

NAVIGATING THE LIQUIDITY LANDSCAPE

TREASURERS ARE MANAGING RECORD AMOUNTS OF CASH IN A RAPIDLY CHANGING REGULATORY AND ECONOMIC ENVIRONMENT. NICK BURGE SUGGESTS STRATEGIES TO HELP THEM TO OVERCOME THE CHALLENGES THEY FACE

For a number of years, corporate cash piles have been subject to scrutiny from finance professionals, analysts and journalists alike. Despite calls for companies to stop hoarding and start spending¹, these 'cash mountains' continue to grow.

Picking one of many measures, cash and cash equivalents on the balance sheets of non-financial corporates within the S&P 1200 Index has grown from the equivalent of \$1 trillion to just over \$3.5 trillion (from the end of 2000 to the end of 2013).

Today, that figure is probably even higher. Corporate treasurers, as a group, are managing the largest amount of cash in recorded history. As a result, liquidity management is becoming a bigger part of the treasurer's role – some are beginning to see themselves as quasi asset managers.

A number of catalysts have contributed to this new dynamic. Financing is readily available for good-quality corporates and at a record low cost. The quantitative easing programmes of many central banks have driven this, with companies choosing to raise capital while they can.



Macro-economic uncertainty and slow growth in many parts of the world mean that many corporates are holding back on spending plans, however. Additionally, the long shadow of the financial crisis has resulted in companies looking to hold bigger liquidity buffers. The challenge for treasurers, in managing ever bigger cash pools in a record-low interest

rate environment, is that it's harder to optimise across the three dimensions of the liquidity triangle – security, availability and return.

Regulatory hurdles

Another aspect of the new liquidity landscape that is adding to the level of complexity is the rapidly evolving regulatory environment. Four specific

regulations directly impact on the providers of liquidity products and consequently on the corporate end users.

The leverage ratio (LR).

This is a new capital ratio for banks under Basel III, which requires holding a minimum capital ratio against absolute aggregate balance-sheet outstandings. For many banks, the LR is now the binding constraint on the size of their balance sheets and, consequently, on their overall capacity to take deposits.

The liquidity coverage ratio (LCR). This short-term liquidity metric under Basel III requires banks to hold liquidity buffers so that they can manage stressed market conditions. Banks are required to calculate the maximum outflow of cash over a one-month period and hold high-quality liquid assets, such as cash or government bonds, against that potential outflow. This will particularly affect treasurers looking to place short-term money.

Interestingly, though, banks must categorise their liabilities by the type of entity making the deposit. The percentage outflow assumed under the stressed scenario varies between both entity

ILLUSTRATION: IMAGE SOURCE

categorisation and liability type. For corporates, banks must assume that 40% of deposits that become due over the month are not rolled over (falling to 25% for cash in operational accounts). This reinforces the attraction of operational cash to banks. Corporate deposits generally, under the LCR, are more attractive than financial institution (FI) deposits, which have a 100% outflow factor.

The net stable funding ratio (NSFR). The long-term funding metric within Basel III requires longer-term and less-liquid bank assets to be funded by longer-term, more stable liabilities. This has a number of implications for the maturity transformation capacity of banks and knock-on consequences to clients, but again tends to favour liabilities sourced from corporates rather than FIs. One area that this shows up in is the relative pricing of repurchase agreements.

Money market fund (MMF) reform. On both sides of the Atlantic, regulators have been looking to combat potential runs on MMFs. Converting to variable net asset value (VNAV) has been confirmed as the way forward for many funds in the US. Europe is expected to follow suit, although there is talk of an alternative 3% capital buffer among European policymakers.

While the move to VNAV isn't necessarily significant for all investors, uncertainty around the future of MMFs, allied to very low returns, is pushing many treasurers to look elsewhere for yield.

The combined impact of these regulations is that there will be a reduction in the credit creation capacity of the banking system overall, and consequent need for liabilities. Aggregate bank balance sheets in Europe have

shrunk by about €3 trillion since 2012 and further shrinkage should be expected as full implementation of Basel III continues to be worked through.

All things being equal, the cost of credit should rise, but the recent liquidity creation by central banks means that this is currently being masked. There should also be a steepening up of the credit curve, but again, this has been neutralised by the fact that interest rates have been so low, for so long. As and when rates 'normalise', a steeper curve should be expected.

Plan and act

The forthcoming bank structural reforms and the new recovery and resolution regime will complicate matters further. Many of these regulations are not standardised across jurisdictions, making the treasurer's job that bit harder: how then can they hope to manage ever larger liquidity pools effectively against such a backdrop of uncertainty and complexity?

The answer, at least in part, lies in updating and, in many cases, broadening investment policies, while continuing to target the three core liquidity objectives of security, availability and return. As simple as this might sound, many companies still have legacy policies that are not fit for the new environment. So what is needed is a more flexible approach.

Corporate treasurers who are keen to review or bolster their investment policies should speak to their relationship banks. Banks have their own internal and regulatory liquidity management policies that can be used as a benchmark and these can help them to ensure that their policies cover all of the right areas.

INVESTMENT POLICY: KEY CONSIDERATIONS

Counterparty risk. Security is the treasurer's number one priority. Are you investing with safe entities? How much risk are you prepared to take?

Market risk. To what extent are you prepared to tolerate interest rate risk and volatility?

Availability/liquidity. Access to your cash when you really need it. What tenors will you hold? What is your anticipated need for cash, and over what time horizon?

Operational risk. Does your policy mitigate human error and fraud? Do you have procedures in place to manage and monitor a broader range of investments?

Investment instruments. Bigger investment pools often require greater diversification. Have you considered different asset classes as well as different tenors? Are increasingly popular instruments such as repos and notice accounts included in the list of investable instruments? And what about direct investment into securities?

Treasurers should also feel able to question their banks around counterparty risk. While credit ratings and market news can provide a good indication of stability, there are quantitative and qualitative considerations that can assist greatly. These include understanding the capital position of the entity that the treasurer is investing with, and its ability to survive stress scenarios, as well as more qualitative considerations such as strength of the relationship.

Liquidity buffer analysis

The final piece of the puzzle is to determine how much liquidity the business really needs – it's not cheap to hold an excess. This requires robust stress-testing. Getting the day-to-day requirement right shouldn't be too difficult; the challenge is to size the unexpected requirements – the liquidity buffer. These might be 'black swan' events, or perhaps an opportune M&A deal.

To determine the liquidity buffer requirement, it's important for treasurers to revisit their strategic planning. This means examining historic cash flow volatility and determining

their expectation of market conditions. Taking a view of future cash flows is also important, together with an analysis of the flexibility in your business levers.

Treasurers might, for instance, have a worst-case scenario cash requirement, but they might also be comfortable that they have the ability to flex that cash requirement – through a changed dividend policy, or by reducing capex, for example.

This level of planning and flexibility should assist greatly if, or rather when, a stress event happens. It will also help the treasurer to transition smoothly from traditional corporate liquidity management to a more dynamic asset management approach. ♡

1 <http://tinyurl.com/nr2pddf>

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