Why is it critical to have a robust intraday liquidity management system coupled with stress testing

It's been a topic of discussion lately whether banks are conducting adequate stress tests on their liquidity, particularly when it comes to intraday liquidity. Many banks see these tests as a regulatory obligation rather than a crucial aspect of their risk management framework. Typically, these tests involve pre-defined scenarios that are inflexible and cannot quickly adapt to market changes. However, recent market upheavals have emphasised the need for up-to-date scenarios that yield quick results, rather than waiting for days or weeks. Banks must actively manage intraday liquidity and conduct intraday stress-testing as a key part of their operations. The increased market, credit, and operational risks have emphasised the need for a detailed, evidence-based understanding of intraday liquidity and exposures. Yet, many banks have not addressed this, leaving them exposed to unknown liquidity levels. Regulators in the UK require banks to maintain liquid asset buffers to deal with stress scenarios, manage intraday liquidity risk, and report data on intraday liquidity usage. Recently, Financial Conduct Authority (FCA) in the UK has extended this stringent approach to payment services providers (PSPs). In a letter to the PSPs, FCA has laid out several outcomes from these stringent controls. These are:

1. Ensure that the customers' money is safe, covering Safeguarding, Prudential risk management and Wind down planning

2. Firms do not compromise financial system integrity, that includes Money laundering & sanctions and Fraud

3. Ensure that customers' needs are met through high quality product and services by Implementation of the Customer Duty

These are further enhanced by cross-cutting priorities:

1. Governance and leadership

2. Operational resilience

3. Regulatory reporting

Looking specifically at the 'Prudential risk management' and 'Operational resilience', PSPs will need to focus on liquidity risk management by implementing stringent risk framework that includes stress testing. Alongside banks, they must also have systems and controls in place to ensure the right level of information is available at the right moment, with appropriate early warning indicators, directed at the right individuals, and compliant with external and internal guidelines, such as around credit limits and fluctuations in liquidity usage. This encapsulates aspects such as knowing the implications of counterpart failures,

customer payment defaults or delays, the impacts if a group of counterparts hits liquidity issues, if a currency is devalued or if something effects the value of a specific collateral type. This then feeds in to ensuring the right liquidity buffer – not too low but also not too high, given the resultant additional funding costs of the latter. The stress testing should be sufficiently flexible to allow institutions to test multiple scenarios – what if A or B happens; what if A and B happens; what if A and a subset of B happens?

Intraday liquidity stress testing has emerged as a crucial component of comprehensive and robust risk management. Banks and regulators are now focusing more attention on improving their intraday liquidity stress testing capabilities, with the emphasis on the ability to swiftly modify stress scenarios and conduct tests on demand. The importance of evaluating counterparties, correspondent banks, and underlying clients cannot be overstated, and on-demand stress testing is the key to achieving this. Banks have to leverage new technologies such as AI or machine learning to move from historical data-based modelling to forecasting/predictive modelling. A particularly valuable application to assess if and when unsettled transactions will settle, especially once the market liquidity starts reducing. This will act as an early warning mechanism for banks to make decisions on when to draw on their intraday credit lines with the central bank, or with their correspondent bank, but also on releasing further payments to that particular counterparty. An automated and flexible stress testing tool will enhance banks' risk management framework and capability to identify vulnerabilities and prevent credit crunch points.