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David Castle's Treasury Notes

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Halloween Special: The Next Crisis, Liquidity Ghost or ALM Exhaustion?

6 minute read.

It's good to be back after an extended break from our column. While away I spent time exploring things we should be on the look out for as indicators of the next crisis. Part of this research was based around predictive analytics and prompted us to re-publish "De-stress tests for Strategic Treasury" asking if we can, in-fact, predict the ***next crisis.***

However, we also identified some Treasury and ALM specific themes that are ***Spooky enough to warrant a Halloween special!***

Our thesis has drawn out a few themes, these include changing market dynamics across various asset classes that could prompt liquidity emergency. We have also looked at what it takes to be a liquidity manager today and is the role simply ***exhausting***. Most halloween of all however is the ***Liquidity Ghost*** who displays themselves as piles of accessible cash pretending to be real liquidity.

No, we are not going to make references to the classic 1984 movie and oversize marhmellow man as a metaphor for bloated cash balances ..... honest.

ROLE REQUIREMENTS, AT A MINUMUM A WORKING KNOWLEDGE OF				
FCA/PRA Handbook		**Prudential Risk Management**		
CRR	CRD IV	IFRS9	FRTB	Mifid II
LCR	NSFR	OP Risk	Solvency 2	Pillar II
Liquidity Risk Modelling		Treasury Market Instruments		
Capital Allocation Requirement		Credit and Market Risk		

Exhibit 1: Hiring Requirements for a Liquidity Management Asscociate

Superhuman Liquidity Manager Required

One of our long held beliefs is that since the financial crisis Treasury has, and will continue, to become increasingly integral and directly influential across all business lines. Regulatory impact has changed the landscape and more directly linked the actions of client to treasury and vice versa. This means that new skills in addition to the experienced judgement of Treasury is required to add increasing value to all parts of the bank.

Adapting to this environment over the last decade has, at times, been exhausting. Organising data, measuring the value of business lines, clients, products and pretty much everything else differently and ensuring that the implications of these changes are understood across the organisation has brought Treasury back to the front-line. ***The expertise required are extraordinary.***

Exhibit 1 shows the hiring requirements for a senior associate in the liquidity team at a major international firm. We came across this when undertaking some desk top research on what skills are now required in Treasury. Our expectation was to find a higher demand for data analytics and modelling resources, strategic funding and collateral skills together with a need for market facing officers able to manage complexity.

What we found, kind of met our expectations, but also highlighted the sheer depth and breadth of knowledge required. Liquidity Managers might be ***Exhausted!*** This may present risks for Treasury, but our view on how to fix this – by adopting advanced technology and bringing new and diverse skills into the treasury team – we think still holds true. In the meantime, best boost energy by buiding a ***Haribo Reserve*** while out Trick or Treating this week. *(Note, other forms of energy reserve are available!)*

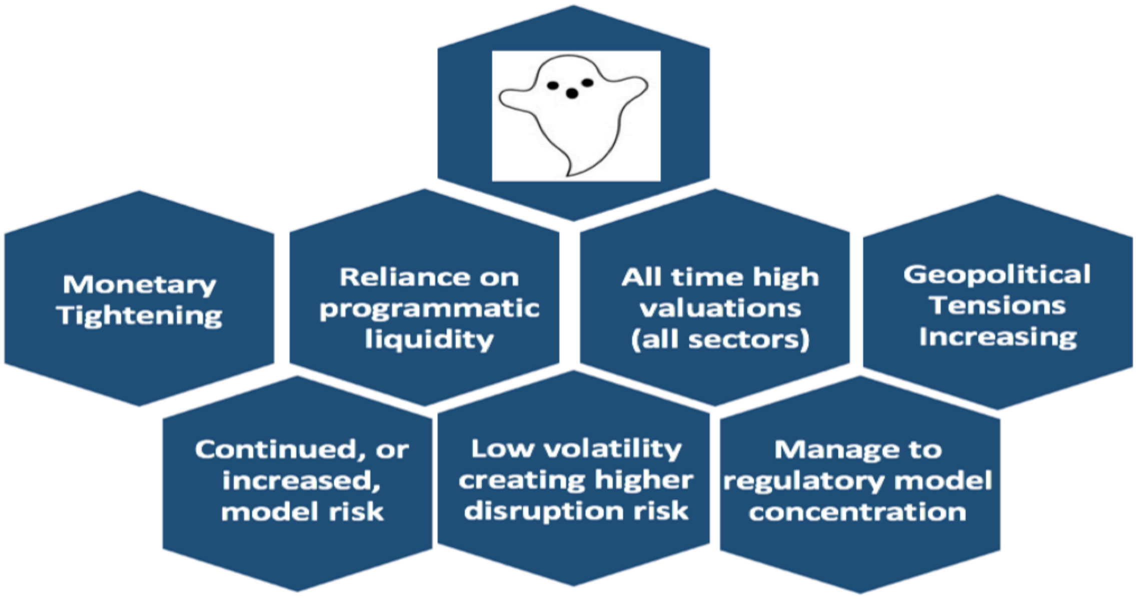

Exhibit 2: Disparate yet connected liquidty risks building up

Is Time Travel Required?

In our drive to explore where liquidity risks may be hidden we looked in the shadows (obviously) but also read a stack of articles and thought leadership pieces on the topic. Exhibit 2 captures several themes that have been highlighted since the summer on each of which at least a handful of research pieces have been written. What has really ***spooked*** us – ahem – is that each of these areas have a lot of weight to them in terms of risk build up. What worries us most is the ***interconnectedness and contagion*** risks that could result from any one of these triggers.

In each of the risk areas we have explored a few phrases stand out, which in combination give us cause for concern – centered on liquidity triggers – especially when considering if lessons from the past are being applied to the current or indeed the future. Reflect for a moment on ....

- "most models still assume that bond liquidity will off-set draws on cash balances"
- "monetary accommodation has driven stocks, especially technology, to all time highs"
- "passive and tracker strategies that operate on autopilot assume liquidity availability"
- "low volatility, in general, appears to make high risk strategies cheaper to carry"

Do any of these sound familiar? These are September 2017 references, not 2005-2007.

Anyone seen the ***Boogyman?***

Exhibit 3: Beware the Liquidity Ghost, he hides in plain sight

The Liquidity Ghost

Ok, you caught us, we were hidden under a sheet, behind the door. Our plan was to jump out and spook you in return for treats.

In reality, a risk if often not identified ***until is happens*** and is so obvious after the event that it turns out that it was hidden in plain sight.

In Tresury we have been responding to the demands of regulators, clients, shareholders, and others to help adapt our industry to be more secure, transparent, cost effective and trustworthy. The banking model of tomorrow may still be somewhat open to debate but we can all say with some certainty that the industry is now better capitalized, more cautious, and more liquid .... Right?

A generational change in the way we work, and especially in how certain types of risk are managed and transmitted across enterprises and the market, is just that –a generation. It takes time, several experiments may be undertaken, leaders lead, followers catch up, and often many can be left confused.

The adaption required in liquidity management, across the industry, includes what types of cash, duration, collateral values and availability, methods of transmission amongst many other considerations. We take comfort from sticky balances (depending on type), the fact that innovators are helping take the less valuable deposits off balance sheet, and that liquid asset markets – broadly – are both behaving and adapting to the uniform (yet strangely fragmented) needs of market participants.

The Liquidty Ghost hops between the market risks mentioned earlier in our article, and the treasury specific cash balance / type / tenor / location risks while also spending time hanging out with liquid assets and clients who can react individually or in unison to be being ***spooked.***

We have come a long way as an industry in un-doing some past errors, adopting new approaches to risk management and technology, engaging our clients and trying to simplfy an increasingly complex life.

But, have we actually, really, learned anything?

Happy Halloween!

About the author

David Castle is the Managing Partner at Waltham Partners Ltd