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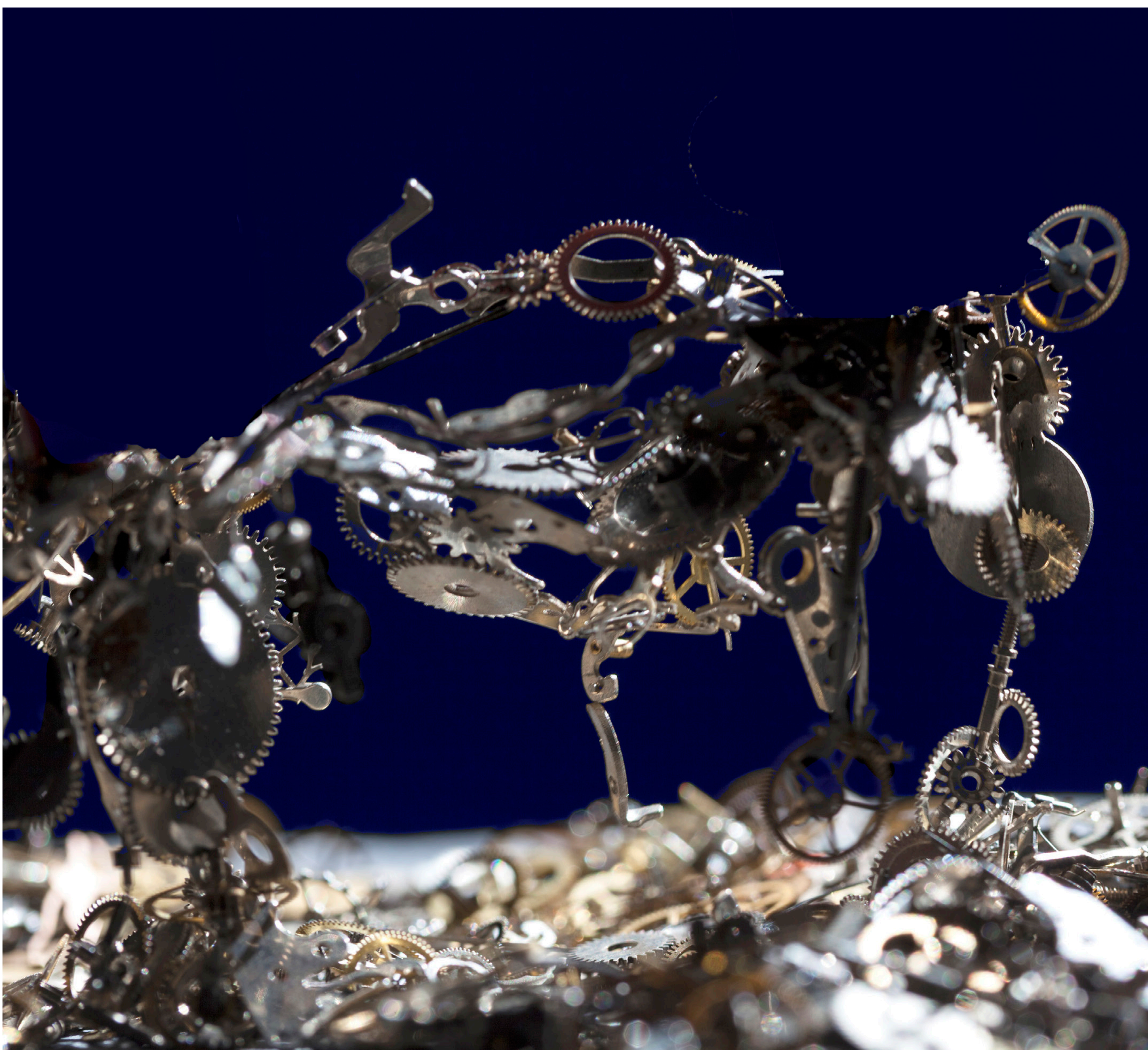
Liquidity—Bringing it all Together

Cash and liquidity management systems are becoming increasingly sophisticated, with firms prioritizing projects that can help meet regulatory requirements and deliver improved efficiencies for the business. In a bid to optimize liquidity management, the market has seen firms move towards intraday models and global liquidity engines. Tine Thoresen reports.



After the fall of Lehman Brothers in 2008, it took some firms days—or even weeks—to identify holdings and positions and, in some cases, liquidity dried up in the process. To avoid this happening again, the changes made in the past years have been profound—new regulation has forced firms to hold more liquid assets such as cash or government bonds, and there has been innovation in the market. Regulators have been busy bringing out new requirements designed to protect the financial system from future crisis, and firms have responded by making substantial investments in initiatives crafted to meet new requirements and create a more robust financial system.

Regulations such as the Dodd-Frank Enhanced Prudential Standards, the Basel Committee on Banking Supervision's (BCBS) Principles for Sound Liquidity Risk Management and Supervision, the International Organization of Securities Commissions' (Iosco) Principles of Liquidity Risk Management for Collective Investment Schemes and Federal Reserve CFR 249 Liquidity Risk Measurement Standards are all raising liquidity thresholds and further narrowing the neck of the collateral bottle.

To justify large reform programs—investments that, in some cases, could impede businesses' ability to exploit other opportunities—firms are increasingly focused on achieving greater value from the work that goes into upgrading systems and processes. This has resulted in projects aimed at meeting regulatory requirements, as well as improved operational efficiencies and more effective control of cash and liquidity management.

The first projects seen to address liquidity regulation after the financial crisis were focused on moving treasury books into highly liquid assets such as cash, government bonds, covered bonds and, to a lesser degree, corporate bonds. Since then, regulators have given guidance on how to address liquidity management. In January 2013, the Basel Committee published *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* that set out liquidity coverage ratios (LCRs), which required banks to have at least 60 percent coverage of highly liquid assets to cover their net outflows over a 30-day stress period by 2015. These requirements will increase step-wise to 100 percent LCR by January 2019 and, to meet Basel requirements, many firms have identified the need for greater insight into assumed net cash positions, fueling investments in projects designed to improve efficiencies in asset liability management.

The cost of holding very liquid assets has in recent years resulted in low yields, making it essential for firms to get the balance right to avoid holding excessive low-yielding assets at an expense of higher-yielding ones. Due to the risk of regulatory breach and the opportunity for cost savings when getting the LCR right—avoiding the need to boost liquidity through costly intra-day borrowing—projects aimed at delivering improved cash and liquidity management have climbed the agenda, and the focus has been on retiring legacy systems, streamlining processes, reducing manual intervention and ensuring more timely access to data.

The evolution of regulation and the introduction of additional requirements for intra-day liquidity management—as well as the cost-saving potential for intra-day management—have taken projects to the next level. "Everything is moving to an intra-day model," says Kurt Eldridge, executive vice president, global sales, SmartStream. Regulation has been a key enabler for the move to intra-day, and even forward-thinking firms that already had capabilities for intra-day liquidity management have made improvements by, for example, incorporating external data to get time stamps on debits and credits to meet new reporting requirements.

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The details on how banks should handle management of intraday liquidity risk were set out by the Basel Committee in *Monitoring Tools for Intraday Liquidity Management* (BCBS 248), and the new reporting requirements—initially scheduled for no later than January 2017, but pushed back to 2018 and 2019 in many countries—have fueled further investment in cash and liquidity management systems.

At Raiffeisen Bank International (RBI), the new regulation led to the firm working with SmartStream and implementing SmartStream Corona Cash & Liquidity—a central tool to monitor and control all aspects of cash and liquidity management. The bank previously built intra-day cash and liquidity management tools internally, as intra-day management had been an ongoing priority, but Basel III introduced the need to source external data, resulting in enhanced visibility into cash positions. Wolfgang Pollak, senior asset liability manager, RBI, says that, in addition to meeting the new Basel reporting requirements, the project resulted in the bank improving its knowledge of what liquidity it needs to hold because of closer monitoring of nostro accounts and better understanding of cashflows.

RBI's proactive approach has created a robust foundation for cash and liquidity management opening up new opportunities for the firm. "The first step is to monitor your external liquidity. and the next step is to monitor your internal cashflow and your customer accounts where you're the manager," says Pollak, explaining that this would be useful for stress testing.

Under Basel III, LCR is calculated on assumed net cashflow for a 30-day stress period, making stress testing essential for the efficient management of liquidity. For firms going forward, it is now about improving the models by getting the inputs right, improving a firm's ability to meet regulatory requirements, as well as resulting in more efficient management of liquidity and potentially resulting in higher yields on its liquidity portfolio. "If you're running stress tests, you need to model what outflows can happen in times of stress and, to get a more accurate model, you need to know the behavior of your customer, which you only get if you monitor what they're doing," says Pollak, who adds that this would also help the firm improve its own liquidity steering.

Following Basel III, banks have been in continuous dialogue with their local regulators, as it is up to these regulators to approve the stress testing used to calculate LCR to ensure it is appropriate to the business model. Pollak says RBI is now aligning stress assumptions, building out stress tests and validating stress models, as stress testing is an important factor in defining LCR and how much liquidity the firm needs. Getting the models right to potentially reduce the buffer is vital for a bank's performance, and could lead to better allocation of excess liquidity to increase returns.

To achieve this, firms need quality data, integrated systems and tools that enable intra-day customer behavior analysis. Pollak says the firm needs to identify when most payments are affected, as well as the timings and the amounts. "You're almost forced to know your customer-base behavior better, which is definitely an advantage," he says, adding that firms would previously have been looking at this data on an end-of-day rather than an intra-day basis. The improved insight into customer behavior could see the firm being able to give more information to customers on the timings of transactions, which would in turn enable the customer to do more, explains Pollak.

Going Global

There is also a trend toward banks increasingly managing liquidity as a service for customers, as well as their own. To do this effectively, banks are finding they would benefit from moving away from viewing data in disparate systems, and are instead building an integrated view of cash and liquidity and other datasets required for the service, such as costs. In Europe, it is now the Markets in Financial Instruments Directive (Mifid) II that is setting the agenda for many operations projects and, as part of preparing for Mifid II, firms are looking to gain increased visibility into the details of cost allocation. When monitoring a client's liquidity they need to understand the cost every step of the way, allocating costs either to the client or to the firm. "The only way to do that is to bring together cash, collateral, corporate actions, and so on, to understand the details," says Darryl Twiggs, senior vice president, strategic initiatives at SmartStream.

Bringing together cash management systems with intra-day liquidity, collateral and corporate actions management appears to be where the market is now moving, and a combination of past market events and regulation are seen as the background to this. The continuous wave of regulation has led to increased sophistication in the market when it comes to liquidity management. SmartStream, which offers cash and liquidity management software solutions that enable banks to break down silos with an enterprise-wide solution for cash management, treasury management, exceptions management and reconciliations management, has recently entered discussions with customers wishing to set up internal liquidity utilities.

A liquidity utility would manage the global liquidity position for a firm, taking data from multiple entities and aggregating the balances to show the liquidity for the firm. "Many firms have some more local capabilities, looking after their own business, but regulators are now looking for firms to report their global liquidity as well," says Twiggs, explaining: "SmartStream is now seeing potential customers asking to accommodate other sources, including securities—in the form of collateral, and market activity, in the form of corporate events—that also have the concept of a utility."

By integrating more sources, the aim is to have real-time monitoring of liquidity that goes across cash and securitized collateral. For SmartStream customers, these projects leverage the fact that all SmartStream Transaction Lifecycle Management (TLM) solutions are based on a single architecture, making it possible to integrate TLM Cash & Liquidity Management, TLM Corporate Actions Processing and TLM Collateral Management. "We deliver our solutions so that they can be integrated," says SmartStream's Eldridge, adding that projects aimed at centralizing and integrating systems will help firms achieve a complete view of settlement, messaging, what is predicted to be settled and the valuation of collateral against the market.

Under the Basel requirements for intra-day liquidity monitoring, collateral is also mentioned, further strengthening the business case for having an integrated view of short-term liquidity steering and collateral. This is already done at the entity level at RBI, and the next step would be to set up a global hub, which, explains Pollak, can offer a firm increased oversight and be beneficial from an information perspective.

An enterprise-wide liquidity engine could be an additional way of further improving cash and liquidity management and centralizing data, but there will continue to be a need for liquidity management at the entity level, too. "Working in different markets, it's not always possible to shift liquidity from one entity to another," says Pollak, explaining that capital restrictions can hinder movement of cash and collateral between countries, which means it is difficult to have a worldwide view of liquidity monitoring without the country-level focus.

For firms in the process of setting up a global liquidity engine, one challenge they could be looking to address is collateral management. "Collateral is a sensitive topic as its liquidity can be questionable," says Twiggs, citing an example that, if a firm holds US dollars as collateral to cover euro trading, the regulator would question the liquidity of the dollar and its value when needed to convert to euros. In other cases, collateral could be under scrutiny by regulators if the liquidity of the assets is questionable.

As regulatory costs have continued to increase, the focus will remain on identifying ways of enabling banks to maximize returns within the requirements set by the regulators. And the winners are the firms that have first-class systems for monitoring liquidity intra-day—systems that are integrated with cash, collateral and corporate actions, and enable the firm to get quality data for stress tests and make sound assumptions about collateral. W