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What impact is the financial tsunami on liquidity risk management and corporate funding strategies



Where is Asia now in respect of the credit crisis?

Global credit crunch

- 2009 – From inflation to disinflation
 - Stock market correction: negative wealth effect
 - Oil: \$30 to \$140 and now under \$70
 - Commodity price index
 - Interest rates
- De-leveraging: contracting money supply globally. Demand for funds contract also as cost of borrowing is high and unsecured borrowing inaccessible

No decoupling

- Asian central banks taking steps to protect Asia banking system
 - Australia
 - New Zealand
 - Taiwan
 - Hong Kong
 - Macau
 - Singapore
 - Malaysia
 - South Korea
- Inter-bank liquidity: not out of the wood yet

Currency extremely volatile

- Trading liquidity declines as banks contract their trading activity and counterparty limits
- Hedging cost increases as long tenure is not liquid
- Future USD clouded by how rescue plan is financed
- AUD down as commodity demand slows
- South Korean won weakened as confidence ebbs re: local banks' ability to refinance their dollar liabilities
- Weak currency sentiment as a result of slowing demand for exports from Asia



Asia still has healthy economic fundamentals

- Over US\$4 trillion of foreign exchange reserves
- Domestic unemployment and NPL have yet to deteriorate. Time for counter-cyclical fiscal stimulus by governments
- Proactive actions taken by Australia, Taiwan, Hong Kong, Singapore
- Asian government and private sector less leveraged than during the 1997 financial crisis

For the corporate world

- Scaled back expansion plan
- Slower exports
- SME sector more vulnerable
- Risk of facing rating downgrade
- More favourable cost outlook (real estate, labour, raw material)
- Opportunities for M&A, easier recruitment
- Shortage of external funding and risk of re-financing (MAC)



Liquidity risk management and corporate funding strategy

The Black Swan Problem

- The eighteenth-century Scottish philosopher, David Hume:
“No amount of observations of white swans can allow the inference that all swans are white, but the observation of a single black swan is sufficient to refute that conclusion.”

Back to basic

- Sharpen your pencil in cash forecast
- Liquidity risk is a “consequential risk”
- Liquidity risk measurement
 - Balance sheet liquidity analysis
 - Cash capital position
 - Maturity mismatch approach



Balance sheet liquidity analysis

- Compare the liquidity profile of each class of assets and liabilities to identify mismatch
- Limitation: No detail on maturity profile of assets and liabilities. Assets not shown at market value. Haircuts for future market value volatility and liquidation discounts depend on the credit quality, central bank eligibility and the market depth of the security to be sold. Off-balance sheet commitments may carry significant liquidity risk.



Cash capital position

- Gap between liquidity assets (collateral value of unencumbered assets) and short term liabilities

Maturity mismatch approach

- Category I: cash flow amount and cash flow timing are deterministic (e.g. repayment of a bank loan)
- Category II: cash flow amount stochastic and cash flow timing deterministic (e.g. settlement of a floating leg of an interest rate swap)
- Category III: cash flow amount deterministic and cash flow timing stochastic (e.g. early loan repayment triggered by a rating downgrade or Material Adverse Clause)
- Category IV: cash flow amount and cash flow timing are stochastic (e.g. early termination of facility by banks that have rating triggers or MAC)

Liquidity gap profile analysis

- Liquidity ratios
- Liquidity risk management structure
 - People
 - Procedures
 - Manage forecast cash inflows and outflows in each time bucket, in each scenario, and in each stress level
 - Reduce contingent liquidity risk through extending liability terms, ensuring stability (not just cost) of funding sources and risk related to funding concentration
 - Keep some asset liquidity reserves as insurance cost of liquidity management
 - Be prepared to enhance liquidity quickly at first signs of warning
 - Models: The famous economist John Maynard Keynes:
“Better being vaguely right than being precisely wrong”.

Liquidity contingency plan

- Crisis warning indicators
 - Triggers
 - Decline in stock price relative to peers
 - Overtrading (significant increase in working capital)
 - Risk premium relative to peers
 - Earnings deterioration
 - Rating downgrade
 - Significant change in currency exchange rate, interest rate or commodity price (either hurt revenue or blow out cost)

Liquidity contingency plan

- Unforeseen increases in funding required
 - Unhedged costs (foreign exchange, interest rate, commodity)
 - Capital needed to cover negative operating cash flow of operating entities
- Unforeseen decreases in funding available
 - Early repayment or inability to rollover ST financing due to rating downgrade/MAC or market disruption
 - Default of counterparty
 - Credit crunch (systemic or bank specific)
 - Drop in value of collateral (reduced capacity from secured borrowing)

Potential action plan

- Refine cash flow forecasts and increase intensity of liquidity reporting
- Resolve adverse provisions in contracts with funds providers (e.g. remove rating triggers or MAC clauses that require early repayment, collateral margin or termination of unfunded commitments)
- Increase size of liquidity reserves (e.g. sale and leaseback of building)
- Free up additional collateral to prepare the need to switch from unsecured to secured borrowing. Identify assets that can be sold or pledged. Perform an updated valuation.
- Refinance loan due to expire within 1-3 years to longer term in anticipation of shortage of bank loan in a down cycle
- Analyse in closer detail the ability (e.g. loan to deposit ratio) and willingness (e.g. sector concentration, single borrower limit) of the fund providers and manage the bank relation proactively
- Slow down business growth. Avoid over-extending contractual commitment.

Source of liquidity



1. liquid assets
 2. Borrowing
 3. operating cash flows
- Intraday liquidity management

Accessing the banking market



- The banks who can lend (monitor their rating trend, stock price, credit loss/capital impairment/toxic exposure)
- Reduce concentration risk
 - Asian banks (e.g. Chinese banks, Singapore banks) versus international banks
 - Banks that require wholesale funding versus banks have retail deposit base
 - Banks that are aggressive lenders versus conservative lenders (loan-to-deposit ratio)



Accessing the capital market

- It pays to do your homework (if you pre-funded prior to the 15th Sept. e.g. Hysan MTN, Towngas \$1b bond)
- Alternate source of fund provider (e.g. fixed income fund manager)
- Sell order from financial institutions as corporate bond has higher risk charge (hair-cut) than cash or sovereign
- Lehman incident (credit loss that eats into capital) accelerated financial institutions' de-risking programme (both stock and bond, as well as illiquid asset)

Cash is king

- Strengthening internal discipline of working capital and liquidity management
- Protect your cash
 - The bank you can trust
 - Government-owned or government-insured
 - Strong fundamentals
 - Minimum exposure to sub-prime
 - Credit risk management
 - Collateral counter-party