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ADDRESSING THE LIQUIDITY CONUNDRUM

Liquidity budgeting and strategic cash management have become critical tools in helping investors successfully navigate a challenging market environment. But more needs to be done to unravel the liquidity conundrum they face.

Institutional investors are holding more cash in their portfolios than ever before, driven by the need to support evolving investment strategies and meet regulatory requirements. This increase has many implications. Cash was almost an afterthought in portfolio allocation prior to the global financial crisis, but now it brings its own challenges, both from a performance, sourcing and management point of view.

Mark Austin, Head of Relationship Management, Self-managed Asset Owners, and Insurance at Northern Trust, says he was surprised to learn that in some cases, pension schemes have increased their allocation of cash from approximately 2% and 3%, to anywhere up to 6% and 7%.

"If you assume a 0% return on cash, which is a quite generous assumption in the current market environment, and you have a 5% target return from your portfolio, then the rough calculation brings you up to a 25 basis point performance drag, before you've even put in place anything like equitisation. Cash may be king, but it is a troublesome king, and it is starting to hurt other parts of the portfolio," he says.

In the past few months, Northern Trust has discussed this subject with 15 large UK and Dutch asset owners – principally pension schemes and insurers – about the liquidity challenges they are facing.

"Broadly speaking, the level of concern around illiquidity is at its lowest when a pension scheme is still open, where there are contributions still coming in, and investments are both growth oriented and liquid. But when a pension fund closes, and becomes more mature, then liquidity really starts to bite. Amongst more mature schemes, liquidity was actually on the top of their list of concerns," says Austin.

LIQUIDITY CHALLENGES

Part of the challenge comes from the unintended consequences of regulation, such as derivative market central clearing reforms. The mandated posting of initial and variation margin on over-the-counter (OTC) derivatives intra-day, means that there is an increased requirement on collateral and cash. In Europe, the European Markets Infrastructure Regulation (EMIR), and in the US, the Dodd Frank Act, were both set up to reduce risks in the derivatives market.

"If I'm an investor the bottom line is, will there come a point when I'm called for cash and I don't have it in place? And if I don't have it, how am I going to get it? The options are expensive, and involve either holding very large amounts of cash in the portfolio, or paying quite a lot of money to get some sort of guaranteed facility in place," explains Austin.

CHALLENGING MARKETS

The current low yield environment does not help. According to Austin, "The challenge on yields has a bearing as well. Clients are finding themselves going down the illiquidity premium route, investing in infrastructure, private equity, and direct loans, all of which are illiquid, and often require large amounts of cash put aside to support them. As a result, pension schemes have to take that cash position out of liquidity calculations. We've found that some clients are no longer investing on a risk budget, but instead on a liquidity budget, saying they will turn down investments if they don't fit within the liquidity parameters that they need to support their business going forward."

UNINTENDED CONSEQUENCES

Steve Irwin, Head of Asset Servicing Liquidity Solutions, Product Management, Northern Trust, says other regulation is having an impact as well. Under Basel III framework, banks have to distinguish between operational cash, which covers general transactional needs, and non-operational cash, which covers everything else. Under Liquidity Coverage Ratio requirements, high-quality liquid assets (HQLAs) must be held equal to:

- 25% of operational deposits, 40% of non-operational non-financial corporate deposits;
- And 100% of non-operational financial corporate and financial institutional deposits.

"The other key piece is the leverage ratio, which is really a non-risk-based measure to limit the risk that banks take on excessive leverage. Banks must hold at least 3% Tier 1 capital in respect to their total assets. This could limit your ability to hold all your cash with your bank providers, and it might also affect interest rates offered on certain deposits. Traditional sources of funding from banks may also become challenged," explains Irwin.

FINDING THE RIGHT SOLUTION

So what can investors do? According to Irwin, there are four key tenets of any liquidity management strategy: security, liquidity, yield, and operational efficiency. "Investors must start taking them into account if they want to effectively forecast their liquidity requirements," says Irwin, "When is the last time you reviewed your cash investment or Treasury policy?"

He also believes there is an emerging fifth tenet, which is cost. Irwin says investors need to find the balance between holding enough operational cash to settle obligations and optimising that cash. "How much is it going to cost you to have certainty around having cash when you need it, but equally how can you ensure that the cost of liquidity is not a drag on overall performance?"

Investors must also think about how they can diversify counterparty risk, and what types of arrangements they have for short-term cash sources, in case of a sudden market movement. They can also consider outsourcing components of cash or Treasury management, in order to focus on core competencies.

In its white paper, *Cash: An Asset in Adolescence*, which will be published later this year, Northern Trust has set out many of the steps that investors need to take to future-proof cash management and investment strategies against liquidity challenges. Among them, investors should identify any unusual sources of liquidity that the fund might be able to take advantage of, such as using securities for Repo'ing, and selling cash equity against total return swaps (TRS). To meet existing requirements, investors can look to centralised collateral management, inventory management, and collateral optimisation. They can also look at segregated collateral accounts, while peer-to-peer lending is attracting particular attention.

Austin believes there is enough cash in the system, however "The problem is that most of the time, it's in the wrong place. So how do we build products to get the cash from the wrong place to the right place, rapidly, efficiently and without too much cost and risk? That is the real challenge for the providers and investors."