

A New Frontier

Finadium's Josh Galper explains how liquidity risk management has become of prime importance for asset managers, hedge funds, plan sponsors and their vendors

EXCLUSIVE

Liquidity management has entered the lexicon of important topics for discussion at asset managers and plan sponsors. Prior to 2008, market liquidity was largely taken for granted, except when holding small capitalisation stocks or other unusual situations. This is emphatically no longer the case, as a wave of regulation, technology and client demand can attest.

In Europe and the US, regulators have taken an active role in requiring asset managers to provide consistent reporting on liquidity. The United Kingdom's introduction of liquidity reporting rules for banks has impacted bank subsidiaries who are asset managers; these firms must now produce liquidity risk management data as part of their parent companies' reporting requirements. Solvency II, a European-wide set of capital rules for insurance companies, has played a similar role for asset manager subsidiaries of insurance companies. While asset managers were not directly targeted with these regulations, the fact that so many large managers are affiliated with banks and insurance companies means that they have been implicitly captured by liquidity risk reporting mandates.

The US Securities and Exchange Commission (SEC) announced earlier this year new rules for money market funds. Along with specific liquidity buckets for 2a-7 regulated funds, money managers must now publish a shadow Net Asset Value (NAV) that shows the liquidation value of a portfolio; saying that funds have a US\$1 NAV no longer is enough, even though the buy-in and redemption price remains US\$1. The SEC is now also allowing variable NAV (vNAV) funds, which offer substantial benefits in liquidity management for both money managers and their clients alike. Like any new product introduction however, it will take some time before these vNAV funds become understood and adopted in the marketplace. To date, other types of US asset managers have not been asked by regulators to report liquidity data, but that does not mean that they are ignoring the topic.

For plan sponsors, while no regulation yet exists to push them towards liquidity risk management, their experiences in 2008 has shown them that careful monitoring of liquidity can only be to their benefit. The inability to meet funding obligations in a timely manner combined with concerns about credit markets freezing or money market funds breaking the buck should be enough to make any plan sponsor nervous. Liquidity risk

management is a clear step towards effectively monitoring for potential trouble.

The technology for asset managers and plan sponsors to evaluate liquidity risk is evolving rapidly. While bank Asset Liability Management risk packages are widely available, the unique needs of asset holders are giving rise to new vendors and offshoots of risk management systems specifically for this market.

These technology firms have found that going after asset holders as risk management clients is not the same thing as targeting the banking industry. As market participants have gotten more comfortable with the notion of liquidity risk, a bifurcation has developed between the needs of banks, insurance companies and asset holders. Over the last year, the idea of liquidity funding risk has been more closely associated with the traditional bank and insurance company activity of Asset Liability Management (ALM), or the ability to pay the bills when the bills need paying versus what cash is on hand. On the other hand, liquidity market risk management has developed a life of its own for asset holders who want to be certain that they can exit investment portfolios on demand.

Clients and stakeholders also want to see how their asset managers are handling liquidity risk. While it is easy to show a client a nice report, this does not necessarily translate into using liquidity risk management, or any other kind of risk management, for portfolio decision-making. Linking risk reports to action steps is what makes the difference, and this is what smart investors are asking for. The first step is acquiring the ability to run analyses, whether from a custodian, as part of a risk reporting or performance attribution package, or whatever else is meaningful to the asset manager for decision-making. The second step is using the results to inform that decision-making.

Banks, brokers, technology vendors and investment consultants have a unique opportunity in the liquidity management market. From time to time, a regulatory development or market trend arises that forces a large segment of asset holders to look in a new direction all at once. This will be the case for liquidity risk management over the next year and a half. Firms with the most experience in managing their own or their clients' liquidity risk are very well positioned to provide tools and consulting help to the rest of the market. We expect that this need will ultimately cut

across nearly every type of asset holder, including mutual funds, registered investment advisors, hedge funds, UCITS funds and pension plan sponsors.

While the largest firms will build or buy their own liquidity management tools, a broad segment of the asset holder marketplace does not have the same financial resources. Instead, these firms will seek out assistance from their prime brokers, custodians and investment consultants to generate liquidity risk management reports, creating an opportunity for service providers to capture additional outsourcing revenues.

However effective vendors are in delivering technology, a gap will still remain in translating liquidity risk management reports into actionable portfolio management. The importance of completing this step should not be underestimated; unless liquidity management reports are used in decision-making, they become nothing more than a tool to please regulators and investors. Alongside the provision of technology, banks, technology vendors and other service providers should emphasise the need for asset holders to create processes that make liquidity management data useful for real-time portfolio management. **AST**

About Finadium

Josh Galper is managing principal at Finadium, a research and consulting firm focused on financial markets. In its research practice, the firm assists asset holders, banks and technology firms with understanding the market for asset services and in maximising the effectiveness of their resources. Finadium research is available on a subscription basis. Finadium also conducts consulting assignments on vendor selection and evaluation, market research and product strategy. For more information, please visit our website at www.finadium.com.