

THE ESSENTIALS OF RISK MANAGEMENT

Third Edition (EoRM3)

ONLINE CONTENT FOR CHAPTER 8

Box 8-4 of EoRM2

From pp. 273–274 of *The Essentials of Risk Management, Second Edition* (EoRM2)

BOX 8-4

LIQUIDITY CRISIS AT CONTINENTAL ILLINOIS

Continental Illinois was the largest bank in Chicago, and one of the largest in the United States, before it had to be rescued by regulatory agencies in May 1984 after a massive liquidity crisis.

The bank had been pursuing a growth strategy since the late 1970s, and in the five years prior to 1981, its commercial and industrial lending jumped from approximately \$5 billion to more than \$14 billion (and total assets grew from \$21.5 billion to \$45 billion).

The first sign of Continental's problems surfaced with the closing of Penn Square Bank in Oklahoma. This smaller bank had been issuing loans to oil and natural gas companies in Oklahoma during the oil and natural gas boom of the late 1970s. It passed large loans that it could not service through to substantial institutions such as Continental Illinois. But as prices for oil and gas dropped from 1981 onward, some of the oil and natural gas companies began to default on their debt, and in 1982, U.S. regulators stepped in to close Penn Square.

Continental was the largest participant in Penn Square's oil and gas loans (more than \$1 billion) and suffered heavy losses on those loans, and also on loans in its own loan portfolio. Many other banks also suffered credit losses in this period, but Continental was unusual in that it had only a small retail banking operation and a relatively small amount of core deposits. It relied primarily on federal funds and on issuing large certificates of deposit to fund its lending business.

When Penn Square failed, Continental found itself increasingly unable to fund its operations from the U.S. markets and turned to raising money in foreign wholesale money markets, such as Japan, at much higher rates.

But when rumors about Continental's still-worsening financial condition spooked the international markets in May 1984, the bank's foreign investors quickly began to withdraw the funds deposited in the bank (\$6 billion in 10 days). In a matter of a few days, Continental Illinois was confronted with a full-blown liquidity crisis, obliging the U.S. regulatory authorities to step in to avoid the danger of a domino effect on other banks—which they feared might put the entire U.S. banking system at risk.

From pp. 275–276 of *The Essentials of Risk Management, Second Edition* (EoRM2)**BOX 8-5****NORTHERN ROCK: LIQUIDITY AND BUSINESS MODELS**

Northern Rock, a fast-growing medium-size mortgage bank based in Newcastle upon Tyne in the north-east of the United Kingdom, was brought down by a bank run in mid September 2007—at the very start of the 2007–2009 global financial crisis. The bank had been growing assets at around 20 percent a year for a number of years, specializing in residential mortgages, and it continued to expand aggressively in the marketplace into the first quarter of 2007.

The bank's rate of growth was supported by a business model and funding strategy that was unusual among U.K. banks. From around 2000, the bank developed an "originate to distribute" approach, under which it raised money through securitizing mortgages, selling covered bonds, and making use of the wholesale funding markets. Northern Rock soon relied much more heavily on investors and wholesale markets (and less on retail deposits) for its funding than many of its U.K. peers.

To mitigate possible weaknesses in this funding strategy, the bank tried to diversify its funding markets geographically. For example, it tapped markets in Europe and America as well as the United Kingdom.*

However, the bank had miscalculated. After years of strong economies and rising house prices, widespread doubts began to surface about mortgage-related assets among investors during early 2007. The doubts were triggered initially by rising default rates in the U.S. subprime market, but soon spread to asset-backed securities as an investment class, to institutions that invested in or depended on securitizations, and eventually the interbank markets.

When the funding market freeze arrived in early August 2007, all of Northern Rock's global funding channels seized up simultaneously in a scenario that the bank's executives later claimed was "unforeseeable." Ironically, earlier in the summer of 2007, the bank had announced increased interim dividends after a Basel II waiver had been approved by U.K. regulators, allowing the bank to adopt advanced approaches to calculating credit risk that looked likely to reduce its minimum required regulatory capital.†

After the funding markets froze, the U.K. authorities discussed various strategies to relieve the bank's difficulties. However, news of the Bank of England's planned support operation for Northern Rock leaked, and was reported by the BBC, setting the scene for a run on deposits between September 14 and 17. The panic was exacerbated by the tight rules then in place for compensating depositors,‡ and calm only slowly returned after a public promise from the U.K. authorities that deposits would be repaid. Northern Rock accepted emergency government support and then public ownership.

* See comments by Adam Applegarth, ex-CEO of Northern Rock, to the House of Commons, Treasury Committee, *The Run on the Rock*, January 2008, p. 15.

† Though the timing of the waiver later embarrassed the bank and its regulators, it was not a significant factor in the loss of confidence in the bank.

‡ At the time, deposits were fully guaranteed only up to £2000, with a further guarantee of 90 percent of sums up to a ceiling of £33,000.

From p. 277 of *The Essentials of Risk Management, Second Edition* (EoRM2)**BOX 8-6****SOUND PRACTICES OF LIQUIDITY RISK MANAGEMENT: U.S. INTERAGENCY POLICY STATEMENT**

- Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk
- Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk
- Comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution
- Active management of intraday liquidity and collateral
- An appropriately diverse mix of existing and potential future funding sources
- Adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs in stressful situations
- Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements
- Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process

Source: U.S. Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010, pp. 2–3