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Intraday Liquidity: Banks get a handle on liquid measures

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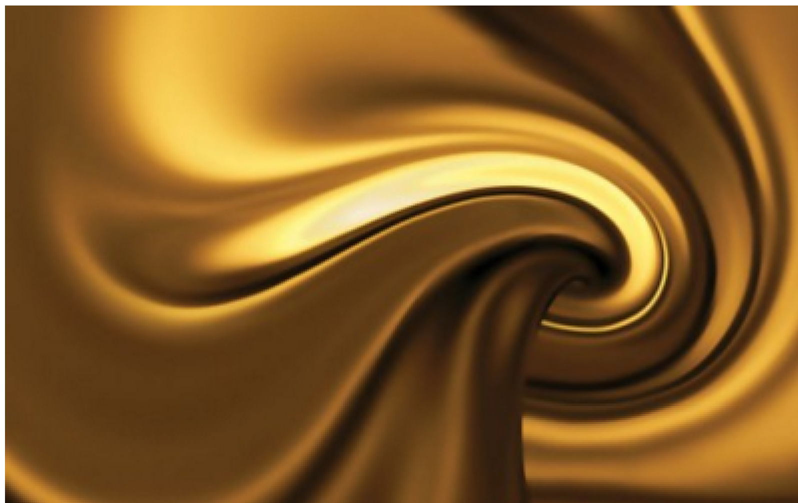
In January it became mandatory for banks to report information on their intraday liquidity position every month under recommendations published by the Basel Committee on Banking Supervision (BCBS). Two months on FX-MM's Neil Dennis examines how the process is being managed and the tools used.



Regulatory changes to banking operations, however well meaning, are usually seen as a hindrance by the industry. Time-consuming and costly to develop and implement. The Liquidity Coverage Ratio (LCR) was designed by regulators under the Basel III accord to ensure banks had enough cash – or assets that can be immediately converted to cash – on their balance sheets to ride out any disruptions to short-term liquidity.

When examining the details behind the financial crisis that started in 2007, central bankers and regulators quickly identified liquidity as the main problem. As the US housing and mortgage market collapsed, global banks examined the bad loans on their books (many tied up in sliced and diced mortgage and consumer loans packaged as derivative debt products) and promptly stopped lending to each other – fearing their peers were in the same boat. Without adequate liquidity, banks fail.

To address this, regulators set out rules for the banking industry on capital adequacy, market stresses and liquidity risk. Banks must now be able to meet their own liquidity requirements on a day-to-day basis, taking the pressure off central banks and taxpayers to bail out struggling institutions. Initially set last year at 60% of exposure, the LCR will increase every year until 2019, when the minimum requirement will reach 100%.

Aside from the disadvantages of having to hold large sums of money in low-yielding, liquid assets such as cash and government bonds, banks are now burdened with having to calculate daily intraday liquidity usage and availability and report these positions every month.

The BCBS also urges banks to consider the impact on liquidity of various market stress scenarios.

In an article for this magazine last year, Nick Noble and Darryl Twiggs, who are respectively Product Manager, liquidity risk management and head of product management at SmartStream, wrote: "Rather than simply ticking a regulatory box, banks are looking to obtain greater value from this focus on intraday liquidity."

Powerful tools, therefore, are needed.

"Gathering the necessary information can be a significant challenge for banks, due to the decentralised nature of the data," adds Noble. "In order to build up a profile of intraday liquidity, banks need to have a time stamp for every debit and credit across every account held by the bank. As well as gathering information produced in-house, banks also have to obtain the necessary information from correspondent and agency banks. This can be particularly challenging for multinational banks which may be working with over 1,000 other banks around the world."

Stress management

In addition to liquidity data collection, those companies that provide management tools are also seeking to help identify how liquidity needs change throughout a single day – through transactions with correspondent banks, central banks and, not least, customers. Armed with this data, they can also help identify areas of stress in the market and help develop liquidity management systems that are better able to cope with periods of global market illiquidity, such as being experienced currently.

MORS Software markets a trio of packages: Treasury Manager, Liquidity Manager and Balance Sheet Manager. Behind all three is a single, real-time engine so that all departments have a deeper understanding of daily transactions.

"Our clients are able to unite these modules and look at the whole bank at the same time," says Mika Mustakallio, chief executive and co-founder of MORS. "It is a growing trend that banks are merging their treasury, liquidity management and balance sheet management departments."

Indeed, one critically important function of most products on the market is the ability to pre-empt any potential liquidity shortfalls, while reaction times can be cut down as all departments can see the results in real time.

"Being able to react to the moment is key," says Mr Mustakallio. "Our clients can run forecasts and hence decisions can be made rapidly. Those banks that had previously only reported liquidity positions at the end of day were forced to run unnecessarily large safety buffers."

Joined-up thinking

The need for joined-up thinking between a bank's departments appears to be the basis for all new liquidity management systems. Bank of New York Mellon has designed Nexen a cloud-based system that uses the same portal for treasury management and risk management, while Bloomberg hopes its suite of products, which includes its LQA liquidity assessment tool, will set the industry standard.

Ilaria Vigano, Head of Regulatory and Accounting Products at Bloomberg, says: "There are huge economies of scale as LQA gives a multidimensional view of the assets held, which can help many departments without having to replicate data. The system is flexible enough to satisfy multiple requirements across banking businesses – on the buy-side and sell-side."

BNY Mellon describes Nexen as a digital ecosystem – a view that is becoming increasingly prevalent across the industry.

Michelle Palombo, Managing Director, Global Client Access at BNY Mellon says: "From a staffing perspective this is much more streamlined. The client can tweak what they want to see with user specific dashboarding, and this can be done across divisions."

Tim Donnelly, Business Development Manager, Risk and Treasury Management at Intellect, reiterates the importance of an incorporated view on liquidity.

"Banks can use this regulatory opportunity to understand and manage their sources of liquidity to support profit margins despite additional capital costs. They can identify what liquidity products work best for them and when. Also, Intellect One LRM enables a Treasurer to prevent liquidity squeezes by providing accurate cash projections with a required level of precision and the most cost-effective funding," he says.

"Intellect's Payments Decisioning and Enterprise Limits and Collateral products allow banks to manage liquidity of high value payment flows across complex account structures and allow banks to have a 360 degree view of the client exposure."

Their bank industry clients have found this level of functionality important in helping mitigate the costs of having to comply with regulatory liquidity reporting.

Regulatory costs Implementing new regulations comes at a huge cost to industry. One of the most audible complaints from the financial services sector during reporting season is rising regulatory costs.

Few tears will be shed outside the world of finance for a multibillion dollar industry facing higher regulatory costs. And if the price tag on implementing these strategies is mitigated over time, the Mandarins on the Basel committee can surely toast a success?

Institutions are not only concerned about implementation costs, however. Liquidity regulations compel them to hold in their portfolios a higher percentage of liquid, but lower-yielding assets at the expense of those assets that can generate higher returns.

In a recent strategy note on bank stocks for Saxo Bank, analyst Peter Garnry highlighted increasing regulatory costs, adding that Basel III rules "fully-loaded will continue to weigh on banks' flexibility and force some to raise more capital". He went on: "The industry does not use its capital efficiently enough and growth rates will be very low for the foreseeable future."

A closer grip

Liquidity tools, therefore, are also being used to help managers deploy capital more efficiently while continuing to comply with liquidity ratios.

SmartStream's Noble says: "The cost of operating liquidity buffers that satisfy the regulator can run into the billions – cash that can be better used from an operational point of view. Our clients are able keep a closer grip on liquidity costs."

Bloomberg's Vigano adds: "If I am a risk officer I have to do two things: I have to submit a regulatory report to demonstrate my liquidity ratio, but I also have to ask: am I really making the right investment decisions and generating the maximum yield out of the assets I am obliged to hold under the constraints of the liquidity regulation?"

This is where LQA in partnership with Bloomberg's High Quality Liquid Assets tool (HQLA) stands out, she says. "These tools can help optimise our clients' balance sheets between what holdings are necessary for regulation and those that generate greater returns."

Mustakallio at MORS also praises this functionality of his company's product. "If you are able to monitor in real-time you can optimise your balance sheet in a different way from those who are only compiling data on a daily or monthly basis. So if you are having to manage with extra buffers of liquidity, the more you have to carry the greater the costs for the banks."

Donnelly at Intellect Design Arena agrees: "We are seeing most of the large banks are investing heavily to control their liquidity requirements. They have additional funds and if they are not able to deploy those funds, it is a major cost to them – so they are using these new tools to utilise their funds better and minimise their capital requirements under Basel III."

Heightened awareness

But what price can be put on a system that can alert to, and possibly even help avert future systemic failure?

Current market volatility can be put largely down to shrinking liquidity as the pool of safe global assets such as quality government bonds diminishes as austerity policies see issuance dry up, while central bank QE operations sap up the rest. Banks, therefore, will need as much assistance as they can get to manage their own liquidity levels effectively in the coming months.

Stress testing – an unnerving experience for financial groups and those who invest in them – could eventually become less trying for all involved if institutional tools can accurately and quickly measure capital and liquidity ratios.

"Awareness is key," says BNY Mellon's Palombo. "The banks now know what their position is from a historical standpoint and they can look for trends that happen on a daily basis or a weekly basis and make corrections accordingly."

Stress testing is a core part of the approach taken at MORS Software for its products, says Mustakallio.

"Our 'scenario tool' allows forecasting for stressed situations," he says. "You can input stress scenarios then lift your hands from the steering wheel and see where you'd have ended up."

This allows risk managers to play out to their natural conclusions, invented scenarios that they can then react to – enabling them to see if their measures would have worked.

"Intellect's Stress Testing module utilises such parameters as positions, MDF, cash flows, scenarios and haircuts for various Stress Testing approaches along with behavioural, hypothetical and scenario based analyses," says Donnelly.

Bloomberg, meanwhile, says that the main benefit from its liquidity tools in helping stress testing is that they use the company's rich seam of data to assess liquidity at a granular level.

"One of the big gaps in stress testing is producing numbers that are defensible and independent across all asset classes – particularly among the most illiquid of assets, where often risk officers are relying on traders and market makers for information that might be challenged by regulators."

Vigaro continues: "Our data is more transparent because it comes straight from the vendor: it might be the same as what the trader provides, but it's more defensible."

The right tools

Liquidity regulations and the measures that have been taken to report intraday liquidity may not prevent the next systemic failure in the banking industry. Banks have, over their long history, periodically found ways of proving that even businesses in the most tightly regulated industrial sectors can still fail.

But the right tools might just help financial institutions navigate the current global liquidity crunch – which, when over, will hopefully prove to have been a glitch and not a full-blown crisis.

"It's very difficult to say if these tools would prevent a liquidity driven failure, but definitely these tools are very good for the industry. I wouldn't call it a panacea, but it is making the banking system more stable," says Donnelly.

The above tools are already being used by most of the world's largest banking institutions, and with the Securities and Exchanges Commission in the US now proposing new liquidity risk management rules for open-ended mutual funds, there could be further growth opportunities in the years ahead for the providers of these tools.