement of liquidity management is a necessary but not sufficient condition of success. Banks should take a long, hard look at their entire operations, from treasury management to marketing to the handling of risk and business planning. Only an ambitious, enterprise-wide solution will work. "Banks must chart a path forward for cutting their way through complexity to achieve both regulatory compliance and a sustainable business advantage," says Giuseppe Niolu, a Financial Risk Management partner with KPMG Advisory in Italy. Niolu also serves as global leader for Liquidity Risk Management Solutions and the Market and Treasury Risk Services Network.

Before explaining what needs to be done, a quick recap is in order. Over a decade ago, banks around the world were ignoring centuries of good practice by imprudently mismatching the maturities of their assets with their liabilities. Funding was so plentiful, they

began to think the old rules no longer applied. The fool's paradise, and the liquidity that went with it, evaporated in 2008 as the financial crisis spread across the world. Banks that had come to rely on borrowing from each other no longer trusted their creditworthiness. Credit dried up. Also, consumers became more concerned about the extent of their deposit protection and opened multiple bank accounts.

Since then, financial conditions have not fundamentally stabilized and a lack of liquidity has become a chronic issue for all but the most creditworthy banks. Furthermore, the world's financial authorities have moved to tighten liquidity requirements to try to ensure the mistakes of the recent past are not repeated. As the previous report by KPMG International pointed out, the laudable intention of the regulators to strengthen liquidity requirements has exacerbated the difficulties of maintaining sufficient bank liquidity. This predicament has highlighted the rise of shadow banks that provided homes for deposits while escaping close scrutiny. Thus, in the midst of a sluggish world economy, fundamental flaws in the Eurozone, and indecisive economic policies, banks face a massive task to meet the liquidity requirement of Basel III.

¹ Liquidity: a bigger challenge than capital, KPMG International.

Basel III proposes two key liquidity-related ratios. The Liquidity Coverage Ratio (LCR) is designed to strengthen the ability of banks to withstand adverse shocks. It would require banks to hold sufficient high-quality liquid assets (including cash, government bonds and other liquid securities) to meet a severe cash outflow for at least 30 days. The Net Stable Funding Ratio (NSFR) is intended to ensure banks hold sufficient stable funding (capital and long-term debt instruments, retail deposits and wholesale funding with a maturity longer than one year) to match their medium- and long-term lending needs.

According to the Basel Committee on Banking Supervision², the average LCR was 90 percent for large, internationally active banks as of the end of June 2011. The average NSFR was 94 percent. For all banks in the sample, the shortfall of liquid assets totaled €1.76 trillion (3 percent of the total assets among the institutions surveyed), if banks were to make no changes to their liquidity risk profile. There was a shortfall of stable funding of €2.78 trillion.

These estimates assume that banks would meet only the minimum requirements, but banks are likely to hold an additional liquidity buffer of 8 percent to 10 percent above the minimum levels for a number of reasons. First, national regulators will require individual banks to meet even more stringent liquidity requirements if they determine that a bank's liquidity risks exceed those covered by the minimum ratios. A second reason is that these national overseers are aiming to "ring fence" branches and subsidiaries of foreign banks and this may force bank groups to hold more liquidity in total than they would if there were no such requirements. Third, the banks themselves might want to hold additional liquidity as a cushion.

Given the scale of the liquidity challenge, conventional means of rebalancing banks' assets and liabilities are unlikely to be sufficient to meet the shortfall and build a strong position in the market. Conventional measures include: an extension of the maturity of liabilities, a switching out of less liquid assets, sales of assets and the raising of capital. These will go some of the way to closing the liquidity and stable-funding gaps. In addition, banks will try to attract more retail deposits,



² Results of the Basel III monitoring exercise as of 30 June 2011.
<http://www.bis.org/publ/bcbst217.pdf>



None of the steps **toward compliance** can be taken in a vacuum. It's **critical**, therefore, to align these **primarily liquidity-focused actions** with **business strategies** and **operational structures** – **especially** since these strategies and structures must change in response to the changing **business environment**.

– *Giuseppe Niolu*

but the total sum of available deposits tends to grow slowly, and other banks will be chasing after the same depositors, thereby pushing up the interest rates paid them. In short, funding costs are likely to go up and the yield on high-quality liquid assets to go down.

Every reputable bank is preparing in its own way to deal with the coming regulations. But to gain a competitive advantage, bank leaders must go beyond mere compliance and make more fundamental changes in the way their banks operate. Nothing less will ensure the survival and prosperity of the financial institution. Moving beyond compliance to identify and exploit business opportunities requires a broad approach that encompasses four main areas: Business Models, Governance, Measuring and Monitoring, and the IT Framework. Success will depend on integrating all four into a strategy that goes beyond compliance.

Business Models

Since global economic trends and compliance with the liquidity requirements will shrink profits, banks will have to innovate to improve both efficiency and revenue. This will require a fundamental reassessment of their business models, burdened as they are by siloed operations, not to mention a complex organization that has multiple business lines and branches. New banking business models will emerge as value chains are modernized and the industry is restructured to create leaner, more nimble financial institutions. This is likely to entail the integration of departments and functions, as well as a rationalization of technology platforms and channels to deliver services to the customer.

The Chief Marketing Officer will take the lead in finding ways to expand the share of wallet, by redefining customer segments and repricing loan products, fees and other means of raising revenue. It will be critical to

develop new financial products. As well as creating new product lines, banks must also consider divestitures or dropping lines of business where the cost of funding rises too high. Banks are already seeing this trend as they compete for new retail deposits or raise additional medium-term wholesale funding. All cross-selling opportunities need to be re-examined.

As banks revamp their business strategy, risk managers will have to play a central role in formulating the new plans. Every planning assumption should face a rigorous stress-test in which the underlying risks are evaluated. Banks should learn from the experience of energy companies in scenario planning, championed by Royal Dutch Shell and others, in which the probability distribution of each assumption is scrutinized.

Governance

Banks will have an almost impossible task of upgrading their business model without a commensurate improvement in their governance. This entails elevating the role of the Chief Risk Officer (CRO) to ensure the bank takes an enterprise-wide view of risk and evaluates the risk inherent in every assumption of the business plan.

Improvements in governance should not stop at changes that will enable banks to prepare new business models; banks must also work to create greater transparency. Externally, this will help to restore the trust of customers, partners and regulators. Internally, it will enable the Chief Executive Officer and his team to tighten control of the whole enterprise. In the past, banks created intricate legal structures to facilitate regulatory arbitrage³. These structures worked so well at shielding risk that even senior management was often unaware of the bank's total exposure.

³ See for example, speech by Mr Jaime Caruana, General Manager of the BIS, 6 June 2012. <http://www.bis.org/speeches/sp120612.htm>

How should banks enhance transparency? There must be a very clear definition of the roles and responsibilities of the different units, with strong mechanisms for integrating and coordinating them. Nothing should be left to guesswork and interpretation. For example, the Chief Risk Officer and the Strategic Planning Unit should jointly design and deploy Asset & Liability Management models to ensure there is equilibrium between the two sides of the balance sheet. Also, the Treasury Department and Strategic Planning should together define new funding policies to improve stability and diversification. Another example: the CRO, the Management Control Unit and the Commercial Units should jointly improve the management control system to take into account the cost of liquidity within a proper Fund Transfer Pricing framework, thereby enabling the proper pricing of liquidity within the organization. These and similar measures will improve internal transparency and coordination.

Modeling and monitoring

One of the paradoxes of the modern bank is that the Risk function is still not fully integrated into strategic planning, despite the failure of risk models to predict the financial crash of 2008. Banks have become better at predicting market risk and credit risk, but the modeling of liquidity risk is less sophisticated. Bank leaders need to put their best minds to work on devising new liquidity-risk models, an extremely difficult task given the speed with which the financial markets change and the fact that the final liquidity regulations are not known yet.

The changes to the business model and governance will place greater demands on the bank's analytical skills in other areas, too. For example, plugging in a risk component to business planning is a very complex task. Each individual step may be simple but it is a real challenge to build a model that can assess all the variables, volatility and correlations at the same time and analyze all the possible outcomes based on those variables. It is relatively easy to build a value-at-risk model for a bond portfolio because there is a wealth of historical data. But to evaluate the risk of establishing 100 new branches in Asia requires human judgment, in the absence of hard, historical evidence.

In particular, banks need to set up a robust process for measuring and monitoring liquidity risk. This process should include a strong framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance-sheet items over a range of time horizons. The framework should include: a good method of diversifying the sources of funding; the ability to manage intraday liquidity positions; the skill to manage collateral positions, differentiating between encumbered and unencumbered assets; the ability to conduct regular stress tests; a formal contingency funding plan in the event of a sudden liquidity shortfall; and the management of a buffer of unencumbered and high-quality assets in the event of liquidity stress.

The Basel III liquidity requirements will force banks to monitor closely their positions against the LCR and NSFR, but banks will need to go beyond compliance by setting up systems that will enable them to make



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forward-looking assessments of their liquidity ratios. These calculations will be based on a range of possible scenarios and behavioral assumptions, such as various estimates of deposit-withdrawal rates in the event of a market-wide financial shock. These systems should also assess the ability of the bank to maintain its LCR and NSFR during a period of balance-sheet growth or restructuring. All the variables will have to be linked to the overall business plan.

IT framework

A transformation of this magnitude will lead to a tremendous increase in the demand for data, from marketing forecasts to liquidity scenarios. And the complexity of managing the data will rise exponentially due to the fact that banks' value chains are so fragmented. Apart from compliance, banks will want to use the data to gain a deeper, richer view of their customers – a key driver of changes to the business model.

In the face of such stringent demands, IT systems will need to be upgraded as comprehensively as the rest of the bank's operations. Highly complex IT systems that are tightly integrated into the traditional banking models are not flexible enough to adapt to the new ways of operating. In fact, a completely new IT architecture will be needed to power the next generation of banks.

Many are spending huge sums on building complex systems designed to meet new reporting and compliance requirements. But the bank leaders are taking a different approach, by rationalizing such systems to make them more flexible and efficient. They are requiring new designs that deliver greater value by aligning the IT framework to the need for new business models. They are asking, "How can I take advantage of compliance with the new liquidity and capital requirements to beat the competition?"

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Conclusion

At this crucial juncture, as the world awaits the final rules for Basel III and from various national authorities, banks must not delay in preparing for change. The bolder and more carefully prepared institutions are likely to be the ones to take advantage of the new regulations. "Rigorous self-analysis, accommodating change and embracing transformation are not easy for any business, but constitute a matter of life or death for banks today," says Niolu.

The liquidity challenge is just one piece of a puzzle that includes capital strengthening, the management of sovereign risk and the global economic slowdown. In such a complex and fast-changing environment, leading banks will focus on developing a fully integrated enterprise-wide risk management

framework, consisting of strategies, methodologies, organizational structures, processes and IT. Only then can banks perceive, evaluate and respond to risks at all levels of the organization, by defining the roles and responsibilities of risk owners, risk managers, risk controllers and risk "planners." By doing so, risk secures its proper place in the bank's operations and strategy – and in mapping a path to sustainable profits.

Banks face a multi-dimensional problem, and liquidity is but one aspect. There also needs to be a strong focus on strategy, organizational structure, capital strengthening and customer relationships. There is no time like the present to tackle these many challenges.

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