Liquidity risk management: new challenges at hand

The financial crisis, in heightening awareness of liquidity risk, has generated increased focus on this discipline from regulators, financial institution and non-financial corporate treasury practitioners. The resulting changes in guidance, policy and practice will alter bank operating models and change relationships between corporates and their banking partners.

The financial crisis highlighted the critical importance of liquidity risk, for both corporates and financial institutions. As asset values dropped, the lack of liquidity and access to funding, in combination with wide asset/liability mismatches, precipitated the failure of key financial institutions and presaged the broader financial crisis. A hard lesson was learned, but financial and non-financial enterprises alike recognized that effective liquidity risk management is critical to continued operations and must be addressed through comprehensive processes, policies and programmes.

Regulators reached a similar conclusion. There is broad agreement among regulators and industry groups that more stringent liquidity management guidelines and frameworks are required to safeguard financial stability, although consensus on absolute targets and the full scope of requirements remains open and subject to further refinement and analysis. New legislation, amendments and policy statements are proceeding at a rapid pace in the US and Europe, driving change across the financial services industry even before the final rules are adopted. Corporates should be aware of these changes, as they will have an impact on the provision of global banking services. Equally, they should consider revisiting their own liquidity management practices in light of the risks and costs associated with inefficient liquidity and working capital management.

Changing regulation and its implications

A swathe of new regulations, guidelines and proposals are under way. Each of these carries operating implications for banks and their clients.

The Basel Committee on Banking Supervision, in its role as arbiter of global banking standards, is in the process of finalizing its recommendations for both capital and liquidity within what is called Basel III (succeeding the Basel I and Basel II bank capital regimes), for endorsement at the G20 meeting in November. The committee’s International Framework for Liquidity Risk Management and Supervision is a step forward in filling some of the regulatory gaps that preceded the crisis. But the net effect is that a proportion of corporate, institutional and retail deposits will be discounted as sources of core and stable funding. This will in turn have an impact on the value ascribed by banks to client deposits that are more heavily discounted. It will also create a structural funding gap that will need to be filled - predominantly through the capital markets, potentially raising costs. For US banks, increased Federal Deposit Insurance Corporation (FDIC) charges and limitations on banking activities will further amplify cost impacts and depress margins.

Adoption of these measures may lead banks to reassess business valuations, provision of certain services and pricing models. For transaction services such as cash management, deposit value is deeply embedded in pricing and margin assumptions. The downstream impacts may be pronounced, with offsetting price adjustments across the provision of both transaction services and credit, including the extension of intraday liquidity. Some banks, without significant scale or resources, and faced with the prospect of reduced margins and profitability, may choose to exit the transaction services market, leaving fewer players.

In the US, the Securities and Exchange Commission (SEC) has made numerous amendments to its “Rule 2a-7”, which governs US money market funds and often influences the management of offshore funds, even as the European Commission works towards a common definition of money market funds and tighter controls. The amendments to 2a-7 raise funds’ liquidity requirements, impose further portfolio limits based on credit quality, tighten maturity limits and require added portfolio reporting. While these changes are intended to make money funds more resilient to short-term market risks, there is likely to be an ongoing impact on the yields available to investors. The tighter credit quality requirements may also affect the cost of funding for lower-rated corporates, as money funds were a major buyer for these securities.

The US Dodd–Frank Wall Street Reform and Consumer Protection Act will have far-reaching impacts on banks and their customers, although many provisions still require extensive rulemaking by various regulatory authorities. The act expands regulatory oversight, imposes additional capital and liquidity standards and extends the powers of the FDIC as it broadens the assessment base. In addition, the act imposes restrictions and controls on certain bank activities. For example, swaps, which are broadly defined in the Act, will be subject to clearing requirements and banks will be subject to higher capital requirements for uncleared trades. Foreign currency forwards and swaps (but not FX options) may be exempted from regulation under the Act, but they will still be subject to additional reporting requirements and regulations. It is not clear how capital requirements will be determined for uncleared FX forwards and swaps if they are exempted.

While there are still many unanswered questions, it is clear that the Dodd-Frank Act will have an impact on corporate hedging practices and costs. For financial institutions, operating restrictions, higher capital and liquidity standards and higher insurance assessments will raise their cost basis, while constraining revenue generation and margins. Some may elect, or be required, to divest or discontinue certain types of business.
These waves of change sweeping the financial industry will require corporates to ask some serious questions about their financial services providers and their continued commitment to the business. Are they scale providers that can control costs and continue to invest in their products and services?

Liquidity risk management practices
When it comes to liquidity risk management, there is growing convergence between financial institutions and corporates in their objectives and the means employed to improve practices. Treasurers of corporates and financial institutions alike are seeking to improve visibility across their operating networks, move towards greater centralization of activities, and implement more robust stress-testing and liquidity contingency plans.

For a financial institution, stress testing and contingency planning is a regulatory requirement and key responsibility of the treasurer. At a very basic level, based on available data, assessments are made of the likely behaviour of sources and uses of funding over specified timeframes and under varying stress and economic scenarios to determine potential gaps and the ability to meet these through access to cash and highly liquid assets. Contributing factors, such as high concentration among either sources or uses, would dial up the risk.

Within this risk management framework, the objective is to gauge potential risk, project and strategically address funding needs, and ensure continued operation within acceptable risk tolerance limits. This requires close collaboration with business units to understand the nature of the positions, ongoing business strategies and balance sheet requirements. It also requires that adequate systems and infrastructure are in place to ensure full visibility and control of positions throughout the bank network.

This risk management paradigm can similarly be applied to corporates. Central to effective corporate liquidity risk management is the ability to align internal sources and uses of funds accurately between operating entities, while reducing dependency on external funding sources. Collation of accurate cash forecasts, with granularity on material inflows and outflows on a rolling 30-60-day basis is bedrock to liquidity planning. Real-time visibility on positions and flows provides early warning on “surprises”, should these occur. Centralization of global treasury processes provides better control against hidden risk-taking by subsidiaries. Moreover, global cash concentration and pooling structures can facilitate easy access to much-needed cash in a liquidity crisis. Linked strategic and operational views of future needs is evident as corporate and institutional treasurers enhance structural funding to mitigate liquidity risk, centralize operational liquidity management processes, as well as take advantage of historically low interest rates.

Facing the future
While the finer points of the various regulatory initiatives are yet to be fleshed out, liquidity risk management is front and centre with both regulators and treasury practitioners. There is little doubt that the resulting economic and regulatory landscape will have an impact on the interaction between corporate clients and their service providers. Banking services and credit may become more costly and, potentially, scarcer. But this evolution should also be viewed in a positive light.

The ‘new normal’ for banks will be more client- and relationship-centric, with less focus on proprietary activities and risk transference. To offset increased costs, banks will need to drive towards a higher levels of balance sheet and operating efficiency, deepening client relationships and return across a wider range of products. They will seek to establish, and reward, relationship business stability. And, as banks streamline and improve their operating infrastructure, they will provide clients with improved tools to achieve financial and business goals. All this will take place within a safer and more transparent banking environment.

The financial crisis, in heightening awareness of liquidity risk, has generated increased focus on this discipline from regulators, financial institution and non-financial corporate treasury practitioners. The resulting changes in guidance, policy and practice will alter bank operating models and change relationships between corporates and their banking partners. Now is the time to enter into a dialogue with your bank to understand better the nature of these changes and their impact on your business. This intricate partnership may be tested on both sides. Corporates may be looking to diversify, but banks may be less willing to support a more limited share of business at diminishing return.

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