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WEATHERING THE 2020 STORM

Market Volatility, Location Disruption, Cyber Threats, and Record Volumes

Asset Servicing at Northern Trust

The COVID-19 pandemic has dramatically impacted the global economy in many ways, but the impact was felt differently than that of the 2008 crisis on the financial markets. Unlike 2008—thanks to lessons learned and changes implemented from the financial crisis — the markets were better positioned to sustain this COVID-19 crisis, but volatility put significant stress on investment managers in similar ways to 2008 and new pressures emerged, particularly around Treasury Operations.

At times an overlooked function for investment managers, Treasury Operations is called upon heavily during times of uncertainty. Some aspects of the COVID-19 crisis presented similar issues to 2008, but with COVID-19 fund managers were forced to deal with the volatility and critical functions in a work-from-home environment. Treasury teams were stretched during these times of uncertainty and now, more than ever, it's critical for fund managers to have the necessary team, process and technology to closely manage and control the areas impacting Treasury below:

- Increased cyber-attacks around cash/wire movements
- Significant increase in margin calls and disputed market valuations
- Rise in wire volumes
- Tracking of counterparty exposure
- Monitoring of unencumbered cash
- Liquidity management

This paper takes a closer look into what happened during the initial stages of the COVID-19 crisis and what Treasury teams were tasked with, while highlighting the lessons we should take away as we prepare for the next crisis (especially as we continue to deal with the COVID-19 pandemic and its continued global impact on Main Street businesses) and what may be an increased focus from an investor and due diligence perspective.

Impact on Treasury Operations during March 2020: automation is key to effectively, efficiently and safely manage increased volumes, volatility and liquidity during a crisis

By the end of March, the Dow was trading nearly 26% lower than its all-time, intraday high, which had been set just 48 days prior. This volatility had a huge impact on Treasury Operations – as seen when examining key trends across cash and collateral transaction volumes, cash levels, and also how managers dealt with the subtleties of exposure and liquidity.

As could be expected with the increased volatility, Northern Trust Alternative Fund Services (NTAFS) noticed a 23% increase in daily wire volumes across clients on their Omnium platform in March versus January of 2020. While some of the volume was due to margin demands, this only accounted for 38% of the total increase in wires, so the increased volume could otherwise largely be attributed to general liquidity needs. COVID-19 quarantine efforts meant that managers had to handle the increased wire volume while working remotely. This, coupled with heightened awareness of risk from cyber-attacks, made it key for managers to systematically and efficiently instruct payments rather than process them manually via fax or letters of authorization which require callbacks and other controls. Managers leveraging a single platform for payments were better able to withstand the additional volume and more closely focus on areas of greater significance impacting Treasury.

Similar trends could be seen across the collateral management landscape as asset managers reacted to a spike in daily margin calls as a result of high volatility. While the market sustained the volatility, there was great stress put on the collateral management function as margin call volumes, amounts and dispute trends were significantly elevated during March. In fact, where managing collateral for bilateral repo and OTC agreements, NTAFS experienced an 86% increase in margin calls in March 2020 versus just two months prior in January. During this same period, the median margin call amount rose by 38%, but more importantly so did dispute activity. NTAFS saw the number of collateral disputes nearly double, with the average client dispute increasing almost 4X, and the median collateral dispute outpacing the median call amount with an increase of over 80%. Similar to wires, the change in volume alone highlighted the importance of having technology and automation in managing the collateral process, which is even more critical given the impact on liquidity.

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86%

INCREASE IN MARGIN CALLS IN MARCH 2020 VERSUS JUST TWO MONTHS PRIOR IN JANUARY.

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Where is your excess cash?

From a liquidity perspective, Hazeltree noticed a correlated upsurge in cash balance holdings as a result of liquidations and deleveraging and a marked flight to safety across their clients. The flight to safety was reflected in the increase in bank deposits as well as an increase of over 90% (from 2 months prior levels) into treasury and government backed money market mutual funds. Bank deposits are typically regarded as the most liquid of any cash location, albeit with lower yields.

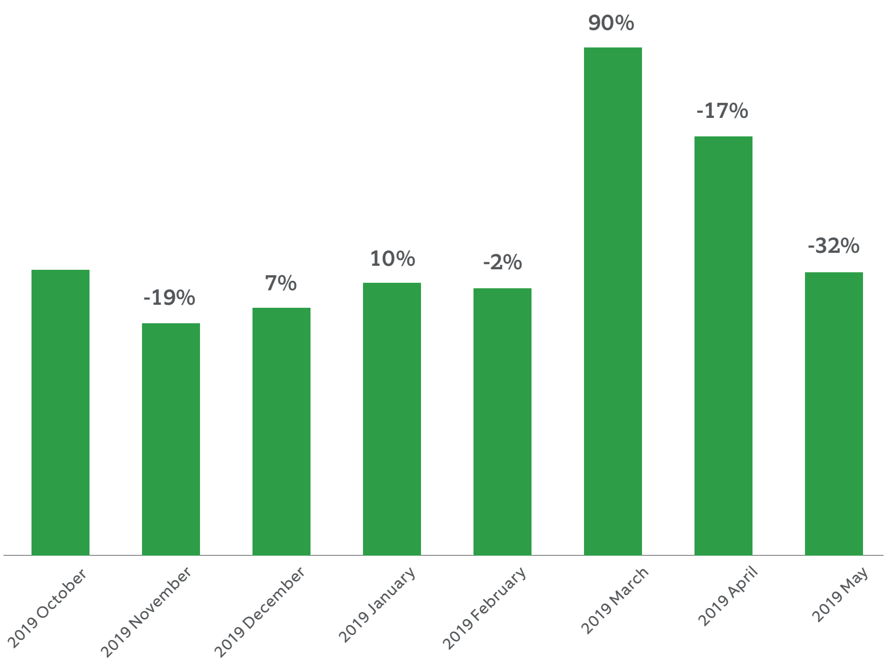
NTAFS noticed a similar trend, with client cash held at banks and custodians increasing significantly over the same period. Interestingly, some of this came at the expense of sweep or money fund positions as these balances decreased including all holdings placed in any “Prime” money market fund.

These trends showed the significance of tightly monitoring liquidity and exposure as well as the importance of managing counterparty relationships and placing cash and cash equivalents where a manager feels they are secure and can be deemed unencumbered. With liquidity being tracked and managed across multiple counterparties and products, it was a distinct advantage (if not a necessity) for managers to leverage the right technology to be able to do this in an automated way.

23%

AVERAGE DISPUTE SAVINGS NTAFS HAS SEEN FOR THEIR CLIENTS ON BILATERAL REPO AND OTC AGREEMENTS OVER THE PAST 6 MONTHS.

SPIKE IN COLLATERAL



Going on the assumption that, during a crisis, cash is indeed king, there are some critical steps to managing and deploying that cash to ensure safety and unfettered access:

Continual monitoring to ensure visibility of cash at all times – there is no substitute for automated aggregation, normalization and centralization of this data across disparate counterparties

Minimizing exposure by setting limits as to how much cash should be maintained at any one counterparty – by counterparty legal entity and counterparty consolidated bases – at any given time and eliminating any zero or negative interest rate bearing accounts

Keeping excess cash at a bank or custodian (as cash, sweep or direct investment into money market funds) versus at a prime broker (as excess cash or even automated sweeps) allows managers to keep control of cash

Understanding the nuances of cash and money market options to ensure a tight level of control, access and ownership rights during a systemic crisis scenario

Using technology to manage cash positions, eliminate reliance on manual spreadsheets and reduce error prone human intervention

Establishing firm-level guidelines to manage cash and having a dedicated Treasury function, staff and resources to enforce them

Also, assuming that protection of assets and efficient use of capital are equally if not more critical during a crisis, there are likely to be areas for operational improvement across collateral and margin management, including:

Tracking and managing daily margin requirements versus prime broker, ISDA and all collateralized counterparties

Actively disputing calls with counterparties through the use of an independent calculation engine. This can free up capital and generate true ROI as NTAFS has seen an average dispute savings of 23% for their clients on bilateral repo and OTC agreements over the past 6 months.

Recalling excess cash and/or non-cash collateral at any locations which can also unlock capital for use

Working from Home — the New Normal?

With the surge in the pandemic globally, participants executed Business Continuity Plans (BCP) and the majority started and continue to work from home. The industry has been productive overall with many considering partial work from home or staff rotations to be part of their new operating model, at least for the foreseeable future.

But, working from home put additional stress on the Treasury function and it was more challenging to manage key tasks, especially without close coordination and collaboration with colleagues. For Treasury operations, working from home brings with it the need for systems and controls to support this new normal. At the top of the list comes the need for information security controls to help prevent cyber-attacks that could occur through vulnerable home equipment. In fact, the industry has noticed a significant increase in email spoofing attempts regarding cash payments as predators seized the opportunity to attack participants working from home. To that end, Treasury teams need to work with information security and IT teams to institute strong policies and preventive and detective controls to thwart such attacks. This should include tight cash controls and wire systems that incorporate:

- Automating of all cash movements processes (versus manual letter of authorizations and email/fax processes)
- Monitoring of cash accounts on an ongoing basis
- Implementing multi-level approver controls for cash movements that considers differing risk profiles between internal and external transfer, transfer size, transfer type, and other factors
- Ensuring systematic authentication for wire activities
- Centralizing all cash monitoring and movements in one system (versus multiple banking portals) to minimize the operational overhead of maintenance/tracking and to unify internal controls
- Ensuring full audit trail tracking of all cash movements

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What managers need to address as they manage Treasury and interact with investors

As experienced in 2008, established Treasury processes and controls are key in times of crisis, and these can also be used in a strategic, differentiated way to preserve dry powder and maintain and control liquidity to be ready to capitalize on investment opportunities. To be sure, the diligent review and monitoring of usable free cash (i.e., excess, unencumbered, dry powder, buying power) and its separation from trading activity by way of cushions or buffers, should be a critical part of the daily process.

In addition, managers can use an enhanced level of control as part of a winning strategy to attract additional capital from investors. With the U.S. outbreak flaring up during the month of March 2020, typical questions from investors and future due diligence reviews will focus on that period and include the following:

Did you have the cash you needed daily? Did any of your counterparties hold back cash? Did you have the right escalation process in place to release your cash?

Did you have the "right" agreements and an open dialog with your trading and financing counterparties? Did your relationship managers know the terms of your agreement and were they able to quickly support your needs?

How did you deal with the increase in margin calls? Did you have systems to independently calculate and dispute bilateral collateral calls to keep control of liquidity?

How did you deal with the increase in wire volume while executing your BCP? What controls do you have in place around payment processing?

Did you have a Treasury function to manage the challenges? Is this function dedicated? Did you have support for your Treasury team (pre-existing)?

Was your Treasury team enabled to make decisions?

Does your Treasury team have the right technology in place or is it using a manual, spreadsheet process?

Are you relying on manual letters of authorizations to approve cash movements or do you have centralized systems for automating/controlling/managing all wires?

Do you have a formalized process for monitoring fund liquidity?

Where do you keep unencumbered cash and how do you track this alongside counterparty exposure?

Conclusion

Overall, the industry has ”weathered the storm” better in the COVID-19 crisis than prior dislocations, but volatility once again brought about similar challenges on investment managers' Treasury functions. The industry also faced new pressures of operating in a work-from-home environment and potential security concerns. This crisis is not yet over and investment managers should take action to ensure that their Treasury teams are effective for this or future challenges with improved automation and capabilities for decision making.

Managing cash, collateral, margin and liquidity is critical during a crisis, but controlling "free cash" and improving cash and collateral practices can help improve bottom line performance at any time. Increased diligence and automation of Treasury operations can create true opportunity and serve as a differentiator amongst investment managers.

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About Northern Trust

Northern Trust Corporation (Nasdaq: NTRS) is a leading provider of wealth management, asset servicing, asset management and banking to corporations, institutions, affluent families and individuals. Founded in Chicago in 1889, Northern Trust has a global presence with offices in 21 U.S. states and Washington, D.C., and across 23 locations in Canada, Europe, the Middle East and the Asia-Pacific region. As of March 31, 2020, Northern Trust had assets under custody/administration of US $10.9 trillion, and assets under management of US $1.1 trillion. For more than 130 years, Northern Trust has earned distinction as an industry leader for exceptional service, financial expertise, integrity and innovation. Visit northerntrust.com or follow us on Twitter @NorthernTrust.

About Hazeltree

Hazeltree is the leading Treasury Management solution provider, serving hedge funds, asset managers, fund administrators and pension funds with powerful, proactive performance enhancement and risk mitigation capabilities that generate alpha from treasury, reduce a range of risks and streamline operations. Hazeltree's integrated treasury management solution includes comprehensive cash management, securities financing, collateral management, counterparty management and margin management capabilities. Hazeltree is headquartered in New York with offices in London and Hong Kong.

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