

Introduction faced by
such problems as
market



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Introduction

Financial institutions often find themselves in difficult positions when they become unable to pay the funds it have been entrusted with by its creditors. This therefore calls for commercial banks to to meet certain standards of liquidity risk management. Furthermore, liquidity position of any institution must be protected and also some requirements should be imposed with respect to the actual liquidity. All commercial banks should display good level of liquidity since liquidity is used as an indicator on the strength of the bank's performance and can win them customer confidence (Howells and Bain, 1994).

Adequate Liquidity

Since banks liquidity implies the ability of a bank to meet its financial expectations. It is argued that the main objective of commercial banks in financial intermediation is to transform short term deposits into long term loans. This aim makes prone to the risk of creditors demanding more repayment than the banks ability to liquidate its assets.

In any market, the strength of a bank is based on its ability to source additional liquidity, such kind of banks are termed as adequately capitalized. The ability of any commercial bank to achieve capital liquidity may be faced by such problems as market failure which is brought about by lack of information hence resulting in uncertainty from banks net worth which affects its credit worthiness. It is always fundamental for any commercial bank to maintain adequate liquidity to avoid facing the risk of market, credit and operation. Consequently, maintaining adequate liquidity is important to

safeguard the commercial banks against some uncertainty which at times result from the scenario of market players hoarding liquidity. This adversely limits commercial bank's ability to relocate or adequately fund its liquidity.

From the above description, liquidity risk is defined as a situation where a commercial bank or any other business, despite being balance sheet solvent it is rendered unable to generate cash to meet its payments. Liquidity risk management is therefore curbing the risk that a bank is unable to fulfill its obligation. The ability of any commercial bank to maintain adequate liquidity is determined by several factors like its reliability to generate enough cash resources which in turn depend on external events which are at times unpredictable and may pose a great risk to the services and operation of the commercial bank (Allen, Carletti and Krahn, 2004).

The bank of Jamaica defines liquidity as "the availability of funds, assurance that funds will be available to honor all cash outflow commitments both on or off balance sheet as they fall" (Bank of Jamaica, 2005, p. 1). These commitments may be achieved by ensuring cash flows that are supported by the availability of assets which can easily be converted into cash or the institutions ability to borrow. Maintaining adequate liquidity among commercial banks is a safe and critical measure. It involves adequately managing the existing assets and liabilities to ensure that the cash in flows match the cash outflows. Maintaining adequate liquidity involves taking the following measures; honoring daily cash inflows, avoiding the raising of funds through forced sale of assets, satisfy statutory liquidity, having sound liquidity policies (Bank of Jamaica, 2005, p. 1) Maintaining adequate liquidity is the principle aim of any treasury. In the process of fulfilling this objective, <https://assignbuster.com/introduction-faced-by-such-problems-as-market/>

banks are faced by several problems which include inefficient banking structures, lack of sufficient information and restrictions on the local currency (Liquidity, 2010, p.

1).

Capital Adequacy

Capital adequacy has been defined in the finance glossary as the “ measure of the financial strength of a bank or a securities firm and usually expressed as the ratio of its capital to that of its assets” (Finance glossary, 2011, p. 1)

Financial regulators have always tried to ensure that existing commercial banks have enough capital and enable them to avoid any difficulty. This is considered to protect depositors and the entire economy since failure to do this may result in what is referred as knock- on effects which have adverse effect on the entire financial sector and may result into a risk called systematic risk. Any commercial bank needs to have enough money that it can use to cushion any losses that might arise in case individuals and businesses they lent money to default on those loans. Lack of adequate capital may result to some banks facing financial failures and might find itself in a difficult position if need be to cover for what it owes to its depositors and the bank may be declared insolvent. In various countries, central banks often do not permit commercial banks to make decisions regarding how much money they should give to cover those risks. Instead they impose capital adequacy ratios otherwise referred as solvency ratio that they set its own finances that may be commensurate to the total loan portfolio.

The Basel accord set a figure of 8% as the standard adequacy ratio but may vary from one central bank to another depending on the jurisdiction.

Commercial banks might also set their own capital adequacy ratio. This norm was established due to the realization that small businesses are prone to default as compared to mortgages on residential property.

This therefore means that banks that transact businesses with small businesses tend to have a high solvency ratio. Capital adequacy have been in existence for a long time and the two most important principles of capital adequacy specified by the Basel committee of bank of international statements and also known as Basel Capital Accord, these are Basel 1 and Basel 2 of 1988 and revised in 2004.

Managing Liquidity

The volatility and the dynamism of the global market have led to a growing concern concerning exposure to the risk of liquidity; this has led to the progress and creation of new techniques and tactics to manage it (Tully, 2002, p. 1) The ability of any financial institution to fund rise in assets and to achieve its goals defines the viability and survival of any banking institution in the market. Due to this, managing liquidity is a crucial task that banks undertake in order to minimize some problems which may arise from it since liquidity problems does not only affect one particular bank but may affect the entire sector as well. Banking institutions are therefore advised to manage and measure their liquidity on regular basis to enable them analyze their funding requirements. Sophistication of the method used by different commercial banks depends on the sophistication and the complex nature of its operation (Sound practices, 2000, p.

1). There are several methods that commercial banks use to manage their liquidity. These are: First is asset management. Though commercial banks differ on how they deal with the issue of liquidity, for small banks who majorly depend on customer's deposits; its assets are majorly loans to small and medium businesses and households and hence enjoy more deposits. The excess of this deposits are invested in assets that guarantees its liquidity, this system where holding of assets can easily be turned into cash when required is referred as asset management banking. Liability management banking is another method used by commercial banks in managing liquidity. Unlike the small banks, large banks do not have sufficient deposits to finance their businesses since they deal with large companies, wealthy individuals, other financial institutions and even the government. This forces them to look for other major lenders which often come in form of short-term liabilities that must be continuously rolled out.

This liability management system has a lot of risks than the asset management system since a large bank that gets its liability management wrong is prone to failure. Another technique used by commercial banks in assessing its liquidity level is the key to liability management. This is the banks ability to borrow making credit worthiness a critical asset in any banking institution.

If the credit value of a bank is found or realized to be doubtful then lenders can be forced to switch to other banks and also change the rate at which a bank has to borrow with this slight suspicion of trouble. During recent times large banking institutions have been utilizing their increase in their asset management in view to fostering their liquidity, they hold a large portion of

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their assets as securities that they can secure their loans with it in order to recycle their borrowed money (Sarr and Lybek, 2002). Another method of managing level of liquidity is the bank runs.

This is the high demand for money by bank's depositors. With the discovery of the policy of deposit insurance, the issue of bank runs by small depositors has been overtaken by events and time. Bank runs has been necessitated by the desire to assume risks and need to have an information about the state of banks balance sheet banks, this is despite the fact that balance sheet does little to reduce risk. The issue of managing liquidity ratio was emphasized as a result of the Basel three conferences since the Basel 2 had failed to ensure that all commercial banks had enough capital to cushion them in case of any emerging crisis like the financial crisis of 2008 or the great depression of 1930 (Huw, 2010, p. 1).

Basel I and II

According to the Basel 1 accord, capital adequacy is the bank's capital ratio to that of its assets.

This accord identified two types of capital, tier one and tier two. Tier one concerns share capital whereas tier two concerns preference shares and subordinated debt. The fundamental requirement was the tier one capital and could amount to at least 8% of shares. Basel 2 on the other hand has been modified and replaced by different new rules; it is based on three pillars that are " capital requirements, supervisory review process and market forces" (Graeme, 2011, p. 1).

The pillar of capital requirements is the same as the Basel 1 principle; the second one applies the principle of advanced risk to judge whether surplus capital is required. The third pillar on the other hand demands more exposure of risks, capital and risk management risk. The argument that Basel 1 and 2 paid more consideration on capital adequacy as opposed to adequate liquidity is true. This is evidenced by the introduction of Basel 3 which was motivated by the financial crisis that hit the world in 2008 and deficiencies in the financial industry. Basel 3 was aimed at strengthening commercial banks capital demands and to introduce some policies to govern bank liquidity and operation.

The Basel 3 accord introduced a new requirement on tackling the menace that is liquidity adequacy. Liquidity was an integral arm in the operation of any financial institutions. Bank capital always tend to cushion the bank from any failure and if the bank experiences more losses than the existing bank capital then it is said to be insolvent hence the higher the bank capital the greater the degree of insolvency. Since Basel 1 allowed a flat rate of 8% on the private sector, it acted as an incentive for banks to move high quality assets out of the balance sheet through securitization. This had a net effect on the reduction of lowering the quality of portfolio loans in the bank.

Consequently the original accord of 1988 did not factor in the operational risk of these commercial banks despite it being extremely important due to the advanced complexity of banking operations (Hasan, 2011, p. 1). The Basel accord especially the 1988 edition did not provide for the credit risk preventive techniques such as collaterals or guarantees although this was late rectified in the more risk sensitive technique in 1999. The Basel accord

especially Basel 1 puts more emphasis on capital adequacy as opposed to capital liquidity by the fact that it sets an established capital ratio that any financial institutions must have and this principle does not take into consideration any certainty of market failure and the problems it presents in the financial sector and an entire economy in case they lack liquidity. It has been argued that depositors might display panic when they get any asymmetric information regarding banks information which may in turn lead to liquidation of the banks assets and create a situation of bank run leading to the failure of the banking system (Raymond, 2007, p. 1). As a demonstration that the Basel accord of 1988 laid a lot of emphasis on capital adequacy is evident when upon its inception it only sought to create a level playing field and seeks to justify that the imposition of capital as a core principle in the Basel accord was to create the same regulatory costs among the competing banks as opposed to it being a measure of protecting systemic stability in the financial sector.

Although the Basel 2 was tailored towards curbing risks that's associated with the banking sector, it failed to relate liquidity with the risks that are typical of banks and instead dwelt on idiosyncratic character of each bank. Portfolio invariance which is associated with Basel 2 is more concerned with the capital needed to back any loan from the bank and should only depend on the risk of the loan and not on the added portfolio. This has the shortcoming of undermining the need for diversification as a pressure on the portfolio risk hence lacks any penalty in case of portfolio concentration. The main reasons for the global financial crisis that was experienced in the year 2008 was associated to the contagion and what is economically referred as counterparty

risk which was as a result of banks dwelling too much in the capital market practices that they did not have sufficient capital for.

This made securitization and off-balance sheet the main problem especially in the case of Lehman brothers and AIG. The amount that a capital has is the fundamental thing. This is in the case of conducting their intermediation roles and to reduce the chances of risks and failure occurring. There is none Basel committee that factored in the issue of capital leverage ratio and this still hangs.

Banks that don't have enough capital tend to opt for the very little in order to maximize their equity (Blundell-Wignall and Atkinson, 2011, p. 1).

Conclusion

All commercial banks should develop an undertaking to avert any crisis in the financial sector. The developments from the deliberations of both the three Basel accord of 1988 is a clear indication that a critical area in the financial sector, the matter of liquidity has been ignored. This is despite the revisions of the same accord in 1999 which failed to address the issue of liquidity and solvency ratio in the commercial banks. The development of the Basel three had skeleton coverage of the same matter of liquidity ratio.

It is also advisable for commercial banks to set aside a higher solvency ratio to prevent any collapse incase of default by its depositors. There is need therefore to revise the existing three Basel accord documents in order to reflect the changes and the dynamism of the market.

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