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FYI from tomorrow's WSJ

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Subject: WSJ -- Liquidity Guidelines to Get Update

CSE Task Forces:

FYI.

Liquidity Guidelines to Get Update
By DAMIAN PALETTA and ALISTAIR MACDONALD
February 22, 2008

In a move aimed at preventing a future freeze in credit markets, U.S. and foreign bank regulators are jointly developing a set of best practices to strengthen how banks deal with cash pressures.

Banks need this short-term funding, also known as liquidity, to finance loans and to pay off debt. One of the most devastating effects of the current credit turmoil has been a virtual seizure in certain financial markets, with liquidity disappearing -- or becoming much more expensive -- for asset-backed securities, other structured financial products and even the market for lending between banks.

CASH CRUNCH
• What's new: U.S. and foreign bank regulators are developing best-practice guidelines for managing liquidity risk. • Why now: The continuing credit crunch means financial institutions are searching for short-term funding in some markets. • What's next: The Basel Committee on Banking Supervision plans to release a proposal later this year.

It was liquidity pressure that eventually led to a run on Northern Rock PLC, which the British government on Sunday said it would nationalize. But while liquidity plays an enormously important role in financial markets, it has always proven to be an elusive risk for banks and regulators to guard against.

"Banking crises are liquidity crises, and once liquidity starts to flow again, that's when the crisis eases," said Andrew Kuritzkes, a managing director at Oliver Wyman who advises major banks about risk management.

The Basel Committee on Banking Supervision, an organization of bank regulators from around the world, plans later this year to update its eight-year-old "core principles" for liquidity risk to "reflect recent experience." Among other things, the update is expected to include an increased focus on a bank's contingency plans for liquidity and a larger emphasis on the impact of market-wide shocks on a bank.

For years, financial institutions obtained liquidity from a number of areas, such as deposits. But during the recent housing boom, U.S. financial institutions turned more frequently to credit markets to fund products such as mortgages. Many banks found themselves overly dependent on these sources as problems in mortgage markets worsened.

Banks in recent months have turned to a number of funding alternatives, such as the 12 Federal Home Loan Banks in the U.S. and a new auction facility offered by the U.S. Federal Reserve.

The deficiencies in how banks and regulators monitor liquidity were thrown into sharp focus by Northern Rock, one of the U.K.'s biggest mortgage lenders. In September, the bank was forced to seek funds from the Bank of England after the markets on which it relied for financing froze during the early stages of the credit crises. Amid the country's first bank run in more than a century, U.K. authorities told a panicking British public that Northern Rock was solvent. But its troubles were in the financing of day-to-day operations.

During a parliamentary inquiry into Northern Rock's troubles, Mervyn King, the head of the Bank of England, said liquidity regulation would have to be "taken more seriously." U.K. rules only require a bank to have enough highly liquid assets to meet outflows for one week without needing to tap public markets. This worked for short-term stresses, and allowed Northern Rock to ride the immediate market storms that followed the Sept. 11, 2001, attacks on the U.S. But its weaknesses were exposed when markets froze for months during the turmoil triggered by delinquent subprime mortgages.

Northern Rock's troubles would have been "picked up" had there been a proper system of liquidity regulation, Mr. King told a panel of British policy makers in September.

Mr. King also said the central bank and Financial Services Authority, the U.K. financial regulator, had been pressing for a parallel Basel liquidity system to run alongside its regime on capital requirements but had found little interest among central bankers.

There hasn't always been such a lack of interest by regulators in liquidity. In the 1950s and 1960s, as much as 30% of a U.K. bank's assets needed to be held in liquid assets, but that is "not much more than 1%" now, according to Mr. King.