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The Oxygen of the Financial Markets: Liquidity Planning During COVID-19

by Vic Drapala

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During 2020 COVID-19 crisis, better liquidity planning has been paying off

Ruth Porat, CFO of Alphabet, Inc., once quoted, “Liquidity is oxygen for a financial system.” And when better to have an abundant supply than during the past ten months? The2020 COVID-19 pandemic-induced financial market crisis was just another in a long line of negative market events. Its effect on short-term money markets and bank liquidity management was substantial. Money markets are the segment of the financial markets that everyone takes for granted until it doesn’t work. Kind of like the way you treat the plumbing in your house: no one gives it much thought until there is a backup, and then all heck breaks loose.

These short-term markets are extremely important because banks are leveraged institutions that depend upon the money markets to access deposits to finance their assets or to obtain collateral such as US Treasuries to cover short trading for market making activities or hedged positions. Access to the money markets is critical for a banking institution to meet liquidity requirements and reduce liquidity risk. These risks and requirements get the highest level of scrutiny by bank senior officers.

Managing liquidity at a financial institution during normal times is relatively straightforward and can take on a routineness that hides risks. This is the time when the junior traders hired since the last crisis may not know what it is that they *don’t know*. When there is a crisis or even a hint of a crisis, market participants who supply funds will tend to pull back and withdraw their lending from the money markets following the old adage of “where there’s smoke, there’s fire” – and you don’t want to be the last one out the exit door. It then becomes much more difficult and expensive to borrow funds, causing assets to be sold – possibly at a loss or, at the very worst, in a fire sale situation.

After the last financial crisis, banks were required to enhance existing liquidity tools and create additional internal structures to protect against the next inevitable crisis. One major enhancement was liquidity stress testing that modeled potential cash flows under three scenarios (institution specific, market, and combined), resulting in an enlarged securities portfolio consisting of high-quality liquid assets (HQLA) to act as a liquidity buffer (sized on results from the three liquidity stress tests). Other major enhancements included a detailed Contingency Funding Plan (CFP) that identified key managers and the information flows to senior management, and a detailed Disaster Recovery (DR) plan with site testing on a regular basis.

But there is always a gap between the minimum level of compliance and best practices. Banks who took the new requirements to heart and understood the depth of risks that were revealed during the last crisis made improvements beyond the base level. These best practice improvements included such things as real time or end of day reporting of key liquidity positions and liquidity metrics, daily reporting to management of emerging liquidity risks, ability to project near term liquidity demands from all sources and uses of funds, consolidated liquidity reports that covered the entire institution and projected the potential impact on capital ratios, an enhanced CFP, and more frequent DR site testing that included operating from DR sites for an entire day.

In March 2020, the market anticipated that COVID-19 would be a significant economic event and the subsequent reaction resulted in steep selloffs in many markets and a redirection of cash flows from unsecured money market deposits to more conservative investments such as overnight repurchase agreements (repos), collateralized with US Treasuries. In that initial March blow-out, banks found it difficult to borrow funds to replace maturing commercial paper, deposits, and certificates of deposit (CDs). In addition, some large money funds that are normally suppliers of cash to banks had to sell some of their investments, such as wholesale CDs, in order to raise cash to satisfy redemption requests.

Institutional Prime Funds hit speed bump

One casualty of the COVID-19 2020 crisis was some of the large institutional Prime Money Market funds. The institutional prime funds invest in a range of high-quality money market paper such as bank CDs and commercial paper. In March and April, many investors who had money invested in prime funds asked for redemptions – causing the funds to sell some of the short-term money market assets they held to raise cash. This demand for redemptions presented the funds with the risk that they might have to trigger withdrawal gates to slow redemptions or that the fund price would "break the buck". These types of risks motivated several managers to convert to a government-only fund. Vanguard converted its Prime Money Market Fund with assets of $125 billion to buying government-only assets[1]. Fidelity converted its Investments Money Market Prime Fund as did several other firms. The initial selling of short-term assets by Prime funds, instead of being lenders of cash, reversed a key source of term funding for banks and corporations, which added to the building pressure in the money markets.

Market pressure continues

This pressure on obtaining funding is apparent when you compare the overnight Fed Funds rate to 3-Month LIBOR rates. The Federal Reserve lowered the target Fed Funds interest rate, first by 50 basis points on March 3, 2020 from 1.75% to 1.25% and then by 100 basis points on March 15 from 1.25% to .25%. USD 3-Month LIBOR initially dropped from 1.46% on February 28 to 1.00% on March 4 after the first rate cut and then to a low of .74% on March 12. But from there, the rate climbed back to the 1.45% level on March 31 even as the overnight Fed Funds rate was cut to .25%[2], clearly showing that the money market was experiencing shortages in the supply of

[1] https://www.cnbc.com/2020/08/27/vanguard-shifting-money-market-fund-to-safer-us-backed-investments.html

[2] https://www.marketwatch.com/investing/interestrate/liborusd3m?mod=mw_quote_switch&countrycode=mr

funding. This shortage was relieved only after additional programs by the FRB and US Treasury took hold.

USD 3 Month LIBOR 10/2019 – 9/18/2020[3]

Best practices pay off

In a liquidity crisis like this, the banks that had taken the initiative to develop a liquidity management structure and management information reports aligning with industry best practices and not just at the required regulatory minimum, were in a much better position to manage the liquidity risks facing the institution, whereas banks that built liquidity management practices close to the minimum requirements had a less positive experience.

Most banks recognized the emerging risks and triggered their CFP, which puts into motion previously developed crisis planning that includes institution specific requirements such as enhanced management reporting, cross-sector management committees, and restrictions on credit extension – to name just a few. The banks that had developed a rigorous CFP that outlined senior management responsibilities were able to mobilize their cross-business crisis team quicker to be better able to respond to market events. Banks with less rigorous CFPs started off a step behind.

Banks that had developed timely daily liquidity reporting to first line managers that could be made available to senior managers up to the board level were able to coordinate the management of funding positions better. Further, banking institutions that were able to produce reports in different locations that could easily be made available to staff at remote locations were again in a better position to manage risks as the industry moved first to their disaster recovery site and then to scattered remote locations.

[3] https://www.global-rates.com/en/interest-rates/libor/american-dollar/usd-libor-interest-rate-3-months.aspx

Banks that operated at minimums and aggregated risks across businesses only monthly were at a significant disadvantage as market factors changed quickly. Inability to aggregate more frequently than monthly required institutions to manage market and liquidity risks in business silos without the perspective of the entire institution. This hampered the ability to identify the full impact of emerging liquidity drains that were occurring in various businesses. The consolidation of liquidity flows across businesses to identify unexpected cash outflows is a key liquidity requirement to support management decisions if produced on a timely basis. Additionally, banks that still aggregated cross business risks manually experienced additional production risk, as staff moved to remote locations.

Disaster Recovery sites are required for every bank, but the size, scope, and depth of DR site setup and testing was always a subject of discussion with regulators: regulators pushing for more, some banks pushing for the minimum. Banks that had taken the location and required testing to heart were able to move staff to their DR quickly and seamlessly. This enabled them to move to the next step of sending most remaining staff to remote locations. The moves to DR sites and remote locations were supported by the daily reporting and remote location production discussed above. The banks that had done less DR site testing or were operating from shared DR sites were at a disadvantage and had to keep staff in main offices for longer periods even as COVID-19 infections accelerated.

Another surprise

The biggest surprise of the COVID-19 crisis seems to be the ability of major financial institutions to operate with 80% – 90% of staff dispersed remotely for a significant period of time and still be able to conduct business without serious issues. Now as infection rates drop, many institutions are considering having more staff return to their original locations – but the long-term implications of having large numbers of staff in one or two central locations in high rent areas, such as NYC, is still unsettled.

Conclusion

The main lesson for liquidity management coming out of the 2020 COVID-19 crisis is that the better the preparations the banks made for a liquidity crisis, the better they were able to see their liquidity risks and to provide management with clearer views of the institutions' positions and to respond to changing events. They had the benefit of an asset/liability system that is constantly evolving and enhancing capabilities. Best practices are called best practices for a reason, and an asset/liability management function that incorporates these practices performs better in any situation. After the dust settles, the regulators will no doubt be evaluating each institution's response to the crisis to determine which institution needs to be better prepared.

About the Author: Vic Drapala

As a seasoned capital markets specialist with broad regulatory experience in market and liquidity risk, Vic brings a wealth of first-hand knowledge to those needing to understand trade risks and risk management practices. He has substantial career experience working in financial institutions, managing trading and liquidity risk, as well as communicating market risks to senior managers. Vic has been responsible for capital markets examinations of large and complex institutions as chartered by the State of New York.

As a permanent onsite rep for the Department of Financial Services at a NY State chartered foreign bank, and also as a supervisor of teams of field examiners, Vic has been responsible for: reviewing risk management practices & recommending improvements; conducting capital markets examinations of NY State chartered institutions; evaluating bank practices, risk appetite and risk parameters in relation to regulatory guidance, standards & best practices; and has reviewed a supervised bank's regulatory issue remediation action in order to determine if all points have been satisfactorily addressed.

His experience as a Risk Management Specialist – in all aspects of the capital markets – is evident in his in-depth knowledge of: Asset Backed & Mortgage Backed Securities, Money Markets, Liquidity Risk Management, Risk Management, ALM, Fixed Income and the Financial Markets. He enjoys lively classroom discussions and interaction with students, and working with professionals who engage in a participatory learning environment.

Vic also is a professor at New York University's School of Professional Studies in NYC. Here he has been instructing adult learners since 2008. These students are professionals needing a stronger knowledge base of the financial markets – concentrating on the risks of each product (such as commodities, FX, equities, fixed income, derivatives) and market niche.

Vic holds a BA in International Studies from Elmira College and an MBA in International Finance from Fordham University.

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