Action stations

Executive summary

- The global economic downturn has dashed hopes that Asia could maintain growth as the rest of the world faltered. Peter Wong, founding chairman of the International Association of CFOs and Corporate Treasurers (China), outlined the challenges facing Asian corporates in managing liquidity risk.

The eighth, and latest, in the ACT's ***talkingtreasury*** series, sponsored by RBS, was held in Hong Kong on 21 October as the repercussions of the growing world financial crisis made themselves felt locally.

Shares in CITIC Pacific, the Hong Kong subsidiary of China's state-owned investment group, were in freefall on the day of the conference itself. The company had just revealed that a series of unauthorised foreign exchange bets made by its senior executives on the direction of the Australian dollar and the euro threatened to misfire spectacularly and lose $2bn. Management had mistakenly assumed the US dollar would continue to depreciate against its Australian counterpart, after a weak performance in recent years.

So the question posed by speaker Peter Wong, founding chairman of the IACCT (China), was even more prescient than he imagined. "What impact has the financial tsunami had on liquidity risk management and corporate funding strategies?" he asked his audience. "And what has been the impact on Asia of the credit crisis?"

Like other regions, Asia has seen sharp falls in its stock markets and faces the prospect of deflation succeeding inflation in 2009. The region is feeling the effects of deleveraging, with the cost of borrowing high and unsecured borrowing inaccessible.

Although banks in Asia have all taken concerted action to protect the banking system, inter-bank liquidity "is not out of the woods yet" said Wong. Trading liquidity continues to fall as banks reduce their trading activity and counterparty limits, while hedging costs rise as long tenure is not liquid.

The region's main currencies have also suffered as the slowdown reduces the demand for Asia's exports. The Australian dollar has weakened as commodity prices head lower, and the South Korean won has also lost ground.

PROACTIVE PAYS OFF Despite the gloom, Asia still has some very healthy economic fundamentals, and its governments and the private sector are less leveraged than during the 1997 financial crisis. Member countries have a total of more than $4 trillion of foreign exchange reserves, domestic unemployment and non-performing loans have yet to deteriorate, and governments still have time to instigate counter-cyclical fiscal stimuli (Australia, Taiwan, Hong Kong and Singapore all took proactive action at an early stage).

But businesses are scaling back their expansion plans and preparing for exports to slow. Smaller and medium-size businesses are more vulnerable and many face ratings downgrades. The more favourable cost outlook in real estate, labour and raw materials, improved opportunities for merger and acquisition, and easier recruitment are offset by a shortage of external funding and the risk of refinancing.

So what does Wong believe that a company's liquidity risk management and corporate funding strategy should consist of in challenging times?

It should recognise that liquidity risk is a "consequential risk", he suggests, and should be measured by balance sheet liquidity analysis, the cash capital position and a maturity mismatch approach.

- **Balance sheet liquidity analysis**
  - Compare the liquidity profile for each class of assets and liabilities to identify mismatches.
  - Potential limitations include: no detail on the maturity profile of assets and liabilities; assets not shown at market value; haircuts for future market value volatility and liquidation discounts dependant on the credit quality, central bank eligibility and the market depth of the security to be sold; and off-balance sheet commitments that may carry significant liquidity risk.

- **Cash capital position**
  - Assess the gap between liquidity assets (collateral value of unencumbered assets) and short-term liabilities.

- **Maturity mismatch approach**
  - Category I: cashflow amount and cashflow timing both deterministic (such as repayments of a bank loan).
  - Category II: cashflow amount stochastic and cashflow timing deterministic (such as settlement of a floating leg of an interest rate swap).

THE ACT'S TALKINGTREASURY EVENTS HAS CONTINUED TO SET OUT THE GLOBAL ISSUE FACING TREASURERS ACROSS THE GLOBE. THE LATEST SETTING WAS HONG KONG.

- Category III: cashflow amount deterministic and cashflow timing stochastic (such as early loan repayment triggered by a rating downgrade or material adverse change).
- Category IV: cashflow amount and cashflow timing stochastic (such as early termination of facility by banks that have rating triggers or material adverse change clauses).

RECOGNISING WARNING INDICATORS The basic procedures in a liquidity risk management structure, said Wong, involve managing forecast cash inflows and outflows, reducing contingent liquidity risk through extending liability terms and ensuring the stability of funding sources, keeping back some asset liquidity reserves and insurance, and a readiness to enhance liquidity at the first sign of warning.

Warning indicators include a decline in the company's share price and/or a risk premium relative to its peers, overtrading and a significant increase in working capital, earnings deterioration, ratings downgrade, and a significant change in currency exchange rate, interest rate or commodity price. A liquidity contingency plan has to address potential unforeseen increases in funding required by the company and unforeseen decreases in the funding available.

His recommendations for a potential action plan? Each of the following merits serious consideration:

- Refine cashflow forecasts and raise intensity of liquidity reporting.
- Resolve adverse provisions in contracts with funds providers (such as removing rating triggers).
- Increase the size of liquidity reserves (for example, via a sale and leaseback of the building).
- Free up collateral ready to switch from unsecured to secured loans. Identify assets that can be sold or pledged, and update valuations.
- Refinance loans due to expire within one to three years to longer term in anticipation of a bank funds shortage in a down cycle.
- Analyse in closer detail the ability and willingness of fund providers and manage the bank relationship proactively.
- Reduce business growth and avoid over-extending contractual commitment.

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