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Navigating the challenging liquidity management environment

New regulatory requirements are having a huge impact on the liquidity investment landscape. Gerry Barber, Managing Director, Regional Head (EMEA) IMG Cash Solutions, BNY Mellon Markets, discusses these developments and how liquidity can be effectively managed in these times of change.

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Liquidity investment strategies are undergoing significant upheaval as the regulatory environment in the wake of the financial crisis continues to shift, with Basel III's liquidity coverage ratio (LCR) in particular affecting liquidity management. Introduced to help mitigate liquidity risk, the LCR stipulates that banks must hold a sufficient level of high quality liquid assets (HQLA) to withstand a 30-day period of 'stressed' conditions. This means that banks must be mindful of the composition of their assets, and carefully consider the type of customer balances they accept in terms of whether they can be classed as 'LCR-friendly' and add value to their balance sheet.

Banks have become more averse to short-term deposits, as they require cash outflow during the 30-day period (due to the funding needing to be repaid), thereby diluting their HQLA position. Banks must also consider whether a deposit is operational or non-operational. Operational deposits (i.e. those operationally tied-in with the client's banking activities, such as cash held by depositors for transactional purposes) are considered of higher value as they are more likely to be rolled over at maturity. Short-term operational deposits are generally accepted by most banks. It is short-term, non-operational deposits (surplus cash not immediately required for daily activities) that pose the greatest liquidity risk for banks. Consequently, hedge funds (for example) have been particularly affected by this revised approach.

In addition to new regulation, which is making liquidity management challenging from a liquidity perspective, record low – and even negative – interest rates are also making effective liquidity management challenging in terms of yield. Certainly, optimising liquidity investment in the current landscape is no easy task.

Liquidity, risk, yield

Yet, regardless of the investment environment, it is important to remember that the three core elements of any investment strategy – liquidity, risk and yield – remain the same; it is the *weight* given to each element that changes according to market conditions and specific individual needs and appetite. The way in which the weighting is adjusted subsequently determines the relevant investment options available in the short-term space. For example, if a client is prioritising yield, it will be the duration they are prepared to commit to (i.e. the liquidity) and the level of risk they are prepared to take that will subsequently drive the yield return. If a bank deems a deposit operationally unfriendly from an LCR perspective, however, they may choose to not offer such an option, or alternatively, offer it at a higher cost. Money market funds are generating greater client interest because of this dynamic.

Adapting to change

The new conditions have resulted in many companies and financial institutions tightening up their risk and investment policies and investment monitoring. Indeed, from a corporate treasury perspective, cash management alone has become a full-time job – many major corporates now have designated teams that almost look akin to professional investment departments, with audit and risk oversight at board level.

Furthermore, despite the complexities of the liquidity landscape, technological innovation is helping to facilitate liquidity optimisation, with platforms that can offer real-time, centralised data visibility and enhanced transparency. Banks are also becoming far more granular in terms of data access and analysis, which is generating a greater understanding of clients' books.

Regulatory reforms are having a huge impact on liquidity investment, with costs and returns significantly affected. But by understanding each other's needs and respective liquidity requirements and circumstances (for instance, it is important that all parties have clarity regarding Basel III's definition of operational and non-operational deposits) banks and their clients can work together to successfully navigate the new landscape. Indeed, many banks are introducing new products and incentives to help generate value for both parties. And equipped with the technology that provides improved control over investment policies and cash management – including global visibility of FX payments – an effective, customised liquidity investment strategy can be implemented, making it possible to leverage liquidity investment options and solutions to meet the needs of individual businesses, and make the most of their money.

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