OLIVER WYMAN

# COVID-19

## A treasurer's liquidity management action plan

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# UNCERTAINTY IS HIGH – SO IS THE NEED FOR A PROACTIVE RESPONSE PLAN

The outbreak of the new coronavirus 2019 (COVID-19) has led to increased volatility in global financial markets (including the biggest single intraday drop in the Dow Jones Industrial Average). This fast-developing situation is almost certain to affect a broad range of industries due to reduced consumer demand, disruptions in supply chains, cutbacks in travel and entertainment, leisure activities, and more. Coupled with the oil price shock and fears of a global recession, COVID-19 has caused the Federal Reserve, the Bank of England, and the Bank of Canada to cut benchmark rates in an effort to temper the shock.

The depth and breadth of the coronavirus crisis is on an order not seen since post-financial crisis liquidity regulations were first implemented, and there is a high degree of uncertainty over how it will unfold. While COVID-19 could turn out to be just a temporary disruption (similar to the 1987 Black Monday crash or the fourth quarter 2018 market sell-off and credit spread widening), it could also be the beginning of sustained stress in markets (similar to 2007/2008), given that it will be months before vaccine clinical trials begin and the impact of monetary policy typically takes time to ripple through the economy. Plus, with global interest rates currently near rock bottom, the effects of additional rate cuts may be limited.

While banks have significantly improved their liquidity positions with the implementation of post-financial crisis regulation, treasurers need to reassess their risks and prepare for a large range of potential outcomes. Typical liquidity stress testing scenario development and liquidity risk driver identification and calibration would not have considered conditions that may develop under this COVID-19 scenario.

# THE TREASURER'S PLAYBOOK

At a high-level, we suggest three broad steps:

**1.**

**IMMEDIATE ACTIONS AND EMERGING RISKS IMPACT ASSESSMENT**

in a foggy market, transforming uncertainties into potential risks to monitor

**2.**

**REFINE AND EXTEND LIQUIDITY RISK MEASUREMENT**

tuning in to better pick up future evolutions and emerging risks

**3.**

**REVIEW PLANNED MITIGATION ACTIONS**

improving resiliency in anticipation of potential adversity

## 1. IMMEDIATE ACTIONS AND EMERGING RISKS IMPACT ASSESSMENT

### In a foggy market, transforming uncertainties into potential risks to monitor

Likely already in progress for most leading institutions as part of a liquidity crisis management response, this step captures the critical actions to execute in the short term (e.g., "no regret" actions such as increasing cash reserves) to anticipate potential shortfalls and ensure the adequacy of the firm's current liquidity position. For institutions that have triggered a liquidity crisis management response (management declared heightened alert or due to breaches in Early Warning Indicators "EWI") — the focus will be to:

**Re-forecast:** Rapidly develop a revised view of potential changes to business-as-usual liquidity and funding usage from prior plans. For institutions with sufficient analytical agility, this will entail conducting an ad-hoc refresh of cash-flow projections, including updated assumptions from business lines, which should include:

- Changes in expected credit usage (including both new demand and draws on existing lines) and customer behavior including prepayment and default
- (Un)Anticipated behavior of corporate and other depositors — for instance, the "flight to quality" effect observed in prior times of volatility that led to deposit inflows and potential issues that leverage-constrained institutions may face as a result
- Impacts on availability of funding sources (such as even more aggravated loss of cash providers in repo markets) and the related implications

- For firms with significant reliance on long-term wholesale funding, an acceleration or reduction or tenor adjustments of the funding plan may be required
- Recent patterns of intraday liquidity, given the huge volatility of global markets

**Re-balance:** Execute "no regret" actions (such as those outlined in current contingency funding plans) to increase liquidity and cash holdings in the short term to deal with the added uncertainty. Furthermore, banks with significant reliance on wholesale funding may want to take advantage of market opportunities when available, even if it means funding transactions may be of shorter duration than typically executed (without losing sight of LCR and internal stress test constraints).

**Re-assess risks:** Assess emerging risks from the current events that previously had not been considered, such as the impact of operational closure or reduced capacity of key markets or financial market utilities ("FMU"). In addition, reassess the severity of key liquidity risk drivers and how they are captured and calibrated in stress testing models. Intraday liquidity usage is potentially one such area where reassessment may be required. Having transparency into drivers of intraday by business activity at FMUs becomes even more critical to understand and project cash requirements. Other unplanned risks may emerge from actions such as forbearance and loan forgiveness, which may impact heretofore planned contractual cash inflows.

# 2. REFINE AND EXTEND LIQUIDITY RISK MEASUREMENT

## Tuning in to better pick up future evolutions and emerging risks

Liquidity Stress Testing ("LST") and Early Warning Indicator ("EWI") frameworks enable effective ongoing monitoring and inform strategic responses to anticipated shortfalls. To remain effective — these frameworks need to be (re-)designed and/or (re-)calibrated to ensure that they fully reflect any unique risks posed by the current situation that were not previously contemplated.

Better identification, measurement and understanding of key liquidity drivers will be a significant driver of an institution's ability to more effectively manage and mitigate liquidity risks. Key actions to support this goal include:

- **Increasing the frequency of monitoring:** COVID-19 has highlighted the need for daily stress testing and EWI monitoring — critical capabilities that systemically important institutions were required to develop
- **Better understanding of risks:** conduct a targeted refresh of the liquidity risk identification exercise to better understand the current exposure of the institution given specific features of the crisis (e.g., oil-related exposures, exposure to airlines or other counterparties significantly impacted by supply chain disruption, etc.)
- **Reviewing and re-calibrating Liquidity Stress Testing and Early Warning Indicators:**
  - **Liquidity Stress Testing:** Re-assessing existing scenarios and/or adding new scenarios to capture the range of the potential evolutions of the crisis and key emerging risks (e.g., virus contained in next x months with light recession vs. sustained spread of virus leading to deep crisis, etc.). Evaluate degree of capture of liquidity risk drivers and whether any emerging drivers need to be integrated or whether existing ones require re-calibration to ensure risks are comprehensively captured prioritizing liquidity risk drivers most impacted (e.g., unfunded commitments, wholesale funding, intraday liquidity, etc.)

– **Early Warning Indicators:** EWIs should be re-assessed immediately from a "go forward" perspective (i.e., given the specific exposures identified — do the current set of early warning indicators fully capture these risks? Which specific EWIs should be added to monitor emerging risks?). At a later stage, treasurers should reassess those from a backward-looking perspective (i.e., were there market signals in the past few weeks that should have been picked up by the framework). Changes will likely be required both in the set of EWIs measured as well as monitoring thresholds set for each metric

# 3. REVIEW PLANNED MITIGATION ACTIONS

## Improving resiliency in anticipation of potential adversity

Effective liquidity risk measurement is only part of the puzzle — anticipated stresses need to be effectively mitigated by actions that are *feasible* under anticipated market conditions, *effective* to mitigate any shortfalls, and *operational* (i.e., the institution should be able to execute actions without undue delay). Treasurers should consider revisiting the list of Contingency Funding Actions to assess those that are most likely to be relevant in the current environment and also to determine if additional actions need to be considered.

In particular, the current market outlook and potential go-forward scenarios may affect the efficacy and feasibility of current contingency funding plans. Meanwhile, testing the operational dimension includes verifying availability of critical reports, such as almost real-time position reports of securities holdings by CUSIP/ISIN and location (legal entities and accounts) and the ability to monetize for example through the Discount Window or by repo with the Federal Reserve or other market counterparties. These challenges will of course be exaggerated by the fact that remote work locations and IT connectivity and communication may serve as additional obstacles in today's environment.

As a final step in the playbook, being prepared to communicate a clear plan to external stakeholders such as regulators, clients, market participants, counterparties, and investors regarding liquidity risk management strategies will be especially important to preserving confidence and strengthening the institution's liquidity position. In particular, continuous communication with regulators becomes of critical importance should considerations such as leverage ratio relief or LCR breaches become a possibility.

# CONCLUSION

Preparing the firm for liquidity stresses and then executing dynamically through times of extreme volatility and market turbulence is arguably a treasurer's core responsibility. Yet we know that any specific scenario utilized as part of LST or contingency funding plan design is highly likely to not be fully predictive. Enacting high-impact strategic actions under unforeseen stress circumstances as now exists under the current COVID-19 scenario is where a well-run and prepared treasury can make the difference — helping firms survive the crisis and thrive in its aftermath.

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