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Liquidity risk gets real

With new regulatory liquidity risk requirements coming in and the need to understand exposures in real-time ever more critical, FX-MM's Frances Faulds examines what real-time risk solutions can offer.

Frances Faulds
Columnist, FX-MM

It became clear after the financial crisis that not enough was being done to tackle liquidity risk. In April 2013, the Basel Committee issued its final paper on *Monitoring tools for intraday liquidity management* outlining a set of intraday liquidity indicators and reporting frameworks to help supervisors monitor how well banks manage intraday liquidity risk.

Until now banks have managed their payment and settlement obligations based upon end of day forecasts. Monthly reporting on the monitoring tools starts from 1 January 2015 with full implementation by January 2017. The demands for data on liquidity flows, rather than balance sheets, will require significant changes to banks' existing data models and processes. Although the requirements do not specify that banks must move to monitoring their liquidity in real-time, in order to generate the reports and show proper management of capital and liquidity under

Basel III near real-time information must be extracted from the banks' systems.

A recent whitepaper published by Swift, entitled *Intraday Liquidity Reporting – The case for a pragmatic approach*, reveals that based on analysis of Swift data, only 20 per cent of total correspondent banking payment instructions on Swift are confirmed with a credit/debit confirmation message. This indicates that even though the Basel Committee requires banks to report intraday liquidity retrospectively, banks will need to build the intraday position for each of their accounts in real-time just in order to be able to provide the level of detail required in the monthly reports.

In order to generate the reports and show proper management of capital and liquidity under Basel III near real-time information must be extracted from the banks' systems

Nick Noble
SmartStream

Quality and time

One of the biggest challenges will be meeting increased industry demand for quality – and timely – transaction data. Nick Noble, Product Manager – Liquidity Risk Management, at SmartStream says that SmartStream has designed a solution to support the banks in not only meeting the regulatory requirements they have for intraday liquidity management, but also to provide a solution that supports an operational risk framework so that they can more effectively gain visibility over their intraday liquidity and manage this risk more effectively.

He says: "Although the regulation does not require a real-time view of intraday liquidity the actual mechanisms to provide the reports do require banks to have a transaction-by-transaction view of their liquidity, on a minute-by-minute basis, what we are seeing in the market is that although the report schedule is monthly, and in theory, could be generated overnight, this is not what clients want to do. They want a real time application so that they can monitor intraday liquidity risk in real time and not a tool that just retrospectively generates reports after the event. They are evaluating their legacy applications, and batch processes, as they desire to have a framework in place where their near real-time visibility of their liquidity risk is achieved."

Banks are no longer satisfied with hourly or end of day cash management; it needs to be almost real time, within seconds of the event happening

Noble says that while banks may have some of the components in place to enable real time risk monitoring, these can be disparate and the liquidity risk requirements demand that they have to think about cash and liquidity management tools to support real time messaging and reconciliation. This data must also be consumed, stored and managed in a central application in order to get a holistic view of intraday liquidity risk and support analytics and stress testing.

He adds: "Banks are no longer satisfied with hourly or end of day cash management; it needs to be almost real time, within seconds of the event happening. It can no longer be siloed; a global central operating model is now needed to fully benefit from a robust cash and liquidity management process."

Significant financial benefits

While the requirements around intraday liquidity risk managements were issued in April last year but the deadline for commencement of

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reporting is not until January 2015, Noble says that many of SmartStream's top tier customers have been using its solutions for many years and that when they move from a batch to a real-time risk management process there are significant financial benefits by having a more accurate and timely mechanism to manage their funding requirements through timely and efficient cash management processing.

Furthermore, he says that more progressive cash management processes will be achievable through profiling and managing the intraday liquidity risk as a result of fully integrating the compliance of the regulatory requirements within a real-time cash management framework.

The Basel Committee believes no single indicator can provide supervisors with sufficient information on intraday liquidity risks or on how well such risks are managed. In all, seven indicators to liquidity management will apply to all banks, including those that access payment and settlement systems indirectly via the services of a correspondent bank.

Mika Mustakallio
MORS Software

As the development of intra-day liquidity risk management continues in banks, the demand for real-time functionalities is increasing. According to Mika Mustakallio, CEO of MORS Software, gaining a real-time capacity is essential for banks, especially in stress testing for producing Regulatory Stress Metrics, Internal Metrics and Rating Agency Metrics. Furthermore, the ability to forecast and manage Stress Metrics in real time and intraday is gaining in importance.

He says liquidity management is central to all the Basel III and underpins all the other rules that banks are being faced with and the seismic shift needed in the banking industry today is to get rid of the silos. He says: "The reporting arm has always reported reconciled figures. At the moment, the figure comes two or three days after the monthly official accounting figures, and banks cannot steer with these. It must change."

It is better to simply extract the information needed for real-time risk monitoring rather than trying to get the whole bank to move to real-time

Removing the silos

The different market divisions within banks are already real-time in limited areas – credit risk, market risk, trading – but banks are now beginning to look for real-time across the whole bank, by breaking down, or interconnecting, the silos to get systems to work together. However, Mustakallio takes a different approach. He believes it is better to simply extract the information needed for real-time risk monitoring rather than trying to get the whole bank to move to real-time.

During the summer, MORS Software spoke to five different European regulators and all said that they wanted to see the real values reported. Liquidity buffers reported with nominal values is not enough. But Mustakallio says that operationally banks are already there, as front office naturally knows the real values, it is just that the reporting layer needs to follow. He says: "We have helped banks moved forward because we recognise that they need to take the meaningful in real-time but that the non-moving items can updated daily, or even weekly, basis.

"This breaks the normal IT mould that the bank can only move as fast as the slowest part. You will never get the whole bank to move to real-time, and you don't have to, but if you have a reporting mechanism on top that can extract the needed information in real-time, the rest of the bank can continue as it is."

This 'different input in different pace' is a wholly new concept that does not demand that every process is in real-time and the bank can comply, and function, so long as the real-time information needed can be accessed. Mustakallio says customer account systems can still batch-process so long as the reporting layer is closer to the speedier operations of the banks.

Guenther Peer
Reval

Proactive planning

For companies too, ineffective visibility and management of liquidity and credit could result in reactive and expensive measures required to secure working capital. By combining cash positions, forecasts and visibility into available credit limits, organisations can proactively plan for potential liquidity shortfalls and benefit from lowered borrowing costs, lower transaction fees and borrowing penalties as well as increased credibility in the treasury function.

The risks associated with not having proper liquidity visibility and access to capital to fund the company's continuing operations are also at the forefront of corporate treasury systems provider Reval's latest upgrade. With Reval 13.1, treasuries can gain more flexible views to enable treasury teams to better analyse and visualise cash forecasts casts, as they need, across accounts, entities, counterparties and projects.

Reval also has a liquidity platform to help banks provide more timely cash visibility and reporting to corporate treasurers. Reval Vice President Guenther Peer says that while Basel III does not have a direct impact on corporates, Reval anticipates a major change in the way banks and corporates work together. "Even without the regulatory pressure, we do see the need to move closer to real time as it is becoming much more important, both for standard cash positioning and for managing risk positions," he adds.

Reval has recently completed a survey with more than 130 corporate treasurers worldwide, which shows that more than half of respondents do not have real-time visibility into their global cash positions at this point, and a third of these firms need more than a week to compile their cash positions. Peer says: "At Reval, we are seeing a move towards real-time visibility and collaboration across the global treasury organisation." For a multinational company, this drive to real-time visibility requires a platform to collect all the data across global treasury teams, and this can be done using Reval's SaaS platform.

As the development of intra-day liquidity risk management continues in banks, the demand for real-time functionalities is increasing

Change at the margin

The biggest change that will come with the new regulations will be that the margins banks have to take will most likely increase. What this means for the corporate is that they will get less interest for their deposits and most likely pay more for their loans. "Creating visibility and being able to manage cash in real time, as well as anticipating cash needs for the future, will give corporates extra leverage with their banks, as well as reduce costs with tighter forecasting," Peer says.

Under Basel III, short-term deposits will have decreasing yields, while long-term will actually see an uptick, so if corporates are able to commit for longer-term deposits they would benefit from higher rates. More drastically, banks might not even accept their short-term deposits, so corporates are going to have to think about different ways of investing cash.

Peer says: "Corporates need to take action. A lot of corporates still think that Basel III only impacts the banks, but they need to start looking strategically at redesigning their banking portfolio. The relationships are highly likely to change, and corporates could even find themselves in a situation where their banks may not want to do business with them anymore."

The return of the in-house bank

As less credit becomes available to corporates, Peer believes that companies will look at different ways to get access to funding, whether this is issuing corporate bonds or even introducing an in-house bank in order to finance their subsidiaries internally. "An in-house bank is seen as a logical next step to running a treasury centrally, perhaps in parallel to moving towards a payments factory and handling payments centrally," he adds. Historically, in-house banks were run only by very large corporates that had economies of scale, but with bank relationships changing, and with margins widening on debt and investments, the case for building an in-house bank is going to be made easier for other corporates as well.

It is a trend that could have huge ramifications on the banking and corporate treasury sector and one that is likely to gain ever more traction as the regulatory focus pushes the cost of credit and borrowing still further upwards but unless both banks and corporates can gain a real-time view of their liquidity in a short space of time finding the best way forward is not going to be easy.

Getting the level of detailed real-time reporting that the monitoring tools required is not something that can be outsourced but must be integrated into banks every day cash and liquidity management processes so that every bank knows its real-time liquidity exposure, that all trading activity can be funded and that it is maximising its investment returns.

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Nick Noble, Product Manager – Liquidity Risk Management at SmartStream, says if implemented correctly, new regulatory requirements on liquidity will give banks a new level of visibility and control over their operations.

Why are global regulators so concerned about intra-day liquidity?

Lack of visibility and control over intra-day liquidity and an inability to cover payment obligations was a major contributor to the collapse of Lehman Brothers. Liquidity issues at an individual bank level are exacerbated due to the interconnectedness of counterparties within correspondent banking and direct settlement markets. This creates an overall risk to the smooth running of payment and settlement infrastructures, which are a fundamental lifeline to the functioning of the global economy.

As such intra-day liquidity became a key element of the Basel Committee on Banking Supervision (BCBS) Principles for Sound Liquidity Risk Management and subsequently culminated in the publication of the Monitoring tools for intraday liquidity management.

What challenges do banks face in meeting new regulatory requirements?

The regulation requires banks to integrate operational elements into their broader liquidity management risk frameworks that include the measurement and prediction of liquidity flows and demonstrating the capacity to acquire and mobilise sources of liquidity where necessary.

The monitoring tools require banks to calculate their net balance and the consumption and offering of intraday liquidity on a transaction-by-transaction basis. In order to achieve these objectives they must have the capability to process, store and report on all payments and receipts across their direct and correspondent banks. If they provide correspondent banking services to financial institutions, they will also need to report on the payments and receipts processed on their customers behalf. This represents a significant challenge to source, capture, process and present the data in a meaningful way.

How can implementing new processes give banks a competitive edge?

The regulatory drivers are pushing banks to implement systems and processes that, if implemented effectively, will provide a bank with a new level of visibility and control over where and when intraday liquidity is being consumed and offered. Traditionally banks would pass over all their payments to their correspondent and rely on them to manage their intraday liquidity against credit lines offered, based on credit worthiness and other commercial factors.

This new level of visibility could quite possibly lead to a change in operational behaviour and the pricing of intraday liquidity. Organisations that do not have robust and timely processes and controls in place might be left behind the curve and incur additional costs and be exposed to risks that other parties are mitigating against more effectively. This then impacts reputation and client service.

What are the benefits of a strategic approach versus a short-term tactical approach when satisfying intra-day liquidity reporting requirements?

Organisations that take a tactical approach might interpret the regulation as only requiring them to provide retrospective monthly reports and approach the monitoring tools as a 'tick box' exercise. It important to stay focused on the broader principles of sound liquidity management, as set out by the BCBS. Banks should implement systems, processes and an overall operating model that allows real-time, minute-by minute, transaction-by-transaction visibility and control over a bank intraday liquidity profile.

Taking this approach will allow the regulatory reporting to be a by-product of an investment that will deliver many more benefits.

What are the business and operational benefits?

Following on from the previous question, once an organisation has implemented a strategic approach they will not only have the capacity to understand their liquidity position in real-time but also profile these positions over a period of time.

This provides banks with the opportunity to identify potential stresses and identify patterns that can be optimised. If intra-day liquidity management is also implemented into broader Cash Management operations, such as reconciling settlement advices in real-time against internal projections, further benefits can be gained. These benefits include being able to identify the lines of business that have contributed to liquidity strains and appropriately allocate costs. This promotes behavioural patterns where the impact on liquidity is taken into account within trading decisions.

The strategic approach that can deliver the operational benefits has been at the forefront of the objectives and design of SmartStream's Cash and Liquidity Management product suite.

If not a career in the financial sector, how would you like to make a living?

I love skiing and snowboarding so a career that allowed six months of the year to be spent on the slopes would be ideal, preferably not as a chalet maid!

For further information: **www.fx-mm.com**