

## Foreword

“Have I not walked without an upward look  
Of caution under stars that very well  
Might not have missed me when they shot and fell?  
It was a risk I had to take — and took.”

*Robert Frost, Bravado, 1947*

### ABOUT THIS MANUAL

*Liquidity Risk Management* has two objectives. One of the major themes is that we cannot understand anything useful about liquidity risk unless we consider the applicable environment. We will define and discuss very distinct liquidity needs. We will examine how various liquidity sources are available to differing degrees — or not at all — in different need environments. Then we will focus on how that understanding can be applied to measuring and managing liquidity.

Another goal of this work is to attempt to meld some of the practical “realities on the ground” — the composition of bank balance sheets and the restrictions imposed by business conditions — with some of the ideas, concepts, and theories of liquidity risk management. These two sets of ideas cannot be considered independently. Too many liquidity risk measurement tools are impractical. Too many liquidity theories are too general to be useful, or they are simply irrelevant. On the other hand, bankers are so focused on practical issues that they often neglect fundamental concepts or the lessons learned by previous generations. This book attempts to bake a cake using knowledge of theoretical recipes, a whole lot of practical methods, and some historical spices.

The content also reflects the often different resources and needs of small, medium, and money center bankers. Issues relevant to the largest banks are often more publicized and analyzed. As a result, large banks are featured in many of the examples used throughout the book. At the same time, however, the interests

and needs of community bank managers are also reflected. When analysis or recommendations might be different for large or small banks, separate comments are focused on only the large banks or only the community banks.

Historical precedents and fundamental concepts are emphasized only when they illustrate key points or provide essential background. The bank manager's need for workable suggestions and practical ideas is an overriding goal of this work.

## **PREFACE**

The field of liquidity risk management is undergoing change. Big banks have gotten much bigger and, in some cases, more international. Community banks now have access to liquidity management tools that were once restricted to large banks, especially the ability to rely on borrowed funds of various maturities. The asset sides of bank balance sheets are becoming more liquid while the liability sides are becoming more dependent on funds obtained in wholesale markets. We have witnessed a growing consensus among bankers and regulators for risk measurement methods. Liquidity ratios using historical data are now relegated to marginal roles. Liquidity measurement is now based on scenario-based cash flow projections.

At the same time, the environment has become far more perilous. The subprime crisis of the summer of 2007 quickly morphed into a near-meltdown of key markets for bank borrowings and bank asset sales. In May 2008, Fed Chairman Ben Bernanke spoke extensively about the role of liquidity in banking. He noted that, "mortgage lenders, commercial and investment banks, and structured investment vehicles have experienced great difficulty in rolling over commercial paper backed by subprime and other mortgages." He went on to say that there are some promising signs, "but, at this stage, conditions in financial markets are still far from normal."

The crisis may be over but its aftermath will be with us for a generation. Liquidity risk is receiving much closer attention. Extensive new regulatory requirements were issued in 2010. Quantitative requirements were issued in 2011. Large national banks have been given a monthly report form for stock and flow measures of liquidity. It is in times like these that *Liquidity Risk Management* is a must-have for your office bookshelf.

## **ACKNOWLEDGEMENTS**

Preparation of this book has involved reading numerous books and articles and having valuable discussions with other bankers. Ideas from many of those sources have contributed to this book in ways not always direct enough to be singled out by specific footnotes. In other cases, ideas from conversations and seminar presentations may have become too commingled or blurred to permit appropriate recognition of their creators. Any omitted acknowledgements are unintended.

Credit for many of the examples, anecdotes, and insights that liven the otherwise dry discussion of liquidity topics must be given to the invaluable assistance provided by many volunteers. Each and every one has my sincere and deep gratitude.

It is a cliché to say that any errors are solely my responsibility and not the responsibility of any of the sources, helpers, or editors. It also happens to be true.