

Batting for liquidity risk management

It is important for banks to demonstrate an enhanced ability to distinguish different risk profiles, balance risk appetite and capacity. **Zaid Kamhawi** emphasises the importance of a credit bureau and data pooling for managing liquidity risk efficiently.

The global financial meltdown has escalated a specific kind of financial risk among the banking industry: liquidity risk. This risk arises from the difference in payment maturities. In other words, banks typically accept deposits that can be withdrawn at any time, while they may lend money to borrowers for longer tenors. This nature of a bank's lending business is likely to lead to a mismatch between assets (loans) and liabilities (funding), resulting in liquidity risk.

Typically, banks mitigate and manage risk by relying on tools available via the financial infrastructure of a country, whether it is interbank lending networks, payment networks or laws and regulations. The current financial crisis has, however, significantly highlighted the need for setting the right infrastructure into place. A robust information sharing network made available by credit bureaus is one such element and represents an integral part of the financial system infrastructure of countries.

The objective of credit bureaus is to facilitate the flow of credit information and enhance risk management practices at financial institutions. They play an important role in allowing banks to better manage and control asset repayments that help better assess a borrower's capability and improve the overall accuracy of decision-making.

Credit bureaus can greatly support banks in managing liquidity risk, in addition to helping them manage credit risk. Banks are conscious of the fact that the ideal way to control liquidity risk is by better managing repayments, defaults and collection of funds. This correlation between credit risk management and liquidity risk management

is twofold. The first is on the liability side and the second is on the asset side of a bank's balance sheet.

The asset side

The current crisis has resulted in banks facing deteriorating loan portfolios as a result of a steep decline in the real estate market, job losses and the general slowdown in the economy. Banks manage credit risk based on certain assumptions made on the ability of borrowers to repay their loans. Any sudden change to these assumptions triggers a mismatch between the expected time of repayment and the actual time of repayment, putting serious strains on a bank's expected cash flow.

Funds from loan repayments represent one of the main sources of cash inflows for banks. This dependency has called on banks to predict more accurately the probability of repayment from potential and existing customers in order to control the risk associated with late payments or defaults. Controlling credit risk and improving the management of lending requires high degrees of accuracy in underwriting decisions. Such accuracy is only possible by relying on comprehensive and accurate credit information that could help determine the exact risk profile, creditworthiness and repayment probability of a potential borrower.

In early 2008, the UAE continued to experience a huge inflow of hot money into its banks on the back of speculation that the UAE dirham was to be de-pegged from the dollar. Unable to distinguish such speculative deposits from regular deposits, several banks continued to lend without assessing the inherent risk, partly due to the abundance of liquidity

that dissolved any urgent need to focus on matching maturities in the short term. In the second half of 2008, this speculative hot money suddenly began to be withdrawn out of the region as the revaluation possibility became remote. This change resulted in a situation where bank loans exceeded deposits.

The prevalent loan-to-deposit ratio has forced banks to curtail further lending until ratios stabilise. However, banks are fully aware that before even considering extending further credit, they need to size up their current loan portfolios to determine the status of current expected inflows. By monitoring how current customers will perform on their loans, banks can make their cash flow projections more accurately and realign their projections, budgets and strategic plans based on market realities.

To combat the challenges faced by banks from liquidity shortages, the UAE government introduced two support packages totalling AED120 billion. The Dubai government's US\$20 billion bond issue was another positive step in that direction. The need for such injections emphasises the scarcity of liquidity and adds additional pressure on banks to be prudent in managing their lending practices when



dispersing such funds back into the system going forward, highlighting the growing need for tools that can help banks determine and maintain the quality of lending.

The liability side

When it comes to funding their liquidity needs, banks tap into a portfolio of sources including deposits, interbank loans, bonds, commercial papers and securitisation. In the normal course of business, they have to carefully balance the portfolio of funding sources to avoid liquidity drying up as a result of isolated events. Each one of these funding sources is, in fact, a loan to the bank, provided by different market participants. Like any other lending transaction, the loan is granted based on certain assumptions made on the ability of the bank to repay the loan.

Similar to any assessment process, a particular bank's decision to lend is built upon comprehensive and accurate information about the bank's risk exposure, in order to establish an element of trust. This trust is a by-product of the amount of information provided by the bank on its current operation and its overall level of transparency. In reality, the lack of liquidity witnessed recently in the global marketplace was a consequence

driven primarily by the lack of trust and transparency in the market and a general lack of understanding of the risks taken by banks.


It is important for banks to demonstrate an enhanced ability to discriminate different risk profiles, balance risk appetite and capacity. By being able to measure the total risk on their books through ratings and others such as Probability of Default and Loss Given Default promulgated by Basel II, banks can significantly improve their risk reporting capabilities and deliver a higher degree of transparency. In turn, banks will have easier and cheaper access to any of the portfolio sources they rely on.

A more-informed risk management approach, backed by credit information services, will have a positive impact on the quality of banks' loan books and their risk transparency levels. This approach will also be beneficial in improving banks' international ratings and reducing the direct cost of funds, enabling them to run a liquidity buffer without facing significant competitive disadvantages.

Banks must return to lending

Banks are in the business of lending money, and credit is the engine of

economic growth. It is necessary for banks to engage in steady growth through prudent lending supported by information analytics provided by credit bureaus. Through an in-depth perspective on their customers' risk profiles, banks are empowered to make more prudent and profitable lending decisions.

If banks are able to manage a healthy credit expansion and credit risk strategy, better assessed through more comprehensive risk assessment tools and services, they will be able to strengthen customer confidence in the banking system and reduce the likelihood of defaults and added provisions. By upgrading their internal polices and embedding insights received from pooled data into each and every critical business decision, banks can be more effective in matching their assets with their future liabilities and also be better protected from liquidity shocks in the future. 

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