

Data and operational challenges in liquidity risk management



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MORE AND MORE BANKS ARE CENTRALISING TREASURY OPERATIONS TO COMPLY WITH NEW REGULATIONS AND IMPROVE INTRA-DAY GLOBAL LIQUIDITY REPORTING

The financial crisis highlighted gaps in liquidity risk management which led a large number of financial institutions to improve their ability to face potential future crises and prepare for more stringent liquidity risk regulations. Indeed, 80% of respondents to a recent SWIFT survey¹ said they had started projects in this area.

Most institutions have already initiated a 'top-down' liquidity risk review. This typically starts with governance, defining liquidity risk tolerances, strategy and stress tests, and also contingency funding plans. It also involves agreeing liquidity transfer pricing mechanisms and rewards for risk policy-compliant practices.

Risk managers also see the need for a more strategic collaboration with businesses so that banks can concentrate on the more profitable businesses under the new regulatory rules. Greater focus on customers – by getting to know them better through behavioural analysis, and by applying the right pricing – will also become an essential part of defining and supporting business targets and decreasing dependency on wholesale funding.

Banks are now also taking a more holistic approach to liquidity risk arising from operational, credit and market risks. For example, the US Dodd-Frank Wall Street Reform and Consumer Protection

Act will affect both banks' operational and liquidity frameworks and could have a financial impact through higher capital requirements imposed for over-the-counter derivatives.

To comply with new regulations, banks are finally initiating projects that focus on intra-day liquidity. SWIFT's survey reveals that 66% of respondents have started a project with the aim of not only addressing regulatory requirements, but also better serving customers who are asking for more transparency on their liquidity positions.

For transaction banks the focus is on the ability to respect payments and settlement obligations. The role of payment infrastructures will be essential and banks are expecting more of them to provide liquidity savings mechanisms. However, beyond processes and organisational improvements, implementing a liquidity risk strategy and all its required changes poses an important data management challenge that needs to be tackled bottom-up². In order to support daily cash and liquidity management (involving reliable stress tests, regulatory reporting, enhanced liquidity service to customers and specific threshold alerts) there is a significant need for data at multiple levels of aggregation including transactional, product, business line, legal entity and at a firm-wide level.

So, banks are building transactional databases and liquidity dashboards to better monitor positions and support the need for historical data and analytics. In doing so they face a number of issues: the need for integration with numerous front- and back-office applications, a lack

of automation in underlying operational processes, and the lack of data interoperability along the transaction life-cycle. To give an order of magnitude, according to a recent AITE-Sybase survey, only 5% of liquidity risk management data is gathered with automated systems and processes.

Intra-day position management

Despite the fact that many banks are building a liquidity dashboard to monitor their liquidity position on a real-time basis, they still have issues to assess their intra-day settled and predictive positions in a reliable and timely manner as well as their customers' positions. Internal cash projections, based on payment flows, are not sufficiently accurate and, on average, the share of transactions reported on the same day by Nostro agents is quite low.

Indeed, 60% of SWIFT survey respondents have fewer than 50% of transactions reported intra-day. As a result, banks are exposed to the cost of intra-day credit lines and overdraft charges. It is therefore not surprising that 90% of the survey respondents want more transactions to be reported more frequently. Finally, very few payments infrastructures have deployed advanced real-time reporting at bank and customer levels.

On the predictive side, banks are building integration with their back or front-office systems to improve monitoring of all commitments made across business lines. However, in many cases treasurers do not have a view on customer transactions that have not been originated by their front offices and which could have an important impact on liquidity. There is little or no business practice on the usage of payment advices (for example, from corporate customers) or trade notification messages (for example, from a central counterparty clearing house to its clearing members) that would enable better assessment of funding needs throughout the day.

Finally, depending on banks' business models, monitoring an unencumbered collateral position on an intra-day basis might be challenging, especially when it involves a large volume of margin calls because of the lack of process standardisation and integration.

Global position management

New regulations require financial institutions to manage and report liquidity positions at a firm-wide level, including all branches and subsidiaries. More and more banks are centralising their treasury management to comply with these new requirements and improve their global liquidity risk management. In

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doing so they are answering key questions such as: How can I optimise liquidity across entities and reduce the need for local buffers? What should be the liquidity transfer pricing method for my entities given their status as providers or users of liquidity?

On the liquidity services side, banks are looking for end-to-end transparency on their cash flows at a global level. However, collecting accurate and timely information on branch positions can be challenging, especially if these have not implemented intra-day reconciliation.

A centralised and integrated treasury system is an alternative that some banks may choose, however this will be a long and costly project. It may also raise issues for countries with restrictive regulations on data privacy. No wonder that almost 70% of the survey's respondents referred to the difficulty in getting this global view.

The need for analytics

Analytics and business intelligence on a daily and historical basis are the cornerstones of liquidity or business decisions, risk monitoring and regulatory reporting.

The scope of requirements is broad, ranging from a concentration analysis of liquidity exposures to a view on the average daily peak of liquidity usage or an historical view on liquidity flows to help monitor deviations and define alerts based on defined thresholds.

Very few institutions already have a 'one click' capability to run these analyses at both group and individual entity level across or by type of currency. In fact, 87% of the SWIFT survey respondents said they need more 'ready-made' analytics as an alternative or to complement integration processes. This lack of information is a key issue in the overall liquidity chain that prevents payments, treasury and liquidity risk managers from reaching their goals.

1. Market research: Managing liquidity risk: industry pain points and SWIFT solutions
2. White paper: Managing liquidity risk in a changed and global world. (SWIFT)

biography

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Key ideas

Liquidity risk

- **Implementing liquidity risk strategy** poses an important data-management challenge that needs to be tackled bottom-up.
- **To comply with new regulations**, banks are initiating projects to enhance their intra-day group-wide liquidity position management.
- **Analytic and business intelligence** are the cornerstones of good liquidity, business and risk monitoring, and decisions.
- **Banks are taking a more holistic approach** to liquidity risk arising from operational, credit and market risks.