Management of liquidity risk concentrations

According to the Committee of European Banking Supervisors CEBS (since 2011 succeeded by the European Banking Authority EBA), concentration risk is defined as exposure(s) that might produce severe losses leading to financial troubles or changes in an institution’s risk profile. Over the course of the financial crisis starting in 2007, several examples of negative effects arising from risk concentrations on the stability of financial institutions have come to light. Still today, banks incur concentrations across different risk types, whereby some of them are intentionally assumed, however, other concentrations remain invisible.

Regulatory Environment

Following the events of the financial crisis, on 14th August 2009 the German BaFin updated their "Mindestanforderungen an das Risikomanagement“ (MaRisk) paying closer attention to the topic of concentration risk. On the European level, in 2010 the CEBS published its „Guidelines on the management of concentration risk under the supervisory review process (GL31)“, which require the analysis of concentrations in each of the individual risk areas of a bank. In order to have a comprehensive overview, banks should consider those areas not in isolation, but rather account for their interactions. For example, a default of a significant counterparty might also have negative impacts on the bank’s liquidity situation, which represents a relationship between credit and liquidity risk.

Beyond just the regulatory requirements, a systematical consideration and controlling of risk concentrations can be advantageous for internal bank steering. One example is the integration of concentration risk results in stress testing activities. In doing so, the effects of occurring risks (e.g. possible shortfall of significant funding providers) on the stability and appropriateness of the bank’s liquidity position become evident. In fact stress testing models that combine the various risk types (credit, market and liquidity risk) are seen as the most advanced models. Furthermore, a determination and controlling of position specific limits contribute to the achievement of a desired level of risk and to the execution of the bank’s strategy (e.g. a bank following the strategy of limiting their exposure in certain countries).

BearingPoint supports the way to a more stable liquidity position

Our comprehensive approach covers the identification of (potential) risk concentrations in liquidity relevant (off-) balance sheet positions, the definition of a monitoring and limit framework and the specification of concentration risk reporting. The approach addresses regulatory as well as bank-internal requirements. As a result, the BearingPoint approach helps to manage and reduce liquidity risk and contributes to a more stable liquidity position to effectively counter future crisis situations.

Our Approach

Concentration risk analysis:

The analysis phase aims at the identification of (potential) risk concentrations in liquidity relevant positions according to certain dimensions like product type or maturity. The determination of relevant dimensions is based on regulatory requirements and individual bank characteristics such as its business model.

As a next step, concentration metrics are defined for each of the dimensions, whereas possible metrics might be simple percentage relations (e.g. the amount of deposits from non-European countries) or concentration measures (e.g. Herfindahl-Hirschmann-Index).

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1 (2010), CEBS, Guidelines on the management of concentration risk under the supervisory review process (GL 31)
By applying those metrics onto the bank’s positions, the results can be assessed qualitatively and quantitatively regarding present concentrations. However, one has to consider institute-specific circumstances, since risk concentrations should not be seen purely negatively by definition. Rather, they might be assumed intentionally and be attributed to a distinct business model.

Finally, it needs to be decided which of the defined concentration metrics are relevant for the steering and controlling of the bank’s liquidity risk.

**Definition of monitoring and limiting processes**

For the efficient usage of the relevant concentration metrics they must be integrated into a monitoring and limiting process. This process outlines the responsibilities of the involved departments with regard to the setting and approval of limits. Furthermore, it determines who is in charge of the continuous control of limit compliance and governs what steps should be followed in case of limit breaches (i.e. escalation process).

When implementing the limit system, a distinction between hard and soft limits can be made. The breach of a hard limit must be followed by concrete countermeasures to bring back the metric within its limit. Soft limit breaches allow more flexibility and a further assessment of possible actions. The determination of concrete limits should be consistent with the overall risk appetite of a bank.

**Specification and implementation of a concentration risk reporting**

For the technical implementation of regular concentration risk reporting, the relevant concentration metrics must be specified. Further, crucial information, that support risk control in its analysis and decision process, should be gathered and implemented as well.

BearingPoint accompanies this implementation process end-to-end from the business specification until the final user acceptance test.

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**About BearingPoint**

BearingPoint consultants understand that the world of business changes constantly and that the resulting complexities demand intelligent and adaptive solutions. Our clients, whether in commercial or financial industries or in government, experience real results when they work with us. We combine industry, operational and technology skills with relevant proprietary and other assets in order to tailor solutions for each client’s individual challenges. This adaptive approach is at the heart of our culture and has led to long-standing relationships with many of the world’s leading companies and organizations. Our 3350 people, together with our global consulting network serve clients in more than 70 countries and engage with them for measurable results and long-lasting success.

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