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David Castle's Treasury Notes

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Liquidity – Fountain or Fire Hose?

5 minute read.

Welcome to our pre-summer blog before we take a break.

It has been a hectic few months in liquidity markets and, as usual, July brings the publication of a number of market surveys, consultation papers from regulators for you to think about on the beach, and the hope that this summer everything will be "ok"!

Before we head off for the beach we have taken a look through the, frankly, mountain of paper that has hit our inbox over recent weeks and tried to figure out which topics will play most top of mind when we get back to our desks. We've certainly not been able to make an exhaustive list – but here is our attempt at the "not-holiday-reading-list"

Exhibit 1: Some Reading Is Most Definitely Best By The Sea

The much anticipated Bank of England PRA Consultation Paper on Pillar 2 Liquidity landed on our desks late last week. Just in time for us to save it to our "device" and take in away on holiday instead of the latest Thriller/Romance/Comedy/Biography!

Early commentators on the contents of the paper have highlighted that the UK seems to be "wanting to gold plate liquidity regulation going above and beyond Basel III LCR requirements". We partially agree with this assessment, the proposed cashflow mis-match reporting requirement (CFMR) has a couple of impacts in our view.

First, it takes the PRA's previous liquidity regime to the next level of granular risk management testing. The effect of this could be further clipping of the level of acceptable liquidity risk that firms are able to acquire – impact will vary significantly by the types of clients and business lines that each firm has and very likely increase the complexity of liquidity product offering to depositor clients.

Our base case, on which we will reflect while sunning ourselves, is that while firms and clients are becoming much more sophisticated in their understanding of the first and second order effects of liquidity regulation the CFMR potentially delivers a further widening in the gap between the need of a bank to manage regulatory cost and client to manage conservative liquidity access needs.

The cost of liquidity continues to go up for everyone – water water everywhere but not a drop to drink?

Exhibit 2: Water water everywhere but not a drop to drink.

Second, the data sourcing and reporting burden to which firms have been adapting takes a further step in complexity. We have written much this year about the importance of both Treasury and Businesses adapting quickly to the use of scale data analytics, big data and alike. The further requirements for modelling effectiveness, connectivity between models and collection of vast quantities of data at high speed is now simply a must have for reporting, risk management and front-line-liquidity management.

All of these are possible with advancement in computational capacity and data collection / storage approaches however most firms we know still have some distance to travel in being able to use their vast data lakes effectively – either for simplifying reporting processes or for the much more important strategic and value added purposes that they offer.

(See Treasury Notes No.3 and our Treasury Tech Series)

Our second selection is the AFP Annual Liquidity Survey, this excellent report by the Association in conjunction with State Street may be found here https://www.afponline.org

What we especially like about the approach that AFP takes to it's survey is that they explore changes in liquidity clients risk appetite, product usage, top of mind issues for the year ahead and explores key drives of changes in each of these aspects.

Taken together with insight from our very good friends at Crane Data, recent market survey responses about the use of MMDAs and our own client research we are able to take away with a few things to thing about over the summer ....

Exhibit 3 : Conservative Liquidity Management with mainly simple products is the order of the day

Cash Holdings continue to increase almost across the board, this heightens the importance of a core bank providing liquidity and investment solutions that meet a client need for access and security. Not as easy as it may sound when trying to balance regulatory cost with client service.

While Prime Money Funds have posted some recovery over recent months it has been muted and many corporate liquidity managers who ceased investing in Prime ahead of the regulatory changes last year do not plan to resume investing in them. For banks and asset management companies this drives the need for innovation in product offerings which meet the needs of clients – especially we have seen liquidity optimisation techniques which help clients "internalise" liquidity become more of a focus.

The top 3 product preferences remain Deposits, Money Funds (non-prime), and Treasury or Government securities for cash management o cers. We have in our own interaction with corporations seen that their "investment desks" are focusing on new deposit structures, supply chain risk participations and other means to bring liquidity in-house.

How each of these impacts liquidity managers we will see over the balance of this year and into next, but our early thoughts on this are that the inter-connectivity between Treasury and Client continues to be ever more direct meaning that our value add to client coverage, product development, technology development has never been greater.

So as we sign off for the mid-term break we are in some ways feeling the water fountain (simple products, core relationships, deposits are the newest old product), but we also have an eye on the fire hose (PSD2, Technology, Rate Rises, Taper, CFMR).

The only thing left for us to do is included our 5th alternative liquidity exhibit of this article and wish you all a very good break.

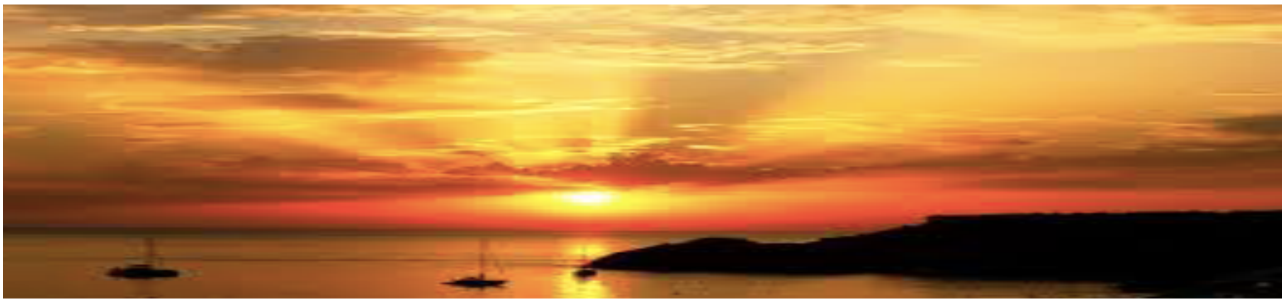

Exhibit 4 : Liquidity Summer

Have a fantastic summer. David will be away until 15th September.

About the author

David Castle is the Managing Partner at Waltham Partners Ltd