LIQUIDITY RISK MANAGEMENT IN ASIA

ENTER THE WATER DRAGON?

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Necessity is the mother of invention. This may explain why European banks are working harder on improving their liquidity management than Asian banks. In Europe, wholesale funding has become so scarce that most banks now depend on cheap funding supplied by the European Central Bank. By contrast, Asian banks mainly avoided the effects of the global financial crisis and benefit from an abundance of retail deposits.

Yet Asian banks are not entirely free from the pressures felt by European banks. Not only must they sometimes source funds from the increasingly volatile global wholesale markets but the economic outlook for Asia also points to a slowdown in retail deposit growth. Loan-to-deposit ratios have increased by about 10 per cent in the last ten years, a trend we expect to continue. Moreover, Basel III and other post-Lehman regulation will constrain cross-border funding and directly mandate Asian banks to improve their liquidity risk management.

Asian banks should not regard this requirement as a simple burden. Liquidity risk management is a source of competitive advantage, which banks should be keen to advance whatever the regulatory requirements. Two important lessons can be learnt from the European crisis. First, well-prepared institutions can gain profitable market share and sustain stable funding lines through an economic downturn or shock to traditional funding bases. Secondly, understanding the true cost of doing business can improve diversification and capital allocation, as well as dampen earnings volatility.

We believe that Asian banks should focus on three elements of liquidity risk management:

1. Funds Transfer Pricing (FTP)
2. War-gaming
3. Cross-border funding
1. FTP

Most banks have Funds Transfer Pricing frameworks. The Treasury “buys” funds from business units that gather deposits or otherwise attract funds and “sells” them to the business units that make loans or acquire other assets. The price at which these funds are internally traded is usually based on the market price for funds of the relevant currency and maturity (e.g. LIBOR). These internal transactions transfer market risk from the business units to the Treasury, which manages aggregate mismatches in the balance sheet, and allows the margin contribution of the business units to be correctly calculated.

However, more sophistication is required to ensure that the FTP accurately reflects the cost of liquidity, which is significant when wholesale funding spreads are high and volatile or when deposits are non-sticky. Specifically, a “term liquidity premium” and a “contingent liquidity premium” should be included in the FTP.

The term liquidity premium is the additional spread paid by the bank to compensate its bond holders for the liquidity and additional institution-specific credit risk they incur by committing funds for a longer term. Because the term premium increases the FTP, it is a benefit to liability-gathering business units and a cost to asset gatherers. The precise charge reflects the tenor or expected average life of the loan or deposit.

The contingent liquidity premium is the cost of holding liquid assets to protect against potential liquidity shocks. A well-functioning FTP framework allocates these costs to the parts of the business that create them, while insulating front-line business from rare, extreme events – effectively operating as an insurance premium for the business unit paid to the Treasury, which assumes the risk.

Liquidity costs for even standard banking products typically vary by 20-50bps, and widen considerably for more complex transactions. This means that an FTP framework which ignores them will misrepresent the contribution of transactions and lines of business: overstating the margin on assets and understating the margin on liabilities. This, in turn, can contribute to poor strategic and transactional decisions.

Banks that do not already account for liquidity in their FTP should make it a priority:

• Create a term liquidity premia curve, reflecting the incremental cost to the bank of additional duration. While asset-heavy institutions may be able to rely on the observed cost of wholesale funding issuance, deposit-rich institutions will need to consider alternative approaches to valuing term liquidity.
• Characterise all assets and liabilities with respect to their liquidity characteristics. Banks will need to identify those with no fixed contractual term (revolvers, standard current account balances), those with embedded optionality (mortgage prepayments, deposits) and multi-year deals which provide locked-in funding over several years (project finance, shipping). Even loans and deposits with defined contractual maturity will often behave differently in practice where pre-payment penalties are small. Banks should reflect all of these considerations in FTP
• Stress-test their liquidity position in response to economic or reputational shocks and use it to determine the required liquidity given the Group’s risk appetite. The cost of holding this buffer should be allocated to major internal drivers, such as cash-calls in derivatives, unused credit lines, and retail customer retention. Many banks now incorporate Basel III (LCR) parameters directly into this cost
• Create a fully-loaded economic P&L for each business unit (which is at least shadow-reported alongside regular P&L) containing charges for liquidity. Systems permitting, liquidity prices should be observable as transactions are entered into, thus helping to optimise transactional decisions

The new Basel III regulations, with their focus on both Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), will require banks to develop a better understanding of liquidity profiles and charges. Many institutions are upgrading their liquidity frameworks not only for the purpose of better understanding their economics but also to comply with the regulatory requirements that are materialising in their jurisdictions.

Our recent survey of European banks’ FTP practices suggests they are evolving rapidly. Survey highlights include:
• Approximately two-thirds of all European banks have either just revised their FTP approach or are in the process of doing so. Many commented that they see FTP as undergoing continual improvement and increasingly becoming a competitive advantage
• FTP differentiates between secured and unsecured funding costs in FTP and characterise all assets and liabilities for liquidity purposes, with behavioural maturities (banking book) and “time to sell under stress” (trading book) methodologies being the emerging consensus
• About two-thirds of banks incorporate contingent liquidity cost into the FTP by charging for the corresponding buffer
• There is no consensus on whether to credit back to businesses the profit made in Treasury from mismatches in the liquidity risk profile of assets and liabilities. Institutions are split 50:50 in how this is treated in Treasury and business P&Ls
• Most institutions now incorporate liquidity premia directly into FTP systems at the transaction level, with the remainder charging ex-post or ex-ante liquidity premia at a higher organisational level
2. WAR-GAMING

A clearer understanding of how a product’s value varies with liquidity costs typically reveals shortcomings in the portfolio. Improvements can be achieved quickly by restructuring liability-side products; for example by tightening conditions on retail deposits and changing asset management products so that they provide locked-in funds. Lending products can be modified to reduce indeterminate maturities and provide better contractual control of rollover conditions; for example in re-mortgaging negotiations.

As banks in Asia improve their analysis of downturn scenarios and the implications for their business strategies, two additional applications of liquidity risk analysis are likely to emerge:

- With a gradual slow-down in GDP growth and expectations for continued volatility in earnings, equity prices and wholesale funding markets, it is important to take account of liquidity risk in strategic planning. Banks typically pay close attention to the supply of wholesale funding and to the prospects for asset growth. But they employ relatively unsophisticated deposit strategies and do not formally link allocation of funds to asset growth strategies. Improved understanding of liquidity profiles now allows leading institutions to not only improve forecasts of P&Ls – via assumptions about changes in liquidity charges – but also to estimate future funding requirements implied by a business unit’s plans. This helps shape funding plans for the planning horizon and beyond and supports more robust assessments of whether growth plans will remain within a sensible risk appetite for future mismatch risk, buffer requirements and survival horizon.

- Oliver Wyman has been involved in a number of war-gaming exercises with banks interested in understanding how their core market will react to a liquidity shock. This considers likely reactions from competitors, the possibility of new entrants and potential regulatory responses. Looking at three or four such scenarios can help to develop reaction strategies. Liquidity issues accelerate faster than asset quality or margin deterioration and responses are often more drastic. The improved understanding of how the demand, supply and cost of liquidity are likely to evolve through a crisis makes such exercises valuable for senior management.
3. CROSS-BORDER FUNDING

Cross-border funding is becoming harder. Post-crisis, many governments now encourage foreign-owned subsidiaries to self-fund locally and make capital transfers difficult. Moreover, there is a trend towards preventing foreign holding companies from converting subsidiaries to branches. Banks must ensure that core Basel III liquidity ratios are satisfied in each currency in which they are active. And multi-national firms’ tax optimisation strategies are coming under greater scrutiny, which imposes further constraints on cross-border transfers. Banks can respond in several ways:

• Increase granularity in characterising liabilities – especially differentiating between rate-sensitive and sticky customers – and focus on deposit-gathering activities. Some banks have quickly raised and then sustained up to $1 BN of local currency in countries where they were not able to fund existing lending or trading operations

• Exit unattractive foreign businesses following a review of their viability given the cost of self-funding in local currency and the degree to which the regulatory environment will allow P&L smoothing via transfers

• A particular issue for Asian banks is the shortage of local currency funding, even in core markets. Many banks fund themselves in US dollars and then swap into local currency. This will be challenged by the required maturity-matching in both currencies under Basel III. Banks are now revisiting their ALM methodologies to develop frameworks for managing the more complex trade-offs between earnings, gap risk, FX risk and P&L volatility

• FTP should reflect the extent to which funding is fungible across borders. For example, institutions should avoid passing on illusory “Group benefits” to business units that need to be self-funding due to regulatory restrictions

Although the short-term outlook remains relatively positive for Asian banks in general, there may be little time to spare. In countries where liquidity is gradually becoming scarcer, Treasurers and CFOs are already leading the charge to improve liquidity risk management and tie it to both resource allocation and broader strategic decisions. Such programs are typically 18 to 24 months in duration. Given the competitive advantages associated with a better understanding of business economics, and the opportunity to get ahead of both regulation and any potential economic downturn, Asian banks should now accelerate efforts to ensure their liquidity risk management framework is future-proof.
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