

## **CHAPTER 5**

### **COUNTERMEASURES FOR STRENGTHENING THE LIQUIDITY RISK MANAGEMENT OF SECURITIES COMPANIES IN CHINA**

This chapter, combined with the analysis of the status quo of the previous chapters and the summary of the problems, and the new concept of supervision, puts forward some corresponding countermeasures and suggestions on the liquidity risk management of China's securities companies. The risk assessment will help each agency determine the acceptable level of risk and the resulting security requirements for each system. The agency must then devise, implement and monitor a set of security measures to address the level of identified risk. For a new system the risk assessment is typically conducted at the beginning of the System Development Life Cycle (SDLC). For an existing system, risk assessments may be conducted on a regular basis throughout the SDLC and/or on an ad-hoc basis in response to specific events such as when major modifications are made to the system's environment or in response to a security incident or audit. In the process of preventing the financial crisis, the management of the securities companies should continue to optimize the governance structure, strengthen the risk management system comprehensively, avoid the individual risk crisis of the financial institutions. On the other hand, in order to prevent the systemic risk of the whole securities industry, the government supervision departments should also maintain macro prudence and pay high attention to the importance of the system, and the liquidity risk of institutions.

#### **5.1 Internal management of securities companies**

##### **5.1.1 Strengthening risk management culture, organizational structure and institutional system construction**

The securities companies should truly make the internal risk management as an important part of the corporate culture. In addition to meeting the regulatory requirements, it should put forward higher and more stringent requirements for risk management.

The implementation of strong and effective risk management and controls within securities firms promotes stability throughout the entire financial system. Specifically, internal risk management controls provide four important functions:

- to protect the firm against market, credit, liquidity, operational, and legal risks;
- to protect the financial industry from systemic risk;
- to protect the firm's customers from large non-market related losses (e.g., firm failure, misappropriation, fraud, etc.); and
- to protect the firm and its franchise from suffering adversely from reputational risk.

##### **5.1.2 Tools and methods to improve the management of liquidity risk**

Securities companies should use various monitoring methods for the first time to find liquidity risk events, and to establish various emergency measures and sufficient liquidity

reserves to cope with temporary and long-term liquidity crises, and to avoid the loss of assets and the reputation risk of the company because of liquidity events. The management of liquidity risk in securities companies mainly include asset liability management, high quality liquidity reserve management, cash flow gap management, risk limit management, pressure test and so on.

The term mismatch between assets and liabilities is the most fundamental underlying factor that triggering the liquidity risk of securities companies. The shorter the debt maturity, the larger the average monthly maturity of the debt, the greater pressure on the debt sustainability, and the greater the amount of cash and high-quality assets required to ensure liquidity coverage. Securities companies should optimize asset liability management, from the company's overall and long-term analysis of the capital demand, and the fund strategy includes an assessment of the overall characteristics of the non-liquidity of the company's assets under the expected holding period and the bad environment.

In case of unexpected business, the company needs sufficient cushions and "life-saving money" - the high-quality liquid assets reserve pool. The core high quality liquidity reserve aims to satisfy the company's debt outflow in the next 1 months and ensure the solvency of the company even if the financing channel is disrupted. The demand for temporary large amount of funds in the period of market volatility and new stock is large, and the continuous target of liquidity coverage will be ensured, and the index of the monthly debt scale increases gradually. Liquidity reserve pool assets choose liquidity and security as the core requirement and ensure profitability under high liquidity and high security. In accordance with the business development strategy, risk preference and market conditions, the securities companies should determine the composition of the high quality and liquidity assets at all levels and the asset management scheme, and continue to track, monitor and adjust the quality and changes of the high-quality liquidity assets to ensure the possession of sufficient and high-quality liquidity assets.

Cash flow gap management is the key to ensure continuous and adequate liquidity of the company. Such as the delamination management of the treasurer: Daytime and overnight liquidity only includes cash positions, and reserve bonds are used to meet longer term funds; cash outflows are fully considered, and cash positions are reserved for futures, management, etc. on the basis of ensuring payment of maturity debt. 7 days, 14 days, 30 days of cash flow.

The company should establish a liquidity risk limit system and measure the liquidity and risk from different dimensions. It includes cash flow index, liquidity portfolio ratio, asset liability term gap index, concentration index, other asset liability indicators, etc., in the link of daily liquidity risk monitoring, through the strict monitoring and management of the liquidity ratio based on the balance sheet and the index of the concentration of assets and liabilities, the reasonable evaluation and early warning of liquidity risk are realized, and sufficient time is provided to the management to take appropriate measures.

With the development of business, liquidity risk management system will become a

necessary tool for risk management of securities companies. Sufficient, accurate and timely information is the basis for effective risk management. Sound and effective risk management and controls promote both securities firm and industry stability which, in turn, inspires confidence in the investing public and counterparties. Securities firms have economic and commercial incentives to employ strong risk management internal control systems. Without such controls, a firm is vulnerable to risk. It is required to maintain sufficient IT input and build an efficient information system, thereby ensuring the coverage of risk measurement and the efficiency of risk analysis.

### **5.1.3 Widening the financing channels of securities companies**

As mentioned in the previous problem, most of our securities companies can only obtain 1-7-day lending funds provided by small banks or other non-silver financial institutions by participating in the inter-bank market by the inter-bank market; In the existing financing channels of securities companies, there is a lack of medium and long-term financing channels, and the mismatch of capital maturity of securities companies also increases the liquidity risk of securities companies. In the new situation that the capital strength of the securities company has been significantly improved, the standard operation degree is obviously improved and the financial market is mixed, the securities companies should continue to coordinate the relevant departments to moderately relax the financing restrictions on the securities companies, allow the securities companies to lend to the banks, relax the restrictions on the mortgage loan, and relax the securities. The amount, time limit and limitation of use of the company's fund borrowing and lending will expand the ability of the securities company to deal with the liquidity crisis and win the pilot qualification when necessary.

### **5.1.4 Reducing the dependence of the short-term capital market**

Although the inter-bank market in China has developed into a large scale after decades of practice, the market base is still weak and lack of diversity, and there is a serious characteristic of convergence and homogenization of the trade direction. Commercial banks are the main body of the inter-bank market, but their functions and properties are almost similar. Their trading direction is basically the same in a specific period. There will be no sufficient funds to be disassembled at a specific time of transaction, resulting in the outbreak of liquidity crisis. Therefore, China's securities companies must fully understand the characteristics of the inter-bank market and prepare carefully to avoid misinterpretation of the overall liquidity and liquidity of the financial system. Their own liquidity is not sufficient to meet the liquidity needs, which may lead to the chain reaction, causes panic to customers and endanger the stability of the whole capital market.

### **5.1.5 Improving pressure testing application technology**

The research on pressure testing in China's securities industry is still in its infancy. The research is not enough. The model and method of pressure testing are not scientific and mature. Therefore, the securities companies must combine the actual conditions of our country and the

characteristics of the securities industry to strengthen the research and practice of pressure testing according to their own operating conditions and establish a real precaution. The early warning mechanism of systemic risk provides a scientific method for securities companies' own risk management. In addition to the unified situation stress test conducted by industry organizations, securities companies should conduct stress tests on other subjects and other methods, for example, reverse stress test shall be carried out on the regulatory indicators to calculate the maximum scale of business supported by high quality liquid assets and stable funds. Suppose that the company has a significant reputation risk, the external financing channels are closed, and the company's shortest survival time is calculated. It is required to assess the cash flow gap caused by pressure and the operation of liquidity monitoring indicators (LCR, NSFR) under each stress scenario, and formulate the corresponding liquidity management strategy.

## **5.2 Macro management**

### **5.2.1 Building a macro prudential regulatory framework**

Under the new economic situation, it is particularly important to strengthen the prevention of systemic financial risks and avoid the "gray rhinoceros" effect. After the international financial crisis in 2008, all countries in the world have realized that the risk management system dominated by micro Prudential Management has not adapted to the needs of the development of the financial industry. It has pushed forward the reform of the financial regulatory framework with macro prudence as the main line. The Basel Capital Agreement III, the Dodd Frank act of the United States and the EU "pan" European financial supervision act. The main contents of the reform reflect the concept of macro Prudential Management. The central bank has significantly strengthened systemic risk management, and most central banks have taken on the supervision of systemically important financial institutions. At the present stage, there is no specialized department for systematic research and demonstration on how to build a complete macro prudential regulatory framework, because the financial industry is divided into separate management and separate supervision. In practice, the banking, securities and insurance sectors will put forward the regulatory requirements of their own departments, to a certain extent, there is lack of communication and collaboration between departments, and it does not constitute a complete system. Based on the current decentralized regulatory model and the different regulatory standards for financial risks by the various regulatory departments, the market bodies seem to have found the way to survive and develop in the economic downturn, and to make use of the non-unified regulatory standards to carry out the so-called financial innovation. The essence is to seek regulatory arbitrage in the financial industry and the financial system in the financial system. The internal self-circulation and continuous leverage behavior deviate from the mission of the financial industry's own development, and also accumulate risks that cannot be ignored. For example, abnormal stock market volatility in 2015, although the SFC has mastered the scale of the two financing businesses in the field, it is unable to find out a large number of over-the-counter funds allocated to banks, insurance and financial products, resulting in lagging behind the drastic cumulative financial risk.

In the national "13th Five-Year plan", we pointed out that we should reform and improve

the financial regulatory framework to adapt to the development of modern financial market, so as to achieve full coverage of financial risk regulation. "China's financial stability report (2016)" issued by the people's Bank of China (2016) pointed out that "it is required to strengthen financial supervision, perfect the macro Prudential policy framework, improve the construction of financial risk monitoring, assessment, early warning and disposal system, and comprehensively investigate the risks. Strengthen the analysis and study of cross industry, cross market risk and risk contagion, carry out the supervision responsibility, prevent the supervision blank and supervision arbitrage, strengthen the bottom line thinking, take effective measures in time, and firmly keep the bottom line not to have systemic regional financial risk." It is reported that the people's Bank of China, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission are making positive and policy attempts. The unified design of the overall regulatory framework of the management of management is being carried out closely, including the formulation of unified standards and regulatory plans for cross industry and cross market financial businesses, and establishment of joint inspection system for related businesses and cross businesses.

### **5.2.2 Exploration and establishment of industry liquidity relief system**

Looking back on the transmission of the subprime mortgage crisis in 2008, Lehman brothers, in the United States, was forced to apply for bankruptcy protection without timely and effective relief, then triggered the Domino effect and passed the crisis to other companies. The US Treasury Secretary, Geithner, realized that although the people hated the government's emergency rescue of those stupid financial beasts, if he had been hated by the government, The creditors or the whole market lost their confidence in fulfilling their obligations, and the global financial system would collapse completely, leading to a more serious economic crisis, and the US government was forced to take large-scale relief measures to prevent the financial crisis from spreading to the real economy. Since then, the EU has launched the largest relief operation in history. From the actual effect, the liquidity relief for the market subjects in the United States and Europe helps many financial institutions to survive, to a certain extent, to limit the spread and expansion of the crisis, and to pull the country back from the edge of the economic collapse. Therefore, at the beginning of the crisis, the necessary relief to the companies in crisis can weaken the destructive force of the crisis to a certain extent and greatly reduce the possibility of the evolution of the individual crisis into a market crisis.

The liquidity risk management level of China's securities companies is still relatively weak, limited to the financing channels and the liquidity risk events are abrupt. Therefore, it is an urgent need to explore the construction of liquidity relief system while strengthening the liquidity risk management of securities companies. Concrete forms include: Firstly, the establishment of industry relief mechanism. At this stage, we can establish a liquidity risk emergency mechanism based on the securities investor protection fund and risk funds. When a securities company has insufficient liquidity, the securities investor protection fund and venture capital fund can provide temporary liquidity support for the first time. Secondly, establishment of emergency response mechanism. The current settlement system should be optimized through the clearing of two cities to settle accounts, widening the path of multiple

market exchange, and realizing the direct process of drawing through funds to improve the efficiency of the fund. Thirdly, establishment of mutual aid financing mechanism between securities companies. If setting up a mutual fund for settlement, a securities company may temporarily finance the mutual insurance fund management institution when there is a temporary shortage of funds. Fourthly, to encourage securities companies and insurance companies and other financial institutions to explore commercial insurance and other relief mechanisms to provide commercial banks with liquidity support.