Liquidity Risk Management

New Challenges at Hand

The financial crisis has created heightened awareness of liquidity risk on the part of regulators, financial institution and corporate treasury practitioners alike. The resulting changes in guidance, policy and practise will alter financial services industry operating models and impact relationships between banks and their clients.

The financial crisis highlighted the critical importance of liquidity risk management 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 learned, but financial and non-financial enterprises alike recognised that effective liquidity risk management is critical to continued operations and must be addressed through comprehensive processes, policies and programmes," says **Elyse Weiner, Head of Global Liquidity and Investments at Citi Global Transaction Services.**

Regulators came to a similar conclusion, and there is broad agreement across regulatory bodies and industry groups that more stringent liquidity management guidelines and frameworks are required to safeguard financial stability, although consensus on absolute targets and requirements remains subject to further refinement, she says. New legislation, amendments and policy statements are proceeding at a rapid pace in the U.S. and Europe, driving change across the financial services industry even before final rules are adopted. "Corporate treasurers, many of whom reacted to the crisis by establishing more comprehensive liquidity management practices, should be mindful that the shifting regulatory environment may also affect the provision of global banking services as financial institutions evolve their policies and practices," notes Weiner.

Changing Regulation and Implications

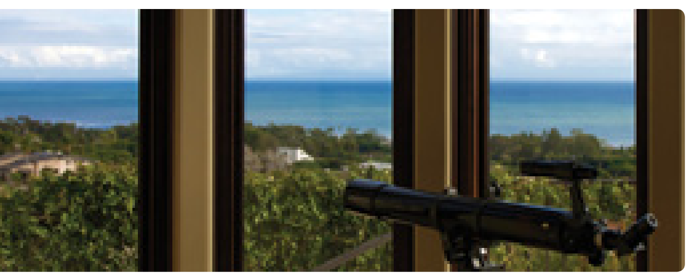
A swathe of new regulations, guidelines, and proposals are underway, with widespread implications for banks and their clients.

The Basel Committee on Banking Supervision, in its role as arbiter of global banking standards, has recently achieved consensus on recommendations for both capital and liquidity, to be presented 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," says Weiner. The proposed liquidity requirements, measured in the form of coverage ratios, will apply varying run-off and liquidity factors to funding sources and assets for assessment of bank balance sheet liquidity and ability to withstand a given stress scenario. The timeframe for implementation has been extended as quantitative impact analysis proceeds, but a clear preference for depository and relationship oriented funding is evident. According to Weiner, this approach will in turn create a value hierarchy that will ultimately impact price and revenue models. As currently constructed, it will also create a structural funding gap that will need to be filled, thus raising costs.

Although broad and uniform adoption of measures at the national level will span years , banks are starting to reassess business valuations and provision of certain services in anticipation of increased regulatory oversight. Weiner notes that, for transaction services such as cash management and custody, the value of deposits derived from transaction flows is deeply embedded in pricing and margin assumptions. The downstream impacts of the new valuation hierarchy may be pronounced, depressing margins, with limited opportunity for offset through price adjustments. "Faced with this prospect, banks without significant scale and resources may be required to refocus on alternative core areas of strength," she says.

In the U.S., the Securities and Exchange Commission (SEC) has made numerous amendments to its "Rule 2a-7", which governs U.S. money market funds, even as the European Commission works towards a common definition and tighter controls. The amendments to 2a-7 raise money 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 ongoing impact to the yields available to investors. Along with the higher capital and liquidity requirements, the tighter credit quality requirements may also affect cost of funding for lower-rated corporate and institutional issuers, as money fund complexes were a major outlet for these securities.

The U.S. Dodd–Frank Wall Street Reform and Consumer Protection Act will also 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 and imposes additional capital and liquidity standards on U.S. banks. It imposes restrictions and controls on certain bank activities, most notably the prohibition on proprietary trading, mandatory clearing requirements for OTC derivatives, and higher capital requirements for uncleared trades. It also extends the powers of the Federal Deposit Insurance Corporation (FDIC) and broadens the insurance assessment base as a function of worldwide net assets. Beginning mid-year 2011, banks will be permitted to pay interest on U.S. business demand deposit accounts (previously prohibited), while the FDIC will provide unlimited insurance on non-interest bearing demand accounts for a period of two years. These changes are expected to drive realignment and re-engineering of bank funding options and the offer of new deposit products for corporate and institutional clients.



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While there are still many unanswered questions, it is clear that operating restrictions, higher capital and liquidity standards and increased insurance assessments will raise the cost basis for financial institutions, while constraining revenue generation. Some may elect, or be required, to divest or discontinue certain types of business, driving industry consolidation. Weiner points out that "Corporate and institutional clients are already asking their banking providers some serious questions about continued commitment to the business".

Liquidity Risk Management Practises

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

"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 between treasury and business units to understand the nature of the positions, ongoing business strategies and balance sheet requirements. It also requires adequate systems and infrastructure to ensure full visibility and control of positions throughout the network," she says.

Corporate treasury management has gravitated towards an objective couched in terminology familiar to institutional treasuries, i.e. effective liquidity risk management rests on the ability to align internal sources and uses of funds to meet the ongoing funding needs of the enterprise, while reducing dependency on costly, and at times inaccessible, external funding sources. "Many corporates have invested in technologies and infrastructure to improve their cash forecasting processes as bedrock to liquidity planning. They have implemented platforms able to deliver real-time visibility on global positions as well as provide early warning on 'surprises', should these occur. To exercise greater control, and guard against hidden risk-taking by subsidiaries, global treasury operations and management are becoming increasingly centralised. Finally, where possible, they are extending and implementing global cash concentration and pooling structures to facilitate access to worldwide cash and take advantage of internal offsets," says Weiner.

"Financial institutions can take a leaf out of this book and better link strategic and operational execution," she notes. As they strategically position the balance sheet to mitigate liquidity risk, taking advantage of historically low interest rates to extend maturities and bolster structural funding, they should also be looking to enhance operational liquidity management processes. Faced with higher costs and declining margins, efficient management of nostros and clearing practises is an imperative, she explains.

Facing the Future

While the finer points of the various regulatory initiatives are yet to be fleshed out, liquidity risk management is front and center with regulators as well as treasury practitioners. There is little doubt that the resulting economic and regulatory landscape will have an impact on the interaction between corporate and institutional clients and their banking providers, just as it will have an immeasurable impact on internal treasury management practises. The provision of various banking services may undergo consolidation and retrenchment as returns and profit dynamics shift and the ability to scale operations becomes increasingly important. However, this evolution can be viewed in a positive light.

"The 'new normal' for banks will be more client and relationship centric, with less focus on volatile proprietary and risk transference businesses. To offset increased cost, banks will need to drive towards higher levels of balance sheet and operating efficiency, deepening client relationships across a wider range of products. In addition, as banks streamline and improve their operating infrastructure, they will continue to innovate, providing clients with improved tools to achieve their financial and business goals. All within a safer and more transparent banking environment," she says.

The financial crisis, in heightening awareness of liquidity risk, has generated increased focus on this discipline from regulators and treasury practitioners. The resulting changes in regulation and operating processes will affect financial services industry operating models, drive consolidation and influence the interaction between banks and their clients. Even as clients seek diversification to address operating and counterparty risk concerns, they will also need to consider which providers have the scale to control costs and the resources to continue to invest in innovative products and services to meet the requirements of an increasingly global and complex operating environment. Banks, on their part, may need to reassess core competencies and their willingness to support a limited share of business at diminishing return. As Weiner says, "Now is the time for bank providers and their clients to evaluate the nature and potential impact of the changes on their respective businesses, with the common goal of improving efficiency and decreasing risk". ■