

# Liquidity Risk Management

If it feels like managing risk is harder than it used to be, you may be right. Complexities are multiplying in every aspect of daily life—from navigating travel and parenting difficulties to simply driving to the store or accessing digital platforms and tools. This unrelenting trend also extends to financial management, where the challenges involved with how to manage liquidity risk are significantly more demanding than they were 50 or even 20 years ago.

Managing liquidity risk—or in other words, managing access to cash—is essential for a company's financial stability, strategic planning, and long-term success. When things are going well, it's easy to take access to cash for granted. But when times get tough, having enough liquidity can be the key to helping businesses stay afloat. Over the years, we've seen how economic shocks can cause organizations with robust earnings and sufficient capital to falter. Every time the economy

hits a bump, it reminds us just how important solid liquidity management is, especially when a crisis in one country, region, or sector can trigger far-reaching effects. Global economic disruptions have turned liquidity risk management from a simple, localized strategy to a complex, global necessity. The good news is organizations can incorporate advanced strategies and tools to enhance their liquidity planning and navigate this interconnected world successfully.



## Liquidity Risk Management Moves from Simple to Complex, from Local to Global

In 2007, the FDIC published an article that discussed the increasing complexities of liquidity planning. Tellingly, the article relates a 1992 anecdote where a financial analysis instructor simplified liquidity assessment by saying liquidity should be rated as either a 1 or a 5, implying a binary state of either having liquidity or not. While this view might contain some truth in extreme cases, many financial experts saw this approach to liquidity analysis as impractical even then.

By 2002, numerous global events further challenged this simplistic view of how to manage liquidity risk. A quick look at a series of economic events from the 1990s through the early 2000s demonstrates the interconnectedness of global economies, showing how shocks in one region or sector can have far-reaching effects, influencing global liquidity, investor confidence, and economic policies.



| Event                                 | Effect                                                                                                                                                                                                                                                            |
|---------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| U.S. Bond Market Crash (1994)         | Triggered a sharp increase in interest rates, leading to losses for investors and increased borrowing costs globally. This event heightened awareness of interest rate risks among global investors and financial institutions.                                   |
| Mexican Financial Crisis (1995)       | Led to capital flight from Mexico, destabilizing its economy and causing a severe recession. The crisis spread to other emerging markets, leading to what was termed the “Tequila Effect,” highlighting vulnerabilities in emerging market economies.             |
| Asian Financial Crisis (1997)         | Resulted in massive devaluations of Asian currencies, stock market declines, and a loss of investor confidence across the region. This crisis underscored the risks of excessive foreign borrowing and the importance of sound financial regulation.              |
| Russian Ruble Collapse (1998)         | Caused a default on Russian debt, leading to significant losses for global investors and contributing to a temporary freeze in international credit markets. This event highlighted the risks associated with investing in politically unstable regions.          |
| Dot-com Bubble Burst (2000)           | Led to a significant downturn in the technology, media, and telecom sectors, resulting in widespread losses for investors and a slowdown in economic growth. The collapse emphasized the risks of speculative investments and overvaluation in financial markets. |
| September 11 Terrorist Attacks (2001) | Disrupted global financial markets and payment systems, leading to a temporary halt in trading and heightened security costs. The attacks prompted a reassessment of geopolitical risks in economic planning and heightened focus on crisis management.           |
| Argentine Financial Crisis (2002)     | Resulted in a default on sovereign debt and a severe economic contraction, leading to widespread poverty and social unrest. The crisis highlighted the dangers of unsustainable fiscal policies and currency pegging.                                             |
| German Financial Crisis (2002)        | Although not as severe as other crises, Germany faced economic challenges that highlighted vulnerabilities in its banking sector, leading to reforms aimed at strengthening financial stability and oversight.                                                    |

The diverse nature and unpredictability of global events—ranging from financial crises to terrorist attacks—make it difficult to anticipate liquidity needs accurately. Each event can have unique impacts on financial systems, complicating risk assessments and requiring financial teams to anticipate not only local factors but also potential international influences and their cascading effects.



## 2007 Turmoil Further Complicates Liquidity Planning

The 2007 U.S. subprime mortgage turmoil further exposed the often underestimated complexities of liquidity risk management. Similar to the events of 1990s to early 2000s, this period of financial instability again demonstrates how liquidity issues in one sector can unpredictably spread to others, creating a domino effect of global financial distress.

As the crisis unfolded, many organizations and banks were [caught off guard](#), having overlooked the possibility of a market-wide stress event. Their struggle to access funding in both unsecured and secured markets revealed a miscalculation of systemic risk. The 2007 turmoil exposed how financial systems can be vulnerable to systemic shocks, particularly

when a broad class of securities, such as mortgage-backed securities with subprime collateral, became illiquid. Simultaneously, wholesale funding sources, like asset-backed commercial paper, lost their attractiveness almost overnight.

At the time, stress tests and contingency funding plans assumed that any liquidity crisis would be short-lived. The subprime turmoil quashed these assumptions, as liquidity rapidly vanished and led to prolonged dry spells. To lessen the blow of these economic shake-ups, financial teams realized they must apply more rigorous and comprehensive liquidity management strategies.



## Traditional Liquidity Planning Assumptions are Like Dust in the Wind

Fast forward to 2020, when the COVID-19 pandemic introduced a new wave of economic challenges and further demonstrated how financial instability and policy responses in one country can have ripple effects on economies worldwide. An already complex liquidity situation was compounded by numerous global economic challenges, including:

### Recession and Economic Contraction

Many economies experienced significant contractions, leading to recessions as businesses closed, unemployment increased, and consumer spending declined.

### Supply Chain Disruptions

Lockdowns and restrictions led to significant supply chain disruptions, affecting the availability of goods and raw materials and eventually leading to inflation as demand increased. Disruptions in international supply chains revealed the dependency of economies on each other for goods and services, causing shortages and delays globally.

### Market Volatility

Financial markets experienced significant volatility due to uncertainty and changing economic conditions.

### Government Debt

To support economies and healthcare costs, governments worldwide increased spending, resulting in higher national debts and fiscal deficits.

### Sectoral Impact

Certain sectors, such as tourism, travel, and hospitality, were particularly hard hit, while others, like technology and e-commerce, experienced growth.



These disruptions required coordinated policy responses, including fiscal stimulus, monetary easing, and support programs for affected businesses and individuals. Additionally, the unpredictability introduced by COVID-19 further complicated liquidity forecasting, as traditional models struggled to account for the rapid changes and unprecedented disruptions in the global economy.

More recently, the effects of the U.S. Federal Reserve's rate cuts further challenged conventional expectations about how to manage liquidity risk. These developments also highlighted how shifts in one area, such as interest rate policy, can have unexpected effects across other sectors like housing and investment markets.

Instead of lowering rates as would typically be expected, the [opposite has happened](#), with the average 30-year fixed mortgage rate rising to 6.62% following a 50 basis point cut in September 2024. This increase is linked to a rising 10-year US Treasury yield, as investors perceive a strong economy and anticipate less monetary easing. A robust jobs report has reinforced this trend, suggesting reduced recession risks. Consequently, further rate cuts this year may be unlikely, limiting potential declines in mortgage rates.

The situation remains complex, as high mortgage rates discourage home sales, but a surge in sales could potentially lower rates. Future mortgage rate changes will depend on the Fed's actions and upcoming economic indicators, which

will provide insights into the economy's health and inflation. If the economy stays strong, expectations for lower mortgage rates may not be realized.

The unexpected outcome of rate cuts not lowering mortgage rates adds uncertainty to financial markets, complicating efforts for businesses and financial institutions to predict cash flows and manage liquidity effectively. This disconnect suggests traditional models may no longer be reliable, requiring reevaluation and possible recalibration to account for new market dynamics. With long-held assumptions upended, flexibility and adaptability is key, prompting institutions to develop more robust models and strategies capable of accommodating unexpected market changes.



## 5 Finance Strategies for Resilient Liquidity Risk Management

By embracing the strategies outlined below, organizations can perfect liquidity planning, minimizing risk and positioning themselves for success. Here are five finance strategies for effective liquidity risk management that can empower organizations to thrive amidst uncertainty:

### 1. Prepare for the Unexpected

- Focus on maintaining adequate liquidity during normal times as well as times of stress.
- Anticipate and plan for worst case scenarios: Economic events affecting liquidity are inherently unpredictable, but over time, unexpected and unprecedented events occur with relative frequency. Planning for the inevitable provides stability and mitigates risks associated with geopolitical conflicts and market volatility.

### 2. Perform Robust Stress Testing and Scenario Analysis

- Enhance stress testing and scenario analysis capabilities to better understand and prepare for varying interest rate environments and their impact on liquidity.
- Explore scenarios where traditional assumptions yield unexpected results.
- Incorporate market-wide scenarios covering longer time horizons in stress tests to account for far-reaching, long-lasting economic events.

### 3. Ensure Real-Time Cash Visibility and Accurate Cash Flow Forecasting

- Improve visibility to enable more precise cash forecasting. Better visibility into cash flows strengthens risk management, enabling organizations to anticipate potential liquidity issues and streamline treasury operations.
- Leverage up-to-date insights into an organization's cash positions across multiple bank accounts and currencies to respond to market changes, predict liquidity needs, and reduce liquidity risk through informed and strategic planning.

### 4. Optimize Working Capital

- Maximize cash reserves strategically to enhance financial health, whether the economy is expanding or contracting.
- Boost liquidity by streamlining accounts receivable, accounts payable, inventory levels, and supply chain management to prepare for economic downturns and seize opportunities during prosperous periods.

### 5. Embrace Digital Transformation

- Harness clean data to provide accurate insights that inform strategic planning and decision-making. With reliable data, organizations can better anticipate liquidity needs and adjust strategies accordingly.
- Automate routine tasks and processes to eliminate manual bottlenecks, increasing efficiency and allowing finance teams to focus on strategic liquidity management activities



### How to Manage Liquidity Risk

Over time, liquidity risk management has evolved from a simplistic, localized focus to a must-have global approach. By adopting liquidity planning strategies, organizations can keep their finances in check and set themselves up for long-term success in a constantly changing world. As we continue to face new economic realities, adapting and innovating liquidity management strategies will remain crucial for financial stability and growth.