FINTECH FUTURES

Uncovering the hidden costs of liquidity

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Liquidity is paramount and real time liquidity is now a must-have. Without it, financial institutions cannot meet their settlement obligations or proactively manage risks (counterparty, market, or own institution stresses). Those institutions that actively manage liquidity and know its position at any given point in the day, are better placed to deal with market risks and uncertainty and to minimise the hidden costs of liquidity.

The days when financial institutions could rely on cheap and abundant liquidity are coming to an end. Interest rates are on the rise again as central banks tighten monetary policies, which saw rates in zero or negative territory for more than a decade following the 2007–2008 global financial crisis. As interest rates volatility continues, so too does the cost of liquidity.

Some estimates suggest that the cost of intraday liquidity to financial institutions could be as high as $100 million to $300 million annually. These costs will be even higher as interest rates rise. The cost is compounded as many financial institutions rely on collateralised overdrafts, which incur additional costs. Opportunity costs can also arise from tying up liquidity and collateral unnecessarily.

Is there an opportunity for banks to avoid these hidden costs? Why maintain unnecessarily high liquidity buffers or borrow at the last minute, when there's liquidity needed to fulfil your settlement or regulatory obligations?

Feedback from our customers suggests that by actively managing their liquidity, financial institutions could reduce their liquidity buffers by as much as 90%, which significantly impacts their profitability. Other estimates suggest that a 30% reduction in collateral costs through optimised intraday liquidity management could net financial institutions a saving of at least €4 million a year.

Regulators sharpen their focus

In addition to reducing the hidden costs of intraday liquidity, active intraday liquidity management allows financial institutions to demonstrate control of liquidity and settlement risks. Eleven years on from the 2007–2008 global financial crisis, regulators continue to stress the importance for institutions to maintain adequate systems and processes to support the active management of intraday liquidity.

In its guide to the internal liquidity adequacy assessment process issued in November 2018, the European Central Bank reiterated the requirements laid out in Article 86(1) of the European Banking Authority's Capital Requirements Directive IV, which calls on financial institutions to have "robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of liquidity risk over an appropriate set of time horizons."

Regulators are not just concerned with institutions' ability to monitor and report their liquidity usage: There is now a need for them to clearly demonstrate active management of their liquidity at regular intervals (hourly or more frequently).

Drawing on the Basel Committee for Banking Supervision's (BCBS) Monitoring Tools for Intraday Liquidity Management (April 2013), active intraday liquidity management is now a priority for a growing number of financial regulators globally. The UK was one of the first jurisdictions to implement the BCBS's recommendations and remains at the forefront of the drive to manage intraday liquidity risks. In February 2018, the UK's Prudential Regulation Authority (PRA) stated in its recommendations for Pillar II liquidity risk assessment that it would consider the quality and the full extent of institutions' intraday liquidity management tools: from detailed metrics and operational processes, through to stress testing and risk frameworks, and the internal policies governing them.

The more that financial institutions can demonstrate to regulators that they have real-time visibility and control over their intraday liquidity, the less likely they will need to maintain high liquidity buffers.

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