Transaction Services Asia Pacific

Liquidity Risk Management: Are Asian Companies Hoarding Too Much Cash?

INSIGHTS | Corporate Clients

The market's perception of liquidity risk is again on an all time high. Concerns over the eurozone debt crisis, possibility of bank defaults in high-risk countries, and difficulty of moving cash between certain jurisdictions have contributed to an increasingly uncertain global outlook.

Against this backdrop, many companies are building up their cash reserves to mitigate liquidity risk in the event of a financial crisis. This article examines the issues surrounding the corporate cash hoarding trend and offers an alternative approach for managing liquidity risk.

The Rise of Corporate Cash Cushions

During the global financial crisis in late 2008, well-capitalized companies suddenly found themselves on the verge of bankruptcy for a simple reason – they were running out of available cash to pay day-to-day bills and unable to obtain new loans or even refinance existing ones.

In the aftermath, liquidity risk management has become de rigueur for financial institutions and large corporations, typically with focus on maintaining a high liquidity ratio to protect their financial well-being. However, there have been great disparity and inconsistencies in the way liquidity risk is managed across companies, regardless of the industry in which they operate. Some have swung from treating liquidity optimization as an initiative to enhance their bottom line, to hoarding unprecedented levels of cash or extending bond maturities.

Large cash cushions may indeed offer a low cost and expedient solution for mitigating risk in a very low interest environment, but in the long run, this approach drags down asset productivity and becomes a cost burden. And it still does not address exposure to extreme market events or consider the company's own cash position in relation to other business risks. For example, companies could experience significant customer defaults, supply chain or labor disruptions, and sudden termination of credit facilities.

Ultimately, cash hoarding works against a well-functioning company as well as the broader economy. At the same time, knee-jerk reactions by the market ranging from neglect to cash hoarding indicate that liquidity risk is simply poorly understood. It's time we pay attention.

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How Much Cash Buffer is Sufficient?

"What is your company's cash buffer for managing a liquidity crisis?" We posed this question to a group of corporate treasurers in Asia at a closed-door client workshop. The responses varied greatly. Due to the current market volatility and low interest rate environment, some companies had cash reserves that were at a record high, for instance, hoarding 10 times their working capital requirements. At the other end of the spectrum, there were companies with negative cash buffer, choosing instead to rely on uncommitted facilities and borrowing day to day. Some firms also felt that they were protected with committed facilities, although they had no recourse should their banks default on the commitment. These anecdotal findings underpin the inherent challenge

treasurers face in predicting the amount of cash buffer their companies need to be safe, or even in defining how safe they want to be.

Banking regulators are taking notice. Since 2010, papers by the Committee of European Banking Supervisors, the Basel Committee on Banking Supervision and the International Institute of Finance have set high hurdles in terms of principles and recommendations. The UK Financial Services Authority (FSA) will soon be publishing proposals for reinvigorating its liquidity risk regulations.

In a global financial market that prides itself in using objective models to measure all sorts of risks such as the Capital Asset Pricing Model for accessing capital adequacy or the Black Sholes Model for Options pricing, it is rather disconcerting that there are currently no frameworks – practical or theoretical – to determine the right amount of cash a company ought to maintain as a security buffer. This applies at all levels of the economy, from central banks assessing the appropriate amount of foreign exchange reserves, to companies of all sizes making daily decisions about keeping a buffer of cash for routine payments. For global enterprises in particular, this is a daunting problem that needs to be solved.

An Alternative Approach for Managing Risk

Not having a cash buffer is inadequate yet holding too much cash becomes a cost burden. In the absence of a cash buffer model, companies need a more holistic risk management approach to mobilize cash in times of need. This involves stress testing using a liquidity access plan and structuring processes and flows that effectively utilizes cash to maximize yield on excess liquidity while minimizing risk.

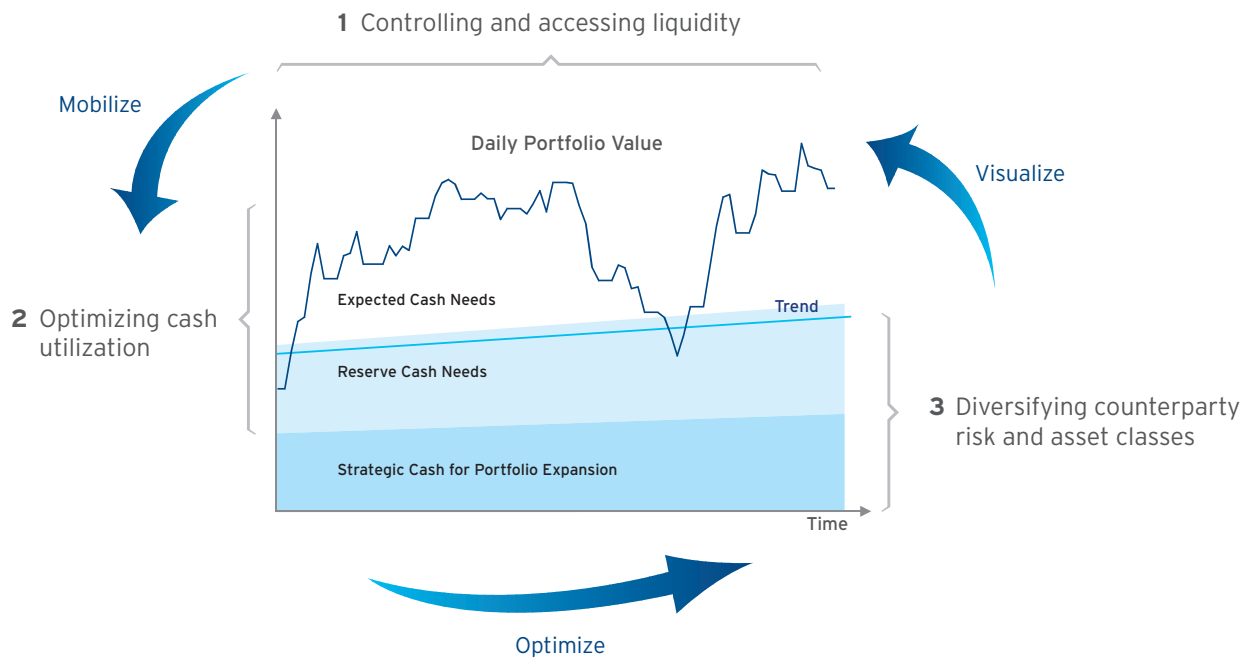
The effectiveness of a holistic risk management strategy hinges on the successful execution of a three-prong approach to (1) control and access liquidity; (2) optimize cash utilization; and (3) diversify counterparty risk and asset classes. Each component should be considered from a company-wide perspective.

1 **Controlling and accessing liquidity:** Companies cannot manage what they don't see; hence they need to have an accurate and real time inventory of all current assets that can be divested quickly to generate cash if required. Typically, these assets will be unencumbered bank deposits or marketable securities due to the need for short notice liquidation and predictability. Tools for managing this underlying information system include collateral management, real time and company-wide cash reporting, as well as cash flow forecasting.

2 **Optimizing cash utilization:** Automated or manual programs that convert and/or concentrate all usable assets such as marketable securities, trade receivables, or bank deposits into a readily accessible buffer of liquidity can be implemented via approaches such as pooling structures and asset securitization.

3 **Diversifying counterparty risk and asset classes:** Companies can establish a set of counterparty risk versus return targets to determine the amount of liquidity buffer required. While the exact size of the buffer will vary by markets, companies and their activities, systems and processes can be developed to protect the buffer and have the ability to engage it on a very short notice.

Holistic Liquidity Risk Management Strategy



Piecing It All Together

Liquidity risk is the ultimate business risk. Corporate treasurers can hedge FX, interest rates and commodity exposures, buy credit default swaps, or apply for committed bank lines, but no amount of capital or insurance can adequately protect a company that is running out of cash, especially during a financial crisis.

Regardless of how simple or complex a company and its balance sheet are, the treasurer's goal remains the same during good times and challenging times alike: Ensuring that the right amount of money is in the right place, at the right time – across counterparties, countries, currencies and legal entities. With continuing volatility and uncertainty in the world's financial markets, a holistic approach to liquidity risk management will be even more critical for any company that wants to remain competitive.

Treasurers can take steps in the right direction by ensuring they have the right tools, information and experience on their side. Rather than hoarding cash as the first line of protection, they should look to enhance their company's information systems, as well as consider centralizing treasury functions and concentrating cash flows on the same banking platform. This will significantly improve their ability to visualize, mobilize and optimize liquidity, and place them in a good position to make informed decisions – on how much cash to hold as a security buffer and at which points the buffer will be needed to mitigate risk and keep their business in operation.

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Citi Transaction Services Asia Pacific – June 2012
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