

# Liquidity Risk Management Best Practices



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# 1. Introduction & Purpose

The purpose of this Liquidity Risk Management Framework document (“document”) is to support LME Clear Members by providing best practice observations for liquidity risk management. This document may be used by Members to benchmark their current practices and assist in determining how to best manage their liquidity risk in a manner appropriate to their circumstances. This document has been compiled based on our observations and summarises the best practices of LME Clear Members.

This document is intended to assist Members in complying with Rule 3, 3.2 Ongoing Membership Requirements. These best practice standards do not impose legal or regulatory obligations on Members, nor do they take the place of existing regulation. In the event of any inconsistency between this document and applicable law, rules, and regulation, the applicable law, rules, and regulation will prevail.

If a Member would like to discuss and/or clarify these best practice observations, please contact your LME Clear relationship manager or risk manager in the first instance.

## 2. Liquidity Risk Management Framework

Liquidity risk management is an essential tool to ensure that Members continue to manage and meet their obligations in both business as usual (“BAU”) and stressed market conditions.

### 2.1. Governance & Oversight

A liquidity framework enables Members to mitigate against liquidity risk both in BAU conditions and across various stress scenarios. This includes effective monitoring and measurement of the Member’s funding flows and associated liquidity risks, ensuring with a high degree of confidence that the Member can meet the requirements laid out in its Board’s risk appetite statement and any applicable regulatory requirement(s). The risk appetite statement should include clearly articulated liquidity risk thresholds regarding failure to meet liquidity risk obligations and steps outlining both the escalation of any breaches to executive management and Board, and mitigation to bring the Member back within risk appetite. The risk appetite statement and Board usually have a zero-tolerance threshold on failing to meet liquidity obligations, including under stressed conditions, and the governance and oversight responsibilities and processes are accordingly aligned to the risk appetite statement.

### 2.2. Liquidity Risk Identification & Assessment

Governance processes usually define clear responsibilities and ensure that the management and Board are kept informed of the ongoing assessment, identification and quantification of the Member’s liquidity risks. This includes identifying the sources of liquidity, how much current and future liquidity is required both in BAU and a range of stress events and how the Member intends to mitigate any risks identified. This should be carried out at least on a daily basis and more frequently if required. Members should consider the level of any price limits set by exchanges when determining the extent of their liquidity stress testing scenarios. Ultimate responsibility for liquidity risk usually sits with the Member’s executive management and its Board. This is normally cascaded down through delegation to the day-to-day decision-makers (committees and individuals) who should have documented responsibilities.



To ensure timely and appropriate identification of liquidity requirements and resources, it is important to establish systems and metrics to measure, manage, monitor and report liquidity risk, including positions, settlements, margin calls, credit limit usage and funding diversification. These should all be:

- a. monitored daily and more frequently if required by the risk and/or finance departments based on set liquidity drivers for the business
- b. consistent with the Member's risk appetite and subject to regular analysis overseen by the appropriate senior management.

## **2.3. Liquid Financial Resource Identification**

Liquidity risk policies and processes usually require the Member to always have sufficient liquidity resources to meet any obligations as and when they fall due, including having effective collateral management to manage payments on a timely basis and the ability to survive any liquidity stresses and/or events. This can relate to actual or modelled cash flow requirements and/or regulatory requirements under extreme, but plausible market conditions.

A liquidity framework normally contains full details with respect to the anticipated sources of diverse liquid financial resources and a framework for assessing when these are expected to be available and utilised. Sources of liquidity may include:

- a. maturing cashflows from cash and collateral management and/or investment activity;
- b. funds available from clients to facilitate their trading;
- c. cash and/or the potential use of highly liquid assets of high credit quality to generate cash;
- d. agreed and/or established lines with banks and/or financial institutions that provide a diversified source and tenor of funding.

Such resources are expected to be pre-arranged, diversified, highly reliable and, where relevant, supported by assets of high credit quality and demonstrable high liquidity wherever possible. Some additional key practical considerations include:

- a. maintaining daily liquidity management processes including identifying sources of liquid resources and uses/requirements.
- b. maintaining processes to identify, manage, control and report liquidity risk to provide visibility to the Member's senior management team under normal operating limits and stresses.

## **2.4. Testing**

### **2.4.1. Stress Testing**

Below are some key best practices that Members may want to consider when establishing effective liquidity stress testing.

- a. Set zero tolerances to identify breaches in the stress testing scenarios, as well as any deficits or breaches as defined by thresholds or risk appetite (which are accordingly reported to the Member's Board or Risk Committee along with any remediation plan).
- b. Ensure that all material forward-looking risks are identified, effectively managed using an appropriate combination of quantification and controls, and covered by liquidity buffers.
- c. Agree a definition of extreme but plausible stress scenarios and provide comparisons of the available liquidity against the stressed liquidity on both a real-time and forward-looking basis, with processes in place to manage, monitor and stress test liquidity risk under these conditions.



- d. Apply stresses that are severe and broad enough for the business model. This should consider if there are significant intra-day or inter-day funding gaps and align this with the time period of stressed cashflows.
- e. Undertake regular reviews and adjustments based on changes in external markets or business models including Member-specific stress, market-wide stress and liquidity requirements relating to business models (e.g. margin calls across CCPs, client collateral withdrawal, substitution, settlement fails, loss of liquidity providers etc.)
- f. Consider the level of any price limits set by exchanges when determining the extent of the liquidity stress testing scenarios.
- g. Some examples of estimating and establishing liquidity requirements and buffers include:
  - setting a reasonable estimate of the minimum and maximum amount of liquid assets that the Member would require to fund its ongoing business operations
  - establishing different types of liquidity scenario stress testing for both historical and hypothetical scenarios
  - modelling negative economic shock that may result in a liquidity need over a short time horizon
  - regularly gauging capacity to raise funds quickly from the different sources.
- h. Document the various scenarios and assumptions and their derivation; the design of the scenarios; the processes of review and challenge including second line oversight; how the stress test results have been incorporated into the overall liquidity risk framework and recovery planning.

### **2.4.2. Reverse Stress Testing**

To identify extreme scenarios and/or market conditions where the available liquid financial resources will not be sufficient, reverse stress testing is usually performed periodically and is considered best practice. These tests include hypothetical conditions which go beyond the standard extreme but plausible scenarios, identifying the severity that would create liquidity requirements beyond available liquid resources.

### **2.4.3. Calibration / Back Testing**

To ensure that the current types of testing and the methodologies used continue to be effective and appropriate, back testing and/or calibration of the existing methodology is usually established, with appropriate reporting to the Member's senior management and Board.

## **2.5. Contingency Funding Plan**

A contingency funding plan will set out a Member's strategy(ies) for addressing liquidity shortfalls versus actual stress testing or regulatory requirements during an emergency or crisis event. Best practice includes having:

- a. detailed management actions formally documented that will bring the Member out of the stress event in advance
- b. access to liquidity, and/or to the invocation of relevant contingency arrangements, which is tested on a regular basis to ensure operational capability and counterpart/provider readiness
- c. access to a diversified range of market counterparts to help with liquidation or sale of marketable assets and/or securities
- d. a list of management actions to be taken in a stress situation, in the case of a liquidity shortfall, to meet any obligations. These actions may be split by preventative measures (i.e. versus stress testing requirements) and reactive measures (i.e. versus actual or regulatory requirements).