Fitch Ratings
KNOW YOUR RISK

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Liquidity - A Rating Agency Perspective

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Rating concepts and methodology

- A long-term issuer default rating (IDR) measures capacity for timely payment of financial commitments
- A short-term rating looks at the same characteristics but over a relatively short time horizon – more focussed on liquidity profile
- The Short-term rating is most closely linked with funding and liquidity management, but tends to be correlated to the Long-Term IDR

Rating concepts and methodology

- The funding and liquidity of a financial institution is assessed as part of a strategic analysis contributing to the rating of a bank
- The factors that contribute most to a bank's rating are:
  - Size
  - Type of business
  - Strength of operating environment
  - Market share/franchise
  - Risks: credit, market, operational, business, liquidity
  - Performance: profitability and efficiency
  - Funding and capital
  - Management and strategy

Exploring the relationship between liquidity and ratings

> A bank can operate without capital (=insolvent) if the regulator allows it

> A bank cannot operate if it cannot meet its obligations (= illiquid): it defaults

> When a bank runs into problems, its access to funding becomes more difficult exacerbating a downward spiral.

> As a consequence, longer term solvency problems maybe reflected immediately in short-term liquidity problems

Exploring the relationship between liquidity and ratings

- Even excellent funding and liquidity management has only a limited importance in deciding a bank's LT rating because liquidity cannot be viewed completely independently from the market's confidence in a bank
- While good funding and liquidity are signs of the market's confidence, deterioration in asset quality, profitability or capitalisation may lead confidence to fall, causing funding and liquidity problems
- Fitch acknowledges this influence by linking ST ratings to LT ratings

Fitch's Examination of Liquidity Management

- Liquidity is the ability to meet obligations as they fall due
- Often, the key question is not whether a bank has liquidity, but whether it has access to liquidity.
  - Conservative management and business model
  - Loyal and diversified retail franchise
  - Frequent issuer (and access to different markets)
  - Good rating
  - Assets that can be pledged or securitised
  - Beneficiary of flight to quality of funding in previous crises
  - Contingency planning
  - Systemic importance/support

The Role of Liquidity Ratios

- Ratios are fallible and by definition historical
- Illiquid assets or liabilities with undefined maturities are not necessarily risky. But they may be if found in the same bank
- UK building societies (for example) have managed well with short-term customer deposits and long-term mortgages.
- Some basic measures to highlight possible maturity mismatches or illiquidity are useful
  - Liquid assets / short-term funding
  - Customer loans / total assets
  - Long-term lending / long-term funding
  - Customer loans / customer funding
  - Interbank placements / interbank borrowings
- Ratio analysis by currency

What Questions Do We Ask Banks About Liquidity?

- A copy of the bank's liquidity policy
- A gap table showing inflows and outflows across time; analysis of any large mismatches; mismatch limits; analysis of rollover/replacement risk.
- Bank's assessment of volatility of deposits e.g. contractual vs behavioural maturities?
- How does the bank assess the "real" liquidity of its liquid assets?
- How does internal liquidity management differ from any regulatory requirements?
- Funding programmes, diversity and location of investors: MTN, CP, securitisation etc
- Use of bank lines: Committed vs 'best endeavours'. How regularly are lines tested?

What Questions Do We Ask Banks About Liquidity?

- Results of liquidity simulations
- How long can the bank survive without accessing external sources of funding?
- What experience do the managers have in dealing with a liquidity crisis?
- What work has the bank done on how to manage liquidity in a crisis?
- How will management deal with any divergent trends in loan and deposit growth?
- How developed are the bank's plans for obtaining other sources of funding?

Fundamentals vs Confidence – ‘Cliff Effect’

- Confidence is key as banking is a confidence sensitive industry
- No matter how good a bank’s fundamentals may be, if confidence disappears a bank <u>will</u> fail
- Extremely high leverage and maturity transformation reduces ability to manage a severe funding stress particularly if asset liquidity is also frozen
- Creates a ‘cliff effect’ in risk profile
- Regulation and intervention tends to mitigate in severe systemic stress (but not a permanent solution)
- No bank can withstand a complete and simultaneous closure of all funding markets

Support

- An important component of bank analysis – and critical in current environment
- Banks tend to “fail” more frequently but default less often
- Historically banks have tended to be supported rather be allowed to default
- A key question is solvency – a solvent bank is likely to receive liquidity to resolve short-term cash-flow problems
- Lack of confidence in bank solvency has forced government action

Response of Regulatory Authorities Matters

> Response (speed and substance) by monetary and fiscal authorities can affect the outcome of a liquidity situation

> In current liquidity crunch, initial response by central banks varied - Some acted quicker than others to make funds available and loosened collateral criteria

> Ultimately liquidity and (guaranteed) funding was made available to banks - subject to collateral and solvency test

> Banks ‘securitising’ own balance sheets to create repo’able collateral

> State capital provided to boost confidence and free market liquidity

> Additional motive to encourage lending into real economy to tackle recessionary pressures

Has the Crisis Changed Fitch's Approach to Liquidity Assessment?

> In a crisis situation, previous assumptions based on normal liquidity conditions break down

> Communication with issuers has been stepped up – understand issues that can lead to loss of confidence

> Need to be sceptical of what management say in a crisis – their priority is survival! – increased demand for data.

> Heightened focus on contingency planning and stress testing

> Rate to facts, not rumours – but need to be aware of market perceptions and that rumours can kill fundamentals – awareness of external inputs (share price movements, CDS etc)

> Revisit liquidity criteria and assumptions

> Liquidity modelling

Balance Sheet Doesn’t Always Tell the Whole Story

- Liquidity needs are not always discerned from the balance sheet
  - SIVs, asset management, asset securitization activities may present “hidden” risks
    - SIVs brought back on balance sheet
    - Asset management activities supported
    - Not legally required, but had moral obligation
  - Representations and warranties on loan sales
  - Unfunded LBOs and committed facilities
- Need to understand implications of bringing off-balance sheet items on-balance sheet and the impact on leverage
- Don’t let the accounting fool the analysis

How is Fitch's Approach to Liquidity Assessment Evolving?

> Awareness of confidence - no bank can withstand a deposit run if confidence is lost

> Analysis of different deposit insurance regimes – can help maintain confidence and may influence support behaviour

> Availability of open market operations – ease with which banks can access repo markets

> Evolution of prudential regulations on liquidity – some banking systems will be tighter than others

> Liquidity modelling
  - Inherently challenging
  - Normal vs stress conditions
  - Stress/scenario models for different types of bank
  - Asset haircuts
  - Behavioural factors

Conclusions

- Liquidity is one aspect of bank analysis – but a key one
- Ratio analysis can be difficult. Focus on qualitative elements as well as build stress/scenario models
- Liquidity assumptions can shift significantly in a stress situation
- Key focus on contingency planning and stress testing
- Increasing focus on liquidity by banks and regulators will continue to mitigate concerns over short-medium term
- Support – a key liquidity backstop for banks
- Confidence is everything

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