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Liquidity risk management: staying afloat in choppy seas

Though the storm is subsiding, liquidity remains a critical issue for financial institutions. After all, another crisis could come at any time.

Liquidity could begin to tighten globally as fears of weaker sovereign credit continue to spread. The finances of many developed debtor countries are also increasingly strained. The calibration of the proposed Basel net stable funding ratio is causing uncertainty and, as central banks reduce their support, there are concerns over whether market-based funding sources will prove sufficient.

It would be a mistake for firms to assume that, simply because they have survived until now, they are well-positioned to weather another liquidity crisis. In any case, another major credit event would almost certainly create new liquidity challenges that could test even the most successful of firms.

Global benchmarking study

Conducted with the assistance of 19 leading financial institutions, PwC's recent global benchmarking study of liquidity management practices reveals that there is no 'one-size-fits all' approach to managing liquidity risk. Firms should seek to develop qualitative and quantitative elements in a coordinated fashion, having recognised that these elements are interrelated.

The qualitative elements of liquidity risk management should be based on sound management judgement, embedded within the corporate culture of the institution, and aligned with the firm's overall appetite for risk. The quantitative elements should be based on specific measures, thresholds or limits that are set around liquidity risk factors and diversification of funding sources, and should be coordinated with other risk management activities, such as credit risk, market risk and asset-liability management.

Governance

Implementation of a sound liquidity risk management framework begins with appropriate governance. Leading institutions are currently focusing their efforts in five areas: centralisation of oversight, establishing and formalising the liquidity risk appetite, board oversight, delineation between tactical and structural liquidity risk and tailoring the related monitoring, measuring and reporting practices and integration of liquidity risk into strategic management of business.

Policies and procedures

There is no questions that every financial institution should have a comprehensive set of policies and procedures in place which describes the fundamental aspects of its approach to liquidity management and should regularly review and update these policies. Minimum elements that should be covered in the policy framework include: clear definitions of the risks under consideration; mandates and principles to be applied in managing liquidity; roles and responsibilities of different business units and functional support groups; authorities, controls and limits; reports produced and metrics used; and key measurement assumptions embedded in the approach.

Improved analytics and reporting practices

While measures of liquidity focusing on balance-sheet ratios are still necessary, the adoption of leading practices requires the implementation of increasingly advanced measures to capture and assess exposures that may arise and affect the liquidity position of the firm (e.g. sophisticated multi-scenario stress testing and varying survival horizons, as well as monitoring intra-day exposures, intragroup exposures and various types of contingent liabilities). Firms should consider as well benefits from increasing the frequency of their liquidity management reporting, especially to other areas of the firm (such as senior management, ALCO, and risk committees).

Leading financial institutions view liquidity risk management as an integral part of their long-term enterprise strategies.

Information systems

There is often a reliance on multiple spreadsheets and time-consuming manual processes. Enhancing application systems and enterprise wide platforms enables users to generate increasingly sophisticated analytics and ensures that liquidity positions can be monitored in real time. And maintaining a centralised repository that provides immediate access to the necessary data at the desired level of quality and granularity enables to have immediate access to all pertinent liquidity risk information and to manage their liquidity profile more effectively.

Significant benefits

Better liquidity risk management inevitably comes at a price. However, firms should find that the cost is more than set off by significant benefits.

An improved understanding of its liquidity profile and risk appetite can help an institution strike a better balance between the desire to maximise the use of capital to generate revenues and the need to set aside reserves of unencumbered liquid assets for use during periods of liquidity stress. Developing alternative sources of funding that can be used to fund profitable business opportunities helps ensure the availability of funds and reduces reliance on any single funding channel, even in times of extreme stress. Improved visibility and understanding of off-balance-sheet exposures, and the implications resulting from events that could bring these exposures onto the balance sheet, enables a firm to remain proactive.

Thus the new world will bring huge challenges and great change. As ever, the firms that will thrive will be those that adapt and evolve quickly and effectively. Leading financial institutions do not view liquidity risk management as a short-term operational issue, but as an integral part of their long-term enterprise strategies. They are reflecting on the lessons to be learned from the recent crisis and preparing for the new world to come.

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