Banks and Liquidity

Some thoughts on term liquidity management

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It requires a very unusual mind to actualise the obvious. Not so long ago, global banking had learnt some lessons from uninvited crisis. After the dust had settled, supervisory authorities have agreed to streamline two core elements of banking industry: *Capital* and *Liquidity*. Both are vital. *Capital* is meaningful, in particular, for loss absorption. In other words, it serves as a cushion when bad times arrived and is used to restrain risk-taking activities shouldered by individual bank. In this piece, however, *Liquidity* shall be the centre of discussion.

There are various aspects of *Liquidity*, but to confine the definition in related context, longer term liquidity management will be in focus. As it became evident in the crisis, illiquidity rather than insolvency caused banks' failure. In this regards, *Liquidity* has divided good banks from ailing ones. Sound but poor liquidity banks may not be able to withstand bankruptcy risk. Thus, it is not exaggerate to say "*Liquidity* is REAL king", especially, when market is squeezed or under crisis.

When reading the data on interbank lending and borrowing (from 2006 – May 2011) which mirroring how banks manage their funds, it reveals that they have concentrated their liquidity management in very short tenors. On interbank flows, *year-to-date* daily average interbank volume is circa THB 87,250 million risen from THB 33,400 million in 2006. Basically, the majority has been resided in overnight (O/N) and tomorrow-next (T/N) tenors, hence, term transactions (1-3 months) have been very limited. On outstanding (original maturity), in the system of 40 commercial banks and specialised financial institutions, 1M- and 3M-tenors have the balances of THB 30,030 million and THB 4,920 million respectively. *This confirms that banks are slow to lengthen their liquidity management.*

In the past, banks were not incentivised to establish a proper THB money market rate fixing since the THBFIX (implied THB interest rate) had worked well. In the present and future, since the global financial landscape has been changed, so banks should collaborate and pursue term liquidity management for some good reasons. For instance, it will allow market to have reliable and executable market reference rate ie., 3-month fixing the so-called “BIBOR”. Also if cash market is broadly liquid, to some extent, participants will be able to use BIBOR as future rate expectation. Last but not least, on interest paying-side, clients will be linked to interest rate that reflecting market dynamics and domestic liquidity conditions.

From liquidity management’s perspective, with notice, banks have been encouraged to extend or lengthen sources of funding. Non-technically speaking, primary purpose is to narrowing the gap between funding and lending. The greater the gap is, the more risky the bank is exposed to. As a result, term funding including interbank borrowing rather than overnight or call can be considered as a more secure funding source, in a sense that it creates certainty of due maturities in orderly manner. In retail market, banks started offering long-dated financial products ie., B/E and ultra-long fixed deposits as they learn to be less reliable on short-term funding to mitigate the gapping.

Under distress conditions, which might arise from time to time, banks have a fair chance to face sudden outflows ie., if all liabilities were running off overnight, and not being able to covert their assets into cash in timely manner. This is due to the majority of bank assets which are loans are illiquid, only parts of their assets ie., government securities are liquid. By modifying funding from short to medium tenor would enable banks to avoid such situation. Therefore, term liquidity will delay cash outflows and provide more time & space for banks to sell the assets.

Apart from this, term liquidity can also help reducing rollover risk. Ones that choose to fund their liquidity shortly will need more frequent debt-rollovers. Under turbulent situation, if they require rollover, short-term funding banks will be perceived as unhealthy, and debtors are not willing to rollover the loans for the sake of prudentiality. If the circumstance is foreseen, then sophisticated banks should start preparing themselves for extending term liquidity management.

From regulatory aspect, prudent *Liquidity* management requires good forecast of liquidity position. Apart from foreseeing future cash flows, money market managers have to incorporate views, scenarios or stress situation by assuming shocks had taken place in the system. Previously, banks have to forecast and prepare liquidity position, *per se*, one-month spectrum to ensure that banks can cover liquidity within their borrowing capacity. However, this had been proven that it was not enough to weather the storms of bank runs.

Under BASEL III, International Framework for Liquidity Risk Management, banks are required to prepare ample liquidity to cope with uncertainty and volatility. It also aims to monitor liquidity risk of banks. Two main indicators which are Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) have been introduced to ensure that banks will not encounter liquidity shortage. The purposes of the first is to encourage banks hold high quality liquid assets to cushion potential outflows in 30 days-to-come under distress circumstance, and the latter is to lengthen funding structure in terms of maturity of banks. The higher the ratios are, the better the liquidity aspects of a bank will be.

Regarding this, BASEL III has given a big hint to banks preparing themselves for accessing stable funding before the framework will be effective. Lines after lines, it is clear that extended term liquidity will be tomorrow's financial landscape. All this means that banks have to shift from short to more term liquidity management. Not mandatory but voluntary, should banks thrive for the betterment, not for others but for themselves.

(The views expressed in this column are the writer's own.)

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