

Discussion Panel

Liquidity Management in a Cross-Border Context

Headed by:

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John Trundle

Coming from a country which is outside the euro, I would like to say that the topic of convergence – or the absence of convergence – has been very much in the news in my country in recent days. I think that today we have seen a very good example of convergence: the discussion that Doug gave us at the beginning on payment system risk could have been given by a central banker, and I intend that as a compliment, Doug. Though you may not take it as such.

And I have been personally very impressed by Citibank's thorough analysis of risks in value transfer networks. Indeed, I have sent members of my own team on their training courses to gain insights into these risks, and so I find those developments very encouraging. And all credit also to the Payments Risk Committee in New York, which I think has in many ways been leading the thinking on some of these topics and contributing to the debate and to this convergence.

I would particularly like to welcome the report. I think liquidity risk is very much today's risk topic. Credit risk remains important. But I think credit risk is now well understood. In a sense we know what we've got to do and the issue is about implementation. We have seen credit risk dealt with effectively in many countries, including many of those represented here. But liquidity risk remains difficult and in many cases not well tackled. The proposals are interesting, and central banks will certainly want to analyse and discuss them; this is a first opportunity to do that. I think that I for one would be keen to distinguish between day-to-day risks and crisis management, as Richard himself acknowledged. For crisis management, it's quite clear that central banks do react, that we care deeply about liquidity. Also, Richard makes reasonable points about us needing to plan how to react, and I think we can have a rich dialogue there.

But I would particularly like to ask some questions today about the day-to-day need for some of the proposals in the report. This springs from the question about whether there is a general shortage of collateral. I suspect that in many countries, that is not currently the case. Certainly on a country-by-country basis we should look at our own

arrangements, to examine the extent to which there is sufficient collateral to support the provision of intraday credit. But in my own country, I certainly don't have a sense that that is a current problem. Again, Richard makes the fair point that we have to look ahead and ask whether that will be the case in the future. But if there isn't a general shortage of collateral at present, what other reasons could there be for making these sorts of proposals? I think one obvious reason is that the proposals will make it cheaper to get intraday credit. It is entirely understandable that the big banks want to reduce costs, but at what expense for the other parties?

I think another possible driver is that there are different interests among different categories of banks. And I think there is an issue about global banks which are expanding their business in local markets and don't want to be constrained by their local balance sheets. Understandably, therefore, they want to use their whole balance sheet to support activity in different markets and to merge their liquidity pots into one pot, which is certainly efficient for them, but it raises questions about whether the local structure should be adapted to facilitate that type of development. I should emphasise that these are intended to be open questions. I'm not implying that I think the answer is no, but I think we need to be clear that this must be one of the drivers.

But let me give you one more reaction, and that is about the central bank's approach in most of its monetary operations. Our approach is to ensure that we provide enough liquidity to support the system as a whole. That doesn't mean we are trying to make sure we provide as much liquidity as any one participant might like; it means we want to make sure the system itself operates smoothly. Sometimes we need to vary our operating procedures to try to ensure that is the case and Y2K, which has been cited, was a very good example of central banks changing their operating behaviour to deal with a foreseeable threat to liquidity and changed behaviour.

But normally we don't want to be that interventionist and we want to make sure that there is a lively private market. In particular, that the market is operating between, for example, our deposit rate and our lending rate, and we want sufficient distance between those for there to be a real market. That's certainly what we do in overnight and longer-term markets. So I'm asking myself whether there are parallels with what we do in shorter-term markets, in the intraday market, where our activities are aimed

at supporting the efficiency of payment and settlement systems. It's not immediately obvious to me that we want to effectively give the participants a put option to be able to liquidate their balance sheet and turn it into cash. The proposals are very modest, of course, they're asking us to take high-quality collateral beyond that which we currently take. But I could extrapolate that and say that a bank might say "take any of my assets and turn it into cash whenever I need it." Where do we draw the line? I would have a concern that if we are too accommodating in terms of being willing to turn assets into cash, we would reduce the incentives for the individual participants to make sure that they themselves are well protected from liquidity risks.

Nevertheless, I think the fundamental thesis that the group, and Richard in particular, was making is that the world is more interdependent. And that is certainly the case. The group is highlighting private solutions in the first instance to try to deal with those risks. I'm pleased that is one of the major recommendations, i.e. to try and iron out imbalances between the availability of credit in different locations. And certainly if there are barriers to putting in place private solutions, I think that's where I can imagine a fruitful dialogue between relevant authorities and the market, to see what can be done to enable market solutions to arise.

Finally, a question for our panellists and for the audience more generally: I am often puzzled about the cost of collateral and indeed have had colleagues who have studied the academic literature to see what can be found. And there is relatively little good quality work on what is the true opportunity cost of collateral. I have heard many figures quoted, but quite often when you actually try to find out what the substance behind those estimates is, it's some internal accounting convention and not something that is satisfying to an economist or a finance specialist. And so I think one way of persuading central banks that there is a problem would be to do better and better quality work in this area to show that there truly is a problem with the cost of collateral in general or in particular markets.

Question and answer session

Question 1: Doug, you explained very well the range of risks that Citibank and each of us faces and complimented the advancement in people's ability to understand those risks. Over the years there have been great advancements international standards are being offered, sound practices are being offered, both from the public sector and the private sector. I would be interested in your perspective on how far those standards are making an impact in the types of risks you face, particularly as we are now in the process of having those standards reinforced through the international financial institutions in their reviews of many of the countries in which you are participating. I think we'll be very anxious to see where there are major gaps that would be worth pursuing.

Douglas George:- I will give you a perhaps an impolitic answer to that question but a heartfelt one. The help is well received, the private sector participated in a number of those discussions, so if we have anyone to blame for any inconsistencies or lack of support it's ourselves as well. In part, Citibank's motivation for risk management is not completely altruistic but is driven off a very thin piece of regulation promulgated by the Office of the Comptroller of the Currency (OCC), Banking Circular 235, issued somewhere in the late 1980s, which is very obtuse and very poorly understood. Nevertheless, it requires us to understand the risks attendant to being a member user or a manager of these things. For nationally regulated banks, of which there are fewer and fewer in the US, this is a prescription for coming up with the methodology to understand granularly the risks. The problem that I find with Lamfalussy and the Basel II Accord is that they really don't focus on the level of detail that's required to fully understand. They tend to be – our fault as well – somewhat apple pie and motherhood. No-one is going to disagree with them. They're basically the same as my policies for Citigroup, which are two pages long, completely apple pie and motherhood, and no-one disagrees. It's the 67 pages worth of procedural manual that ties everyone up in knots and causes great angst within the firm. We don't have a 67-page procedural manual, we don't have the insistence that people like David Mazza spend endless hours of research on how a system actually works, what the bylaws and

what the operating requirements of those individual systems are. We tend, all of us unfortunately, to gloss over. There are systems that have been described to us as RTGS. If someone says XYZ country's system is an RTGS, it automatically fills a niche in my brain with "Hey, that's ok! I like that!" When you find out through very granular research that it's really a deferred net settlement system settling in batches every three or four hours, your risk paradigm shifts completely and your understanding shifts completely as to what the risks are. So if I were to say anything about what the central banks could be doing, and the regulators in conjunction with the private sector, it is basically a carrot and stick approach. I would make Basel II responsive to things that currently it doesn't anticipate, which are the risks of being a member / user / owner in a value transfer network. It speaks about operating losses. Arguably, the losses that one can incur in the VTN world are only partially "operating". Operating losses are defined as a breakdown in process or procedure. If I make a bad loan, and my customer is unable to pay me, that is categorised as a credit loss. If I make a bad loan and I lose the promissory note and therefore can't sue my customer in court, that's viewed as an operating loss. If I have a loss-sharing we're not quite sure how to categorise that. Nor have the regulators given us guidance on how one thinks about loss-sharing arrangements, loss of margin, loss of collateral, should a VTN default. This is a series of risks that are yet unaddressed, basically, by the public and private sector.

More needs to be done, more awareness, more forums for exchanging viewpoints. There's nothing magic about what we do. It largely results in best practice sharing. We were in discussion in one of the Asian countries, on a deferred net settlement system that has its own unwind and scares the pants off me. We said, "why don't you do it the following way?" and they all thought that was pretty smart and boy, weren't we clever to come up with it. Well, it was nothing more than something that had been invented years ago in CHIPS and in fact convinced the regulators it was a good idea. We took that same model and moved it there, and we look like heroes.

Question 2: Richard, I think that in looking at the liquidity risk issues that you were pointing out, we are all very much intrigued by the proposals coming out. You are suggesting that, looking forward, advancements in mobilising liquidity cross-border can not only implicitly prevent problems but also improve efficiency, improve risk management. I was wondering if you could also forecast – to the extent that we act upon those proposals – how you see those advancements changing the nature of competition and concentration amongst the global and local players active in each of the markets.

Richard Pattinson: The recommendation of the CCP Task Force is that if this is adopted, it's open to all. That doesn't mean that everybody will want to use it, because clearly today people make choices about whether they want to play directly in the liquidity markets or whether they are content to use liquidity suppliers or nostro agents. But clearly there should be no barrier, it should not be offered to a select few but open to all.

Going back to what John said, I think it's obvious to all that there is enough liquidity provided by the central banks to flood the ocean, so to speak. The problem is, in this connected environment, that it might be in the wrong place, with the wrong people, in the wrong system, when something goes wrong. And that's the key to it. It's not the quantum that we're arguing about; it's the availability of it when it's locked in a particular system, because that's the one that's just crashed and we can't get access to it. Or it's in a particularly large player which has a problem. Or it's a combination of all of that. And again, liquidity is there, but we can't get our hands on it. It's no good having the ability to get lots of liquidity if you can't actually get your hands on it and mobilise it. So that's what the CCP is about. It's not creating more liquidity, because there's enough. It's about creating it at the right time, for the right people, in the right currencies, when there are times of tension. And I think that's the key point to remember: we are not arguing about the quantum, because by definition there's always enough liquidity. Otherwise we would never settle anything at the end of any day.

Turning to the price of what the private sector would do, which was the second part of John's question. I agree totally with John that the private sector has very efficiently

responded in the liquidity area to the sort of day-to-day operations that many central banks have today got in force. If the Fed or the Bank of England or the ECB effectively puts a collar around the overnight price of money, i.e. day-to-day liquidity – once the central banks do that, then it doesn't take much time for the private sector to operate within those boundaries and create a market where much of the business is done between members of the private sector, and we don't trouble the public sector, the central banks, too often. But they have to put them there in the first place, for the private sector to create its market. It doesn't usually do it of its own volition. And that works for a domestic market, so why can it not work for an international cross-border market. If you put, if you will, the collar around these arrangements, that says the price of it is whatever, the private sector will equally do the same job that it does domestically. It will create a private sector solution that we don't have today, to operate within those boundaries. And therefore the mere fact that they're there and available means they'll probably not be used that frequently because the private sector will in most circumstances create its own market. It's in times of tension and when something unusual happens – and that's likely to happen more frequently in this connected world than it ever has in the past – that we need to get it in the right place at the right time. It is not just creating more liquidity.

Douglas George: Let me add a little point to John's statement earlier. It was something that struck me upon joining Citigroup, the distinction between large Global Behemoth Bank and Local Bank that you offered up. As I looked at Citigroup and as I looked a number of other large global players, I began to realise that, particularly on Citigroup's part, we tend to be local banks and local economy. Surprisingly to me, we celebrated our 75th anniversary in Brazil quite recently. We had a Chairman who was born and raised in Argentina. We are the biggest bank in Poland. We have a large measure of membership in the local bankers' association. 96% of all the people in the relative geographies are local. Oddly, we have strange management, we may have Indians managing the Japanese branch, which doesn't make any sense to me, but nevertheless, that anomaly exists. We tend to be the local bank in the local market, and have been there for donkey's years. To describe us as a big New York-based bank, coming into rape, pillage and plunder the locals, is somewhat arguable. We would like to monetarise our balance sheet but also maintain responsibility for the quality of the asset we ask to monetarise. New York is supposedly home, but is not the major source

of our revenue. As you look at the way our balance sheet and P&L are constructed, it's just another market. It's one of the 102, it's a big part, but it's by no means the predominant market.

Question 3: I would like to take the opportunity of having representatives from the banks and from the central banks at the table to raise a question. We have been talking about central counterparties' main roles in helping liquidity matters, and helping prevent failures and domino effects. One important question I have is that nowadays most of the central counterparties that I know usually have credit lines established with banks within the country in order to obtain liquidity if someone fails. Today most of the arrangements are with the banks, and I wondered if the central banks would consider extending similar credit lines to central counterparties, as they do for the banks, and if the financial banks would have something against the central banks doing this for the central counterparties.

Richard Pattinson: I should actually ask the central bankers to respond to that. But clearly that's one of the major dislocations in the market. No doubt the pendulum has swung away from the central bankers providing a lot of stability to what are essentially private-sector institutions for the benefit for the private sector. John, as a central banker, can maybe say whether you consider that would be appropriate. We would love very much for the central bankers to respond with – a large cheque.

John Trundle: I would say the main focus, as the Chairman of the CPSS even mentioned earlier this morning, is to look at the risk management and controls within the central counterparties. In fact, that is a major effort that we're undertaking this year, to ensure that risk controls are robust, they're understood and that they're executed properly, given the important role that the CCPs can play in different markets.

Question 4: What do you think of the central bank using a charging policy which penalises commercial banks that are abusing the payment system or sometimes stopping liquidity from flowing to the central system?

Richard Pattinson: I understand the question is should the central banks charge for intraday liquidity, or providing liquidity. My simple answer to that is yes they should, and can you do it as soon as possible. The reason I say that – and it's a very personal view – is because the sooner we stop playing in this false market where the private sector seems unable in many circumstances to recognise that there is a true cost to liquidity, the better. It's created a false market for itself over many years. Because, basically what it hasn't done is charge directly for intraday liquidity. It has done it indirectly by fees and all sorts of things. And now there is an explicit cost on intraday liquidity because there is a time value to it. It is now very difficult that something you have historically given away free in most currencies, because you wrapped it up in other charges, you can now make an explicit charge for. Because people don't like new charges, even if you're reducing charges. They just see it as a new charge. So my very personal view is that it just makes the situation a whole lot clearer, a whole lot more transparent, if the central banks charge a similar fee across the board for intraday liquidity. Then we can all get on with life and we all know where we stand.

Douglas George: To that point, I would also tend to agree. And it speaks to an issue that has long plagued me within the transaction services business. Two-thirds of the risk that Citigroup faces is intraday risk, evidenced through a number of the provisions of transaction services products. We are in fact the execution arm of everything that goes on within the firm. We don't risk-adjust, or even charge for the risk of those processes. We have broker-dealers, as do most of the major banks, and we let the broker-dealers use the balance sheets all day long, the major industrial companies use the balance sheet all day long, without recompense. It's the silliest thing I've ever seen. If we institutionalised and made people more aware of the true cost of intraday liquidity and our risk-adjusted basis, we would be better off. And the system of safety and soundness would be much better off as well. So I would tend to

agree with Richard, please don't tell our Chairman that we're asking for more charges.

John Trundle: Can I just very briefly put the other point of view. Which is: a reason for providing free credit is that intraday liquidity in the course of the day is a public good, something that is shared. So the person who pays early is supporting the system. And that, I think historically, has been the reason why central banks that have adopted that policy have chosen to provide intraday credit free. It is, of course, perfectly consistent to come up with a model where you have a market for intraday credit. And that's a very natural thing for market-oriented economies to want to do. But if you do that, you have to have a parallel mechanism to make sure that the obligations on the members of the system prevent free-riders. For example, effective through-put rules.