The liquidity mirage

Maddie Saghir reports

Liquidity has been one of the main challenges over the years, but how has the financial crisis helped to prepare the industry for the ongoing pandemic?

Liquidity has been described by some in the market as the "fetish of the financial services industry", while others have referred to it as "a mirage that evaporates as soon as you try to reach it".

In the event of a crisis, assets can evaporate overnight when times are volatile and trust between institutions is lost – is this the case with the ongoing COVID-19 pandemic?

A recent R&M survey found that the asset servicing industry has coped well with the challenges presented by COVID-19, as clients are overall happy and appreciative of the support given.

In terms of liquidity, COVID-19 has certainly brought about volatility, and back in March, the Bank of England cut the interest rate to provide liquidity and much-needed support for small and medium-sized enterprises.

But this liquidity challenge isn't new, liquidity has been a prominent challenge for the industry over the past few years. And, since the strike of the pandemic, different liquidity reporting and monitoring requirements have been triggered.

Reporting and monitoring requirement changes

In terms of liquidity reporting and monitoring requirements that have been triggered by COVID-19, Nadeem Shamim, head of cash and liquidity management at SmartStream Technologies, observes that since the pandemic there has been an extra focus on liquidity, not just in terms of end of day reporting or short-term liquidity management, but on intraday liquidity.

"Banks are finding it almost a necessity to know exactly what liquidity they have, where it is, and at what time it is being used throughout the day," Shamim says.

In addition, Shamim notes that they are also looking at the value of the collateral that is used to secure that liquidity. The market has been rather turbulent and so the valuation of the collateral could either plummet or alter largely.

Meanwhile, in the context of the US and North America, Don Mumma, managing director at AxiomSL, identifies a couple of trends that happened.

The first was an increase in the frequency of reporting. Mumma explains: "The big banks in the US that have to comply with the liquidity coverage ratio (LCR) do that by submitting a federal reserve report called 2052a. Within 2052a, there are some characteristics that are based on a certain set of criteria that the Federal Reserve calculates the LCR for those banks. When banks use our software and their own they also calculate their own LCR."

However, Mumma says: "The frequency for 11 G-SIBs that includes eight domestic and three foreign banks reporting and have been reporting daily for some time, the balance of the banks only had to report their LCR and their 2052a monthly. The increase from monthly to daily was a massive deal for a lot of them and the challenge of getting their data together in order to be able to run daily was the first big change."

Mumma highlights the speed with which changes occurred and had to be adhered to was extremely significant. He remarks: "The Federal Reserve allowed some banks to report weekly for a month but then they had to go daily. This was a very fast ask."

The second big change involved the Fed saying that they have made changes to improve liquidity that has been adverse to the LCR, according to Mumma.

"Therefore, the Fed said they would give relief from the calculation of the outflows that are associated with the support that has been given by the treasury and the Fed in the calculations and compliance of LCR – and that was with immediate effect," Mumma notes.

Thirdly, the frequency of calculation of stress testing in the US also increased. Mumma says: "A lot of the banks started doing that on their own because they were very concerned about what was happening and they were trying to show some stress scenarios that were reflective of changes in their cash flows that weren't necessarily related to things such as the LCR calculation."

Further challenges revolve around the operational side of things. Shamim comments: "In order to do the reporting and monitoring, the data needs to be gathered on time. With teams being located in different locations – and potentially reduced teams as well – it is causing operational issues. There are delays in establishing liquidity positions, which could effectively mean that the banks are leaving additional liquidity, excessive liquidity, which is unused."

Minimising the challenges

For minimising the challenges associated with liquidity, firms can reduce their dependence on manual processes in favour of a more automated solution.

Shamim says that if firms start the journey of putting an automated solution in place then that can improve their ability to handle unusual events.

"They can closely monitor intraday solutions. If you make that an active part of your intraday management then you are aware of your acute events within a day far quicker than waiting overnight to find out. Many of the leading banks have already invested in an automated solution," Shamim notes.

Shamim remarks that while some organisations have robust end-to-end straight-through processing (STP) and automated liquidity monitoring in place, the vast majority have just some elements of automation but not all aspects, which means they are not necessarily able to know where the liquidity is throughout the day or who is holding it. "This is the key differentiator between how the banks are coping," Shamim highlights.

Shamim also stipulates that COVID-19 has exposed the shortcomings in banks in terms of how the banks used to think it was ok to have a manual process of their end of day liquidity.

But because of the operational challenges, manual processes are causing delays in getting liquidity positions sent overnight. Shamim explains that this creates challenges for the treasurers as they will want to know whether the liquidity is being managed to the best ability.

"There are also concerns as to whether liquidity is being wasted, and whether they can operate within the internal rules and regulations and policies that have been created. If the data is not received quickly enough then the challenge is that there could be delays in being alerted to any issues in a timely manner. There will be quite a lot of operational challenges until an automated solution is presented," Shamim says.

At AxiomSL, Mumma says the software has been able to accommodate the changes very quickly. He notes: "The main thing is being able to access your data and to be flexible to accommodate changes."

"Once our clients give us their data, we can change the way it is being calculated and mapped, which is one of the flexible features of a software."

"Coping with data inside of a bank is something that has been in the works for a while. There has been a challenge in getting data readiness and the big thing now is that the frequency is much more frequent," he says.

Meanwhile, lower data costs are something that could help to increase liquidity. Indeed, a new report on market data costs highlights that global principles must be implemented to effectively address high market data fees and unfair licensing provisions.

Authored by the European Fund and Asset Management Association (EFAMA), International Council of Securities Associations (ICSA), and Managed Funds Association (MFA), the report recognises that the uncompetitive conditions of trading venues were the motivation for high data price.

Bryan Corbett, president and CEO of MFA, says: "Excessive market data fees harm investors and their beneficiaries, including pension funds which require reliable returns to fund workers' retirement. Access to market data enables investors to participate in capital markets, increases liquidity, and better serves all market participants."

Stress testing is another factor that is of paramount importance when it comes to minimising challenges.

Liquidity stress testing aims to test the ability of banks to meet near- term payment obligations, under funding loss and other counterparty cash drain. Shamim notes that this is now more important than ever.

"If you have an ability to test your liquidity and stress the liquidity on demand and know that in a stress condition which one of your potential counterparts can create a crunch in your liquidity then that gives the treasurer much better control. On a business as usual (BAU) basis, this will allow you more control of your liquidity," Shamim explains.

Echoing this, Mumma adds: "Liquidity stress testing is very important because it gives the bank or the institution that is doing the stress testing the ability to determine their own vulnerabilities and create scenarios that reflect their individual vulnerabilities."

In the case of COVID-19, this was a systemic event. Mumma affirms: "The liquidity challenge hit everybody fast and hard. Stress testing helps you discover what your vulnerabilities are and putting stress scenarios around that, which will lead you to have enough liquid assets to be able to accommodate the outflows that are not going to be offset by the inflows."

Regulatory guidance

Currently, there is still room for more regulatory guidance when it comes to liquidity. However, Mumma points out that regulators tend not to want to make changes to their rules without a long process of talking among themselves and consulting with constituents on changes they might want to make.

Most treasuries in 2008 were not prepared for these kinds of liquidity issues. Mumma explains: "With the strengthening of the post-2008 liquidity standards rules that were made with LCR and other stress testing, banks are much more attuned to their liquidity vulnerabilities."

Interestingly, over the last 18 months Mumma has observed that many big banks said they did not need such large amount of liquid assets, as it was costing their ability to provide more financing to clients.

They thought it should be relaxed, and in the US they did just that.

In October last year, the US came out with a revised set of rules that loosened LCR requirements for all but the G-SIB banks.

Shamim also notes that there could be more guidance from regulators.

He concludes: "In terms of intraday liquidity level, some regulators are saying they would like banks to be reporting the periodic reports but they are not asking for the active management of liquidity."

"Linking in with stress testing, to become a periodic business as usual process then you would be able to see the effect of any events happening and how the banks would respond in a more logical and not just periodical way."