Planning liquidity requirements during the COVID-19 crisis

The regulated financial services sector is familiar with liquidity management and planning under normal and stressed environments, but for most other corporate treasury functions it's not an area that often merits any structure or guidance.

We have seen a fundamental shift in the liquidity markets over past couple of weeks and while the change has been sudden, it will have long lasting implications for how corporate treasuries think about their liquidity strategy. During these extraordinary times, it is helpful to consider some of the approaches adopted by those working in banks, insurers and asset managers.

How do banks approach liquidity management and planning?

Banks have to manage to minimum liquidity requirements, as detailed in Basel frameworks, and provide regular reporting on these metrics to their regulators. The Liquidity Coverage Ratio ("LCR") is one of the two key metrics (the other being the Net Stable Funding Ratio). It is designed to ensure that banks hold a sufficient liquidity buffer – defined as a reserve of high-quality liquid assets ("HQLA") to allow them to survive a period of significant liquidity stress lasting 30 days. The period is selected as the minimum period for corrective action to be taken by management.

The LCR liquidity stress scenario is prescriptive and based on assuming:

- external funding sources have closed
- no additional inflows from customers
- outflows maintained at existing levels.

Banks also undertake reverse stress testing which looks at the various scenarios that would need to arise for the firm to cease to be able to pay out on its obligations. This may include sale of assets at distressed prices, accelerated outflows and delays in liquidating certain assets.

Building a liquidity forecast

Adopting a structured approach in developing a forward-looking liquidity risk view is key. There are three key focus areas which will input into the model:

1. what are my assumptions for income?
2. what are my assumptions for payments?
   a. core payments?
   b. discretionary payments?
   c. sales-related payments?
3. what type of recovery should I plan for – a V-shaped or a very fat U-shaped?

There are a number of models that one can adopt to determine liquidity requirements, but the following three-step approach may be effective across a range of businesses and circumstances.

<u>Estimate Liquidity Requirements</u>

- Apply a top down approach to estimating liquidity requirements as the current bottom-up cash forecasting approach is unlikely to provide any insights given the current situation. Supplement this with data on any large customers or suppliers where the payments are being monitored closely.
- Either follow the forecasts from the OECD or the WTO as featured in the ACT weekly COVID-19 newsletters (https://www.treasurers.org/node/374193) or assume a rapidly falling

decline over the next 3 months with a flat line over the following 3 months and then a slow recovery until mid-2021.

- Apply an 80:20 rule that ignores any smaller items of transactional activity
- Assume a faster decline in revenues or assume no revenues, depending on your particular industry sector
- Set a buffer / contingency for the unknown. Given the nature of the crisis, decide if 10% is sufficient or it should be increased to 15% or even 20%

Undertake scenario analysis

- Undertake a range of scenarios to create a "funnel of outcomes". The value of this is that it will help you and your board to assess your own version of likely outcomes and to collectively agree on a suitable path for your organisation. It is also a reminder of what the best (and the worst) outcome could be.
- Regularly review assumptions and update outcomes.

Explore all your funding options

- Identify any low points in your liquidity requirement and use this to work out when to draw down on any committed facilities.
- Note that drawing down all of your committed facilities may seem like the best thing to do but, as covered in the article by Clare Francis – CEO U.K. & Regional Head Global Banking Europe at Standard Chartered Bank (https://www.treasurers.org/covid-19-how-much-liquidity-enough) - , it's not helpful to the overall financial ecosystem and currently there's no sense of a lack of liquidity at the banking industry level.

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