

The Imperatives for Strengthened Regulation and Supervision of Liquidity Risk in Malaysia

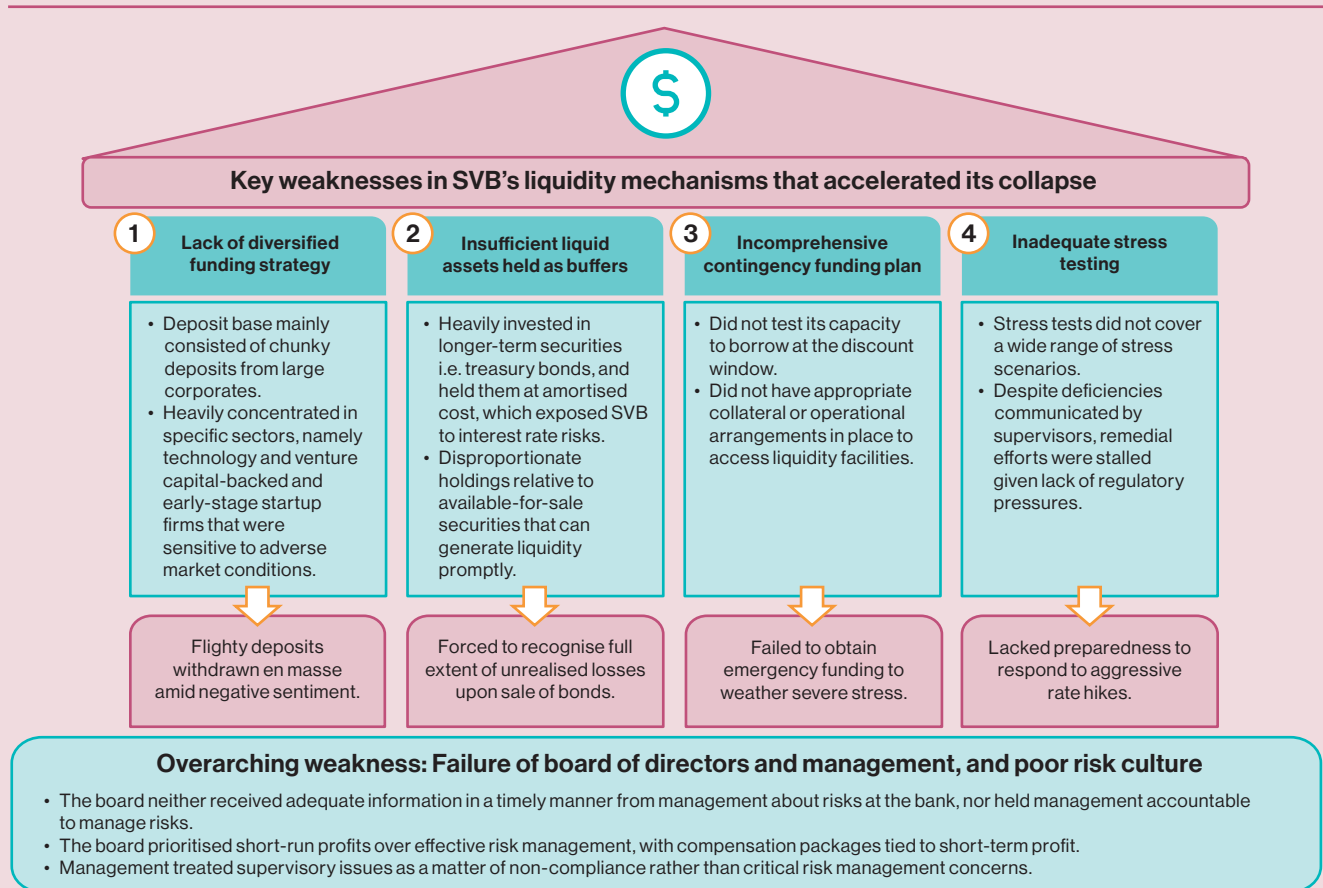
The Silicon Valley Bank (SVB) crisis

The global financial crisis in 2007–09 saw a raft of global regulatory reforms put in place to improve the banking sector’s ability to absorb financial and economic shocks. This includes Basel III which comprises measures to strengthen global capital and liquidity standards. The higher quality and levels of capital and liquidity held by banks have helped ensure the continued resilience of the banking system against various financial and economic shocks, including the COVID-19 pandemic.

In early 2023 however, a number of notable bank failures in several advanced economies triggered what has been termed the most significant system-wide banking stress since the global financial crisis in terms of scale and scope.¹ One such bank failure was that of SVB in March 2023, which experienced a sharp outflow² of its deposits within just a few days, leading to its collapse.

Various observers have pointed out that while SVB’s collapse was precipitated by rapidly changing macroeconomic conditions, its fragility was ultimately rooted in its core weaknesses in liquidity risk management (summarised in Diagram 1).

Diagram 1: Key Weaknesses in SVB’s Liquidity Mechanisms that Accelerated its Collapse



Source: Board of Governors of the Federal Reserve System

¹ Basel Committee on Banking Supervision, 2023.

² Withdrawals peaked on 9 March 2023, which on that day alone saw USD42 billion in deposit outflows. SVB was subsequently placed into receivership on 10 March 2023, which resulted in deposit withdrawals being temporarily suspended. It is estimated that had it remained open, SVB would have seen a further USD100 billion in deposit outflows that day, resulting in total withdrawals amounting to 85% of its deposits.

The collapse of SVB also revealed how the dynamics of liquidity have evolved with the digitalisation of finance, heightening the challenges faced by banks in managing liquidity. First, the increased prevalence of online and mobile banking, as well as instant payments, while bringing about greater customer convenience, also enabled customers to easily move funds in and out of any bank. Second, the rapid and widespread dissemination of information through the use of social media has heightened the sensitivity of banks to reputational risks and shifting public sentiment, especially in times of uncertainty. These factors amplify the speed and magnitude of bank runs, increasing the challenge of managing liquidity risk for banks.

The global regulatory and supervisory response

The effects of the turmoil arising from the events at SVB and other bank failures in 2023 were relatively contained, with limited impact on global financial system stability. This affirms the effectiveness of Basel III and other financial reforms implemented in the aftermath of the global financial crisis to increase the quality and levels of capital and liquidity of banks. It also underscores the critical importance for all banks to adopt sound liquidity risk management practices.

At the global level, the Basel Committee on Banking Supervision (BCBS) has conducted a stocktake of regulatory and supervisory lessons arising from the failure of SVB and the turmoil. The BCBS is also pursuing analytical work to determine whether features of the Basel Framework, specifically those related to liquidity risk and interest rate risk in the banking book (IRRBB), had performed as intended during the crisis.

Developments in the regulation and supervision of liquidity risk in Malaysia

While events at SVB and the broader banking turmoil have had only a limited impact on Malaysia, Bank Negara Malaysia (BNM) has taken measures to further strengthen the regulation and supervision of liquidity risk (summarised in Diagram 2). These include implementing a number of initiatives in 2023, many of which were either planned for or initiated prior to the SVB crisis. The banking turmoil however provided additional impetus and surfaced new dimensions of risks to consider.

As part of ongoing supervision, BNM conducted **targeted supervisory reviews of liquidity risk and funding management practices** during the year by looking at how banks manage deposit concentrations and set monitoring thresholds for key risk indicators, as well as evaluating their liquidity stress test assumptions and contingency funding plans.

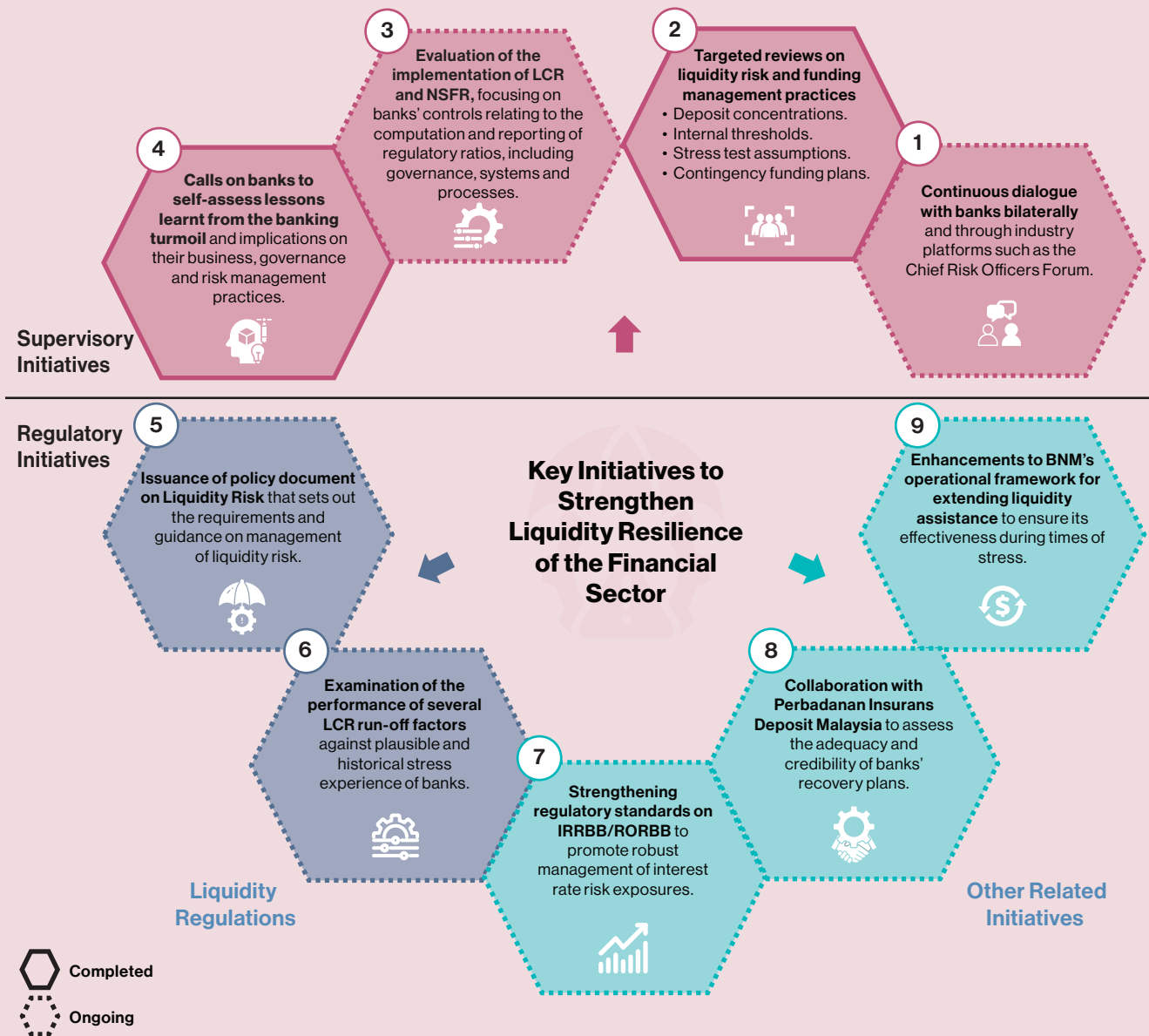
In addition, BNM also conducted a **thematic assessment of the implementation of the Liquidity Coverage Ratio (LCR)³ and Net Stable Funding Ratio (NSFR)⁴** by banks, focusing on the effectiveness of controls, including governance, systems and processes, surrounding the computation and reporting of the ratios. While controls were generally found to be adequate and effective, the review identified some areas for improvement at individual banks. These include enhancing internal policies and procedures to ensure adequate oversight and periodic review of the computation and reporting processes.

Banks were also tasked to perform **self-assessments, reflecting on the lessons learnt from the banking turmoil** and implications on their business, governance and risk management practices. Following these reviews, banks have taken steps to further enhance and fine-tune aspects of their liquidity risk management practices. These have largely focused on enhancing the parameters used to monitor and model depositor concentrations; requiring internal monitoring thresholds to better account for liquidity risks associated with online channels; and testing of contingency funding plans.

³ A quantitative requirement that seeks to ensure that banks hold sufficient high-quality liquid assets to withstand an acute liquidity stress scenario over a 30-day horizon.

⁴ A minimum standard that requires banks to maintain a stable funding profile to support their assets and off-balance sheet activities.

Diagram 2: Key Initiatives to Strengthen Liquidity Resilience of the Financial Sector



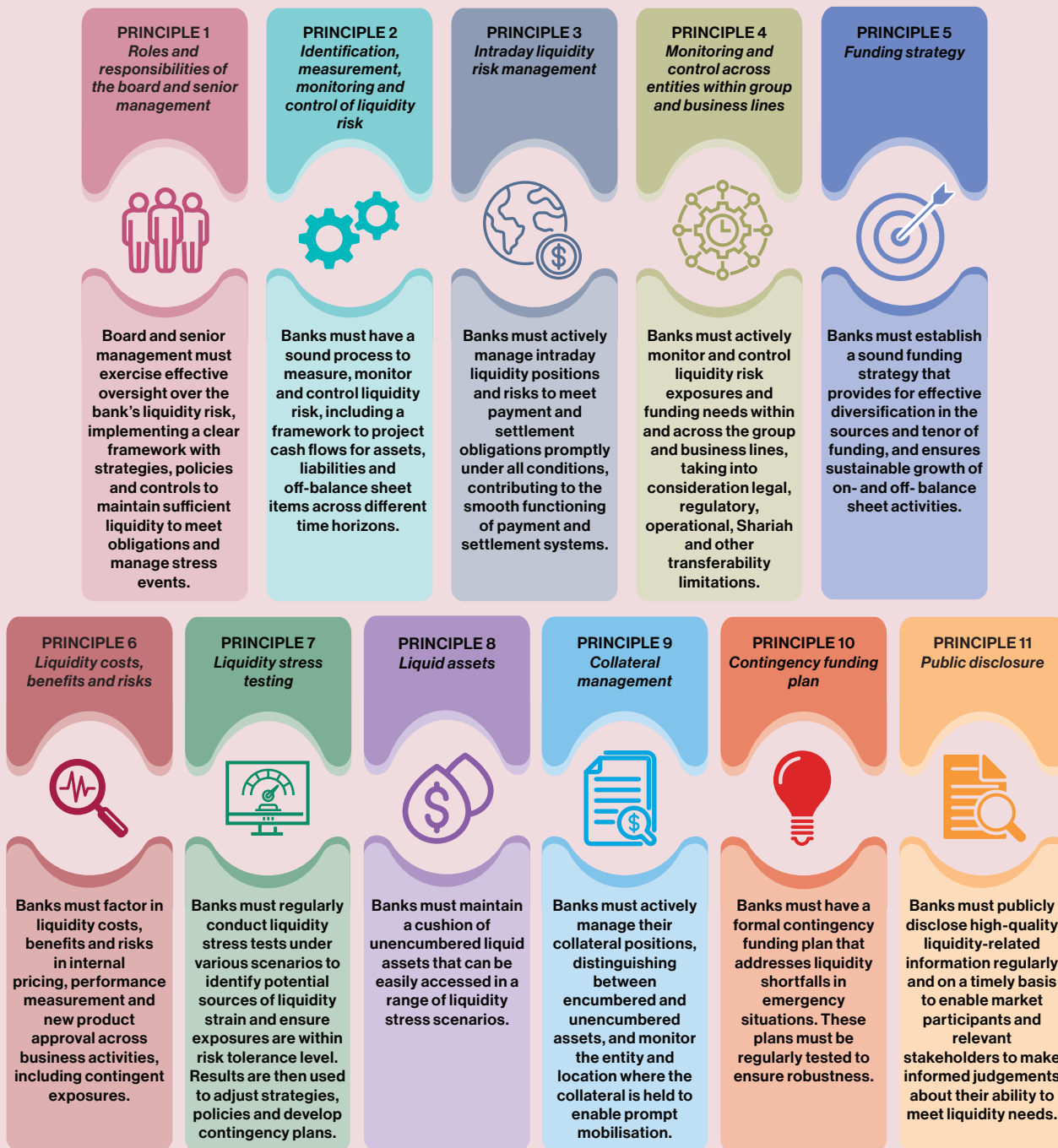
Source: Bank Negara Malaysia

In August, BNM issued an **exposure draft on Liquidity Risk** for public consultation. The exposure draft sets out standards on sound liquidity risk management practices for banks (summarised in Diagram 3), thus complementing the minimum regulatory liquidity requirements specified by the LCR and NSFR.

Expectations in the exposure draft are also consistent with principles⁵ issued by the BCBS and Islamic Financial Services Board, and aligned with BNM's long-standing approach to the supervision of liquidity risks in the banking system. They aim to establish a common baseline for sound practices, while also incorporating lessons learnt from the recent banking turmoil. This includes specific expectations for banks to adequately assess and manage concentration risks, and to evaluate the quality of liquid assets from multiple dimensions. Banks are also expected to accord due focus to emerging risks such as those associated with online withdrawals and negative public sentiment on social media, considering the changing dynamics of withdrawal behaviour brought about by digital finance. BNM targets to finalise the requirements and issue the policy document in the second half of 2024.

⁵ This refers to the *Principles for Sound Liquidity Risk Management and Supervision*, issued by the BCBS on 25 September 2008. More recently in 2019, the BCBS completed a review of the principles and found them to remain fit for purpose. <https://www.bis.org/publ/bcbs144.htm>

Diagram 3: Summary of Key Principles of Liquidity Risk Management



Source: Bank Negara Malaysia

Concurrently, as part of efforts to ensure the efficacy of BNM's minimum regulatory liquidity requirements, we conducted an **examination of the performance of LCR run-off factors** to determine whether their calibration is reflective of plausible and historical stress experiences of banks. The study revealed that for some banks, actual historic outflows observed under extreme scenarios for certain deposit types – such as that for SMEs – exceeded that of LCR prescribed run-off rates. Nonetheless, banks which experienced such outflows also reported high overall LCR ratios, typically ranging between 148% and 300%, thus providing sufficient buffers to withstand potential deposit outflows.

BNM is also **strengthening regulatory standards on IRRBB/rate of return risk in the banking book (RORBB)**, as part of its efforts to promote robust management of interest rate/rate of return risk exposures and more broadly, stronger asset-liability management (ALM) practices in banks. More specifically, BNM is working towards enhancing industry

practices in identifying and measuring the sensitivity of their assets and liabilities to interest rate/rate of return risk and consequently, taking actions to address any emerging vulnerabilities. This work is expected to draw on parallel efforts by the BCBS to update its calibration and methodology used to calculate the impact of interest rate shocks.

BNM's recent efforts on this front also include ongoing collaboration with Perbadanan Insurans Deposit Malaysia (PIDM) to strengthen capacity and preparedness in responding to crises. In 2024, BNM and PIDM will conduct a **review to assess the adequacy and credibility of recovery plans** prepared by banks to respond to liquidity stress. In parallel, BNM is also working on efforts to **enhance and clarify various aspects of its operational framework on liquidity assistance** to banks in the event of a liquidity crisis.⁶

Addressing structural challenges in the management of liquidity risks by Islamic banks

Islamic banks face a number of structural challenges in managing liquidity risk. These challenges include that relating to the differences in the asset and liability profiles of Islamic banks compared to their conventional peers. In particular, Islamic banks tend to see higher concentrations in wholesale funding, given their traditional reliance on corporate deposits to support financing growth. The market depth of Shariah-compliant liquidity instruments also remains more limited given the shallower pool of market participants and Shariah-compliant money market products relative to conventional options.

BNM has been working closely with the banking industry over the years to address these challenges through a number of measures (summarised in Diagram 4). As part of these efforts, BNM is also undertaking a holistic review of the role and operation of investment accounts with the industry to address the funding imbalances observed in Islamic banks.

Diagram 4: Key Initiatives Pursued to Address Challenges Faced by the Islamic Banking Industry



Source: Bank Negara Malaysia

References

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Silicon Valley Bank Financial Group. (2023). 'Q4 2022 Financial Highlights'. Retrieved from <https://ir.svb.com/financials/quarterly-results/default.aspx>

⁶ Refer to the box article on 'The Bank's Liquidity Operations to Achieve its Mandate' in BNM Quarterly Bulletin Vol. 38 No.1 for further details. https://www.bnm.gov.my/documents/20124/10644344/qb23q1_en_box1.pdf