

# Liquidity Risk - The Definitive Methodological Paper - Drehman

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 Monday, 9 March 2009 |  Risk - Research

The European Central Bank has this weekend published a working paper which in my view provides the definitive methodological approach to Liquidity Risk analytics for any financial institution.



In my view any consulting firm or software house advising you on Liquidity Risk analytics and NOT referring this paper, is advising you in a "private language"; you should regard this paper as the benchmark against which to qualify and assure yourself that you are being given the right advice. This paper is the methodological blueprint for 'best practice' in Liquidity Risk analysis, just look at the authors and editors; it has had the European "first XI" 'hall of fame' in risk management expertise working on it, reflecting the importance of the issue right now.

[John A Morrison Profile<sub>\[1\]</sub>](#)/[email John<sub>\[2\]</sub>](#)

The paper details are as follows;-

**EUROPEAN CENTRAL BANK WORKING PAPER SERIES NO 1024 /  
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# FUNDING LIQUIDITY RISK DEFINITION AND MEASUREMENT

by Mathias Drehmann (BIS) and Kleopatra Nikolaou (ECB)

## ABSTRACT

In this paper we propose definitions of funding liquidity and funding liquidity risk and present a simple, yet intuitive, measure of funding liquidity risk based on data from open market operations. Our empirical analysis uses a unique data set of 135 main refinancing operation auctions conducted at the ECB between June 2005 and December 2007. We find that our proxies for funding liquidity risk are typically stable and low, with occasional spikes, especially during the recent turmoil. We are also able to document downward spirals between funding liquidity risk and market liquidity.

## FINAL CONCLUSION

Overall, this paper introduces the idea that a proxy for funding liquidity risk can be constructed from bidding data in the central bank auctions. An empirical proxy for funding liquidity risk was missing up to now in the literature. So far, it was thought that such a measure would require a large data set using private information from banks. However, given equilibrium relationships banks' bids during open market operations will reflect funding liquidity risk. Our idea therefore simplifies matters considerably and allows us to construct for the first time a proxy for funding liquidity risk. We are therefore able to provide, for the first time, empirical evidence that funding liquidity risk has similar properties as market liquidity and that funding liquidity co-moves with market liquidity, as suggested by the relevant literature. In that sense our paper provides a useful contribution to the liquidity literature not only because it opens up ways of further empirical research on liquidity, an area of research hindered by the unavailability of proxies, but also because it can be used as a very efficient tool for policy analysis and monitoring.

The paper is here;-

<http://www.ecb.int/pub/pdf/scpwps/ecbwp1024.pdf> [3]

The authors gave a pre-publication presentation, which is here;-

[http://www.bundesbank.de/download/vfz/konferenzen/2008\\_10\\_17\\_muenchen//presentation\\_drehmann.pdf](http://www.bundesbank.de/download/vfz/konferenzen/2008_10_17_muenchen//presentation_drehmann.pdf) [4]

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