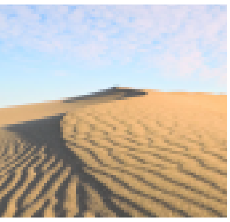
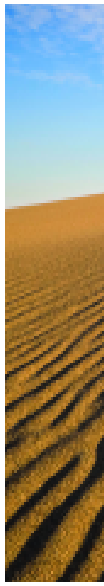


Refreshing liquidity management

THE INTRODUCTION OF INDIVIDUAL LIQUIDITY ADEQUACY STANDARDS IS PRESENTING TREASURERS AND BANKERS WITH AN OPPORTUNITY TO REASSESS LIQUIDITY SOLUTIONS. **PETER WILLIAMS** FOUND OUT MORE.



In the wake of the financial crisis, a stampede of regulators in the UK, Europe and globally has been driving towards a single goal – the construction of a robust system to replace the many deep-seated and often optimistic assumptions on which financial supervision had been based. While these changes will focus heavily on transforming behaviours within banks, they also give rise to potential opportunities for treasurers and financial directors who proactively manage their funds.

One key initiative to emerge from this great rush of conjecture and analysis has been the introduction last year of Individual Liquidity Adequacy Standards (ILAS). These rules give much the same regulatory importance to liquidity management as has been given to capital adequacy. It obliges firms to consider in much more detail than before their precise internal processes, planning and risk protections and requires that they embed robust controls and behaviours to allow an appropriate response to a liquidity risk event.

The aim of ILAS, in short, is to ensure banks avoid the disasters of 2007-2008 by having the appropriate quantity and quality of liquidity.

Robert Hare, director of specialist sales and liabilities at Lloyds Bank Corporate Markets, welcomes the objectives of the ILAS regime: "What they're doing is absolutely right. As long ago as 2004, I recall the Financial Services Authority [FSA] observing that one weakness in the then Basel II accord was that it was quiet on liquidity – a key likely cause of system failure. We've seen how absolutely right that worry was. And it's sensible that they're now doing something about it. In the same way as insisting on an appropriate level of capital through the Internal Capital Adequacy and Assessment Process [ICAAP], the ILAS rules are now designed to ensure that banks hold an appropriate level of liquidity, as well.

"In just the same way as we now talk about an advanced status for banks when it comes to capital adequacy, this is now forcing banks to achieve an advanced status for liquidity too. And the key thing we're now all urgently considering is exactly how to reduce the impact that the introduction of ILAS is bound to have on our customers, especially as they continue to navigate today's volatile markets."

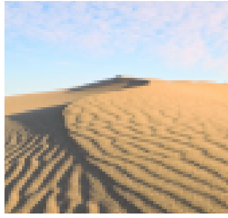
Banks are reviewing the quality of funds their customers hold and are engaged in detailed discussions with the FSA to define precisely what the standards mean for deposits from all customer types, from sole trader to multinational.

The key to these discussions is an understanding of the FSA definition of quality, as this will drive the liquidity benefit attributed to the funds and thus a bank's appetite for them. As a treasurer, it follows that understanding a bank's view on what constitutes quality can be the key to unlocking return.

"UNDERSTANDING A BANK'S VIEW ON WHAT CONSTITUTES QUALITY CAN BE THE KEY TO UNLOCKING RETURN."

So how can quality be defined? Richard Brown, senior manager, liquidity products, at Lloyds Banking Group Capital Markets, says: "ILAS is quite clear that quality is determined by perceived outflow risk – the risk of a customer withdrawing their deposit – during a time of financial market stress. The higher the likelihood that a customer will withdraw funds from the balance sheet, the higher the liquidity risk and therefore the lower the liquidity quality."

How is outflow risk determined? "A number of factors will impact on the perceived outflow risk," Brown continues. "Understanding customer behaviour is absolutely at the core of this and our experience shows that customer type and sophistication are two elements which influence this. If you consider the example of how customers might behave in the event of a market crash, your answer is likely to be different if your customer is a sole trader rather than a multinational. Similarly, the type of funds is also important. Customers are



much more able to move instant access savings funds than operational/transactional cash, meaning they carry relatively higher outflow risk.

"Finally, product type is also important as this determines whether a customer is able to withdraw funds during the risk event. Fixed term deposits are an example of products which carry much lower outflow risk due to their product design. As a result, customers generally receive a much higher reward for using them."

This final point is key in considering opportunities to proactively manage a company's cash resources. If these can be managed in a way that is sympathetic to the pressure imposed on banks from a regulatory perspective then there is undoubted opportunity for increased return.

Evidence of this can already be seen in the market. The sharpened focus on liquidity for businesses across the board is generating its own new dynamic. As banks report under the complex ILAS rules, one positive outcome is a renewed emphasis on product innovation to maximise the customer's return from funds on deposit in today's uniquely challenging market environment.

LIQUIDITY SOLUTIONS Lloyds Bank Corporate Markets has worked closely with customers to develop solutions that meet both customers' and the bank's needs. "The impact of ILAS has been so profound," agrees Hare, "that we naturally turned to those customers who were likely to be most significantly affected. Together, we undertook a really detailed analysis that drilled deep to give us a unique understanding of how the client's needs would be affected.

"The outcome was the launch of our 95-day deposit product. It's tailored to overcome all the major challenges posed by the ILAS regime. In practice, for example, one ILAS-induced hurdle is the need to demonstrate that customer deposit funds cannot be withdrawn within a 90-day period – that's the stress factor period effectively imposed by ILAS. Our 95-day product ticks all the boxes and makes it easier for customers to commit to term with the funds they're depositing – and to maximise the return on those funds."

And that's by no means the end of the industry's regulatory challenges. While negotiators work towards conclusions with the FSA about how funds are to be priced and valued, and how the complexities of the ILAS regime are to be applied, there hovers a host of additional measures which will impact banks and the customers they serve.

"As we come to terms with ILAS," Hare explains, "hot on its heels we've got the big implications of the Basel III accord on banking capital/liquidity adequacy coming through very fast. Those Basel III measures take an even longer-term view of the type of funding banks need as buffers against any likely risk scenarios. The introduction of a 'Net Stable Funding Ratio' which regulators are now driving towards is actually stretching funding requirements from three months to 12 months and beyond.

"But the practical reality, right now, is that we're all facing challenges in achieving what the authorities like to call 'gold-plated regulation' of UK financial enterprises – and none of us can yet be quite certain exactly what that is going to mean."

As the industry strives to clarify these regulatory impacts, what should customers be looking for from their bank? Hare is clear: "What our clients want, above all, is a determined willingness to be tirelessly proactive in working with them to develop innovative products and pricing mechanisms that really do face up to these regulatory challenges. And in this, the credit standing of the bank is clearly a significant plus."

RELATIONSHIP STRENGTH PAYS OFF

The strength of the 20-year relationship between Lloyds Bank Corporate Markets and the UK's largest independent stockbroking firm, Brewin Dolphin, is paying off with a solution that specifically addresses the challenges of tightening liquidity and historically low interest rates.

"I've been pleased to see the way that certain banks have taken such a proactive stance," says Robin Bayford, finance director at Brewin Dolphin. "It's been, if you like, one of the unintended consequences of the impact of the ILAS rules on banks: it was clear to us that, unless our clients' funds could be valued and viewed differently, then the returns we'd be receiving on these funds would be measurably diminished.

"In that sense, the positive thing about ILAS is how it's encouraging the banks to be really innovative in the way they construct products to satisfy customer needs. And we're certainly seeing some good examples of this."

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