POSTTRADE 360°

From left, top row: Volante Technologies' Vinay Prabhakar and SmartStream's Paul Randell; bottom row: Planixs' Pete McIntyre and 3C Advisory's Olaf Ransome. (Background photo: Markus Spiske / Unsplash)

Banks still hitting the buffers on intraday liquidity management

PAUL GOLDEN 2024-07-16

DEEP LOOK | **Despite the opportunity cost to banks of holding huge amounts of high quality liquid assets in payment systems, relatively few financial institutions have made meaningful progress towards measuring and managing intraday liquidity in real time. Join our contributor Paul Golden as he speaks with five experts to frame what it's all about and how to get better at it.**

Regulations – notably Basel – require banks to maintain a certain amount of capital reserves to cover their exposure obligations. The problem is that some banks have set aside more capital than necessary because they don't have a real time understanding of all available sources and uses of liquidity.

The amount of cash we are talking about here is substantial. Data from the Basel Committee suggests that the largest global banks had a total of $4 trillion in liquidity buffers as of June 2023, of which as much as 30% was set aside for settling trades and making payments.

The precise opportunity cost for the major cash management banks from the enforced inactivity of these assets varies. While they are unavailable for income-generating activities such as lending to businesses or investing in market opportunities, **Pete McIntyre**, liquidity expert at Planixs observes that in the UK the Bank of England is paying interest on these ring-fenced assets.

"For many large banks, keeping their liquid assets with the Bank of England might not be a bad option because the interest they receive can cover or exceed the cost they incur to attract deposits," he says. "However, the European Central Bank requires banks to hold a minimum set of reserves without any interest return."

In addition, with most experts expecting interest rates in the UK to start falling this year the difference between what banks pay to attract deposits and what they can earn from the central bank will narrow, making the decision to leave money inactive less economically viable.

Regardless of the opportunity cost, it is clearly in the interests of every bank to be able to measure and manage intraday liquidity in real time. A 2022 report produced by Oliver Wyman suggested most large banks worldwide have spent significant efforts and time enhancing their intraday liquidity management capabilities over the last decade.

More work to be done

However, **Olaf Ransome**, founder of 3C Advisory reckons they have a long way to go. "Broadly, there is no end-to-end thinking," he says. "Treasury are stuck with the assessment of the buffers while cash management deals with settlement."

The best that many banks have achieved is getting real time insights on balances. Some can see whether a certain counterparty has paid in or not, but very few can accurately track what is happening at the counterparty level with any degree of confidence.

That is the view of **Alex Knight**, head of EMEA at Baton Systems, who says most banks have limited capabilities that only cover a few core currencies. “They ultimately lack the real time visibility and control needed to effectively monitor, measure and manage intraday liquidity at the level required to proactively instigate the corrective actions necessary to minimise a liquidity shortfall,” he adds.

While many banks claim confidence in managing data liquidity, in practice they often cannot update their intraday profiles in real time – and certainly not for all their accounts – or cannot compare these profiles to intraday forecasts says McIntyre.

“This discrepancy can hinder their ability to react effectively to market changes and stresses,” he continues. “In addition, the lack of real time visibility and forecasting makes it difficult for banks to manage liquidity when they cannot anticipate or respond to fluctuations in client behaviour.”

The mid-tier banks in the $10 billion to $100 billion asset size are where the greatest challenges lie since they are too big to perpetuate the manual and workaround-oriented approaches of smaller institutions but are not of a size to enjoy economies of scale in compliance or technology suggests **Vinay Prabhakar**, chief marketing officer at Volante Technologies.

Siloed infrastructures and the absence of a single source of real time data create significant data issues for intraday liquidity management according to **Paul Randell**, product manager cash & liquidity management at SmartStream.

“Banks may have invested in solutions to perform this business critical function, but these solutions must be reviewed frequently to ensure they address changes such as ISO 20022 and central banks’ continued evolution of BCBS 248 reporting and periodic reviews,” he says.

Paying the price

The Oliver Wyman report refers to smaller and less complex banks that have not prioritised investments in intraday liquidity management being incentivised to upgrade their capabilities in the face of increasing customer demand for instant payments. Real time settlement creates liquidity requirements when debits are out of sync with offsetting credits.

"The move towards faster payment settlement has made intraday liquidity management more challenging because there are more places where money is needed, which fragments liquidity," explains Ransome. "Estimates of what is needed mean buffers are driven by peaks rather than actual data about patterns."

Faster payment mechanisms have become an option for intraday money movement at less expense and with greater transparency than traditional wire or RTGS (real-time gross settlement) services. The ISO 20022 standard enables the transporting of detailed data with each payment that can be used for intraday reconciliation.

"All these possibilities create challenges though," says Prabhakar. "Most treasury systems, like core banking and payment systems, are designed around start/end of day reporting and reconciliation workflows and cannot generate real time reports. Also, faster payment settlement systems are not merely faster – they are 24×7, extending reporting and reconciliation into a round-the-clock operation."

McIntyre suggests that although most banks are getting their heads around the infrastructure required to handle instant payments, there is insufficient consideration of the impact on liquidity and in particular, intraday liquidity.

"Instant payment systems are causing a shift in customer behaviour, moving away from more predictable patterns," he says. "This unpredictability poses a significant challenge to banks as they can no longer rely on past performance data to forecast future liquidity needs accurately. Without real time data and analytics, banks often resort to over-providing intraday liquidity to ensure they can meet any sudden demands arising from instant payments."

Netting not a panacea

Netting has improved intraday liquidity efficiency by reducing the number of transactions that need to be settled individually. But while this leads to lower funding costs, in many cases it also increases the operational burden on banks as the calculation and agreement processes often include manual processes.

“The effectiveness of netting depends on the extent to which it is implemented across different markets and currencies,” says Knight. “Banks that have comprehensive, automated and robust netting arrangements in place can manage their liquidity more efficiently, even in a fast-paced settlement environment.”

Randell agrees that efficient netting reduces the number and value of payments and therefore the size of liquidity pools required to support them.

“This can be challenging in a bank that has fragmented internal payment infrastructures, although even netting within each individual payment system can provide reductions in payment volume and value,” he says. “But banks should not only review their transactions with external parties. A programme to analyse the impact of intercompany cash movements at a large tier 1 bank found that putting in place netting for internal cash movements positively impacted intraday liquidity usage.”

On the question of whether there is sufficient availability of technology solutions and vendor support to enable banks to monitor intraday activities and improve intraday liquidity management, Knight refers to growing availability of solutions and support that provide an advanced level of visibility and control across business silos.

“The challenge that remains, however, is to ensure that the pathway to the deployment of these solutions is as simple and riskless as possible, so interoperability with existing systems is key to success,” he says.

Achieving the best outcomes

According to McIntyre, best practice intraday liquidity management involves three capabilities:
• **Monitoring** – assessing intraday liquidity in real time, understanding what is going on, and determining necessary actions

• **Active management** – influencing the use of intraday liquidity either in real time or over a longer period. This includes strategies such as throttling payments to reduce liquidity usage, alerting to potential issues, and analysing historical usage to pinpoint which parts of the business drive liquidity needs and also involves changing business behaviours and counterparty relationships if they negatively impact liquidity performance
• **Risk and regulation** – understanding intraday risks, identifying them, determining mitigations, conducting stress testing, and providing regulatory returns

"Another important consideration is ensuring the solution meets the bank's functional and non-functional requirements," says Randell. "For example, does it have the value-add features that can automate the cash and liquidity processes? Banks need to think about features such as rule-based automated sweeping, real-time matching, liquidity alerting, transaction lifecycling, and intraday liquidity stress testing."

However, Ransome suggests availability of technology is not the major issue. "The real challenge is achieving a top-down understanding of costs and drivers and from that a desire to manage the process really well," he says.

Prabhakar agrees, suggesting that most financial institutions still see intraday liquidity as a regulatory requirement to which minimal resources should be allocated rather than an opportunity for improved internal treasury operations and increased visibility to customer flows.

"As a result, investment in upgrading or replacing current systems is slow," he says. "Also, while there is a clear need to integrate payment flow data and treasury visibility, most treasury systems and payment systems are developed independently – even where the same company supports both systems. So there is a lack of true integration between vendors, which means that it is harder for banks to tap into the value of intraday money movement and liquidity management across operational silos."