

Liquidity for Investment Institutions in a Crisis

Interview with Brenda Lyons,
Gino Timperio and Paul Selian



Introduction

The COVID-related market downturn created a liquidity crisis for institutional investors and their asset managers. During March and April, investment institutions sold listed equities, corporate bonds and emerging market securities, and stocked up on cash and developed world government bonds, generating a lack of demand in normally liquid markets similar to that of the 2008 financial crisis.

Asset owners faced particular liquidity challenges. Defined benefit schemes need predictably priced access to cash to meet their obligations. Many defined contribution scheme members looked to protect their savings by moving their portfolios into cash and safe high-quality assets. Insurers dealing in various types of life, health and employment covers saw spike in claims, as a result of COVID-19 and its broader economic impact.

The asset managers that provide those asset owners' funds and strategies were consequently forced to compete for cash and quality assets.

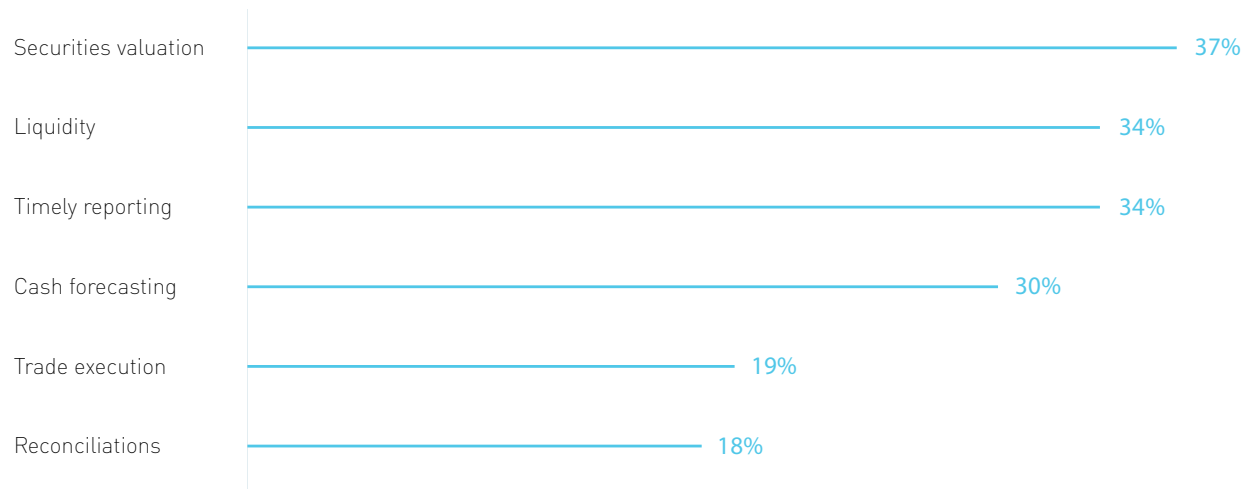
Beyond just access to cash, these institutions needed to accurately assess the value of liabilities and asset prices in the illiquid environment, and understand the cost and extent of their ability to convert assets to cash, both in terms of timescale and pricing.

With markets having recovered for now, the risk of future volatility remains high, commensurate with the risk of new outbreaks of the COVID-19 virus and of a sustained economic recession.

State Street sponsored research taken in April, shows that approximately a third (34 percent) of global institutional investors considered liquidity to be one of their biggest challenges, while accurately valuing securities was among the top three priorities for 37 percent of respondents (see Fig 1. opposite).

Looking into the future, 27 percent believed cash would continue to be one of their top three portfolio allocations for at least the next three to six months. Two thirds (67 percent) did not expect a return to economic growth until at least the end of March 2021, with nearly a quarter (24 percent) predicting not until the end of next year or into 2022.

Fig. 1: During the COVID-19 crisis, have you experienced challenges in any of the following areas? Responses 'Challenging' or 'Extremely challenging')



Source: CoreData COVID-19 Market Pulse Survey, April 2020

State Street Dialogue

Our panel of experts discuss capital market liquidity in a crisis.



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The Height of the Crisis

James: What were the principal liquidity challenges that financial institutions faced during the initial March and April bear market and how did they develop as the crisis unfolded?

Brenda: What we saw with our clients depended on the products they were managing or using and the jurisdiction in which the products are regulated. So, the liquidity challenges they were facing, or how they had to address those liquidity challenges, differed. The primary challenge everyone was facing was meeting redemption or other short-term liquidity needs that they had for their portfolios. However, the balancing that they had to do to meet liquidity requirements, from a regulatory perspective, to get the liquidity that was available in the market for the particular instruments that they were trying to trade, may have been different.

Valuations also absolutely came into play. We saw things happening like negative yields on certain money funds or even negative interest rates on certain portfolio holdings. So those types of scenarios would also alter behaviours, or perhaps outcomes that the investment managers needed to achieve. Then the last thing that we saw happening was regulators jumping in early with liquidity programmes that certainly helped the industry as well.

Gino: What we were seeing a lot from clients was the stress in the market was happening so fast and furious that clients were looking to raise liquidity any way they could. So, in the fixed income market, pretty much every asset class is under stress. We saw the central banks, the US Fed in particular, come in with an abundance of programmes to address that area, such as the Money Market Mutual Fund Liquidity Facility (MMLF).

The equity market sold off because, for one the economic conditions changed so quickly, but also because, while people may not have liked the price of the equities, it was the most liquid asset class that clients had to sell. So, when you looked at the dramatic fall in the equity market, it was a compounding effect of all those factors. And we were looking to help clients with liquidity considerations because they had a lot of margin calls to make on an abundance of transactions.

On the other side of the equation, clients were looking to do a risk off transaction, as they were flush with cash and looking to put cash somewhere in the prime money market space. So clients were asking, "Where do I place cash?" And our two-fold goal with clients was, "How do you raise cash most effectively? And, once you have cash, where do you place the cash, given the pronounced impact that prime money market funds were facing?"

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BRENDA LYONS

James: Are there any specific liquidity challenges for types of financial or investment institution?

Paul: We have a very broad set of institutional clients. We work with mutual funds, asset managers, private equity firms, real estate firms, insurance companies, even large industrial corporations and municipalities. As such, we have unique lending and liquidity products for each type of client. When the market is hit hard, as it was at the beginning of the crisis, we often see an overreaction. What investors typically do is, as was mentioned before, look at their own portfolio and they go to the top of their liquidity stack and start selling, based on what's most liquid in their portfolio. For us, that's often mutual funds because they're mostly publicly traded. A lot of them have equities or fixed income behind them.

We see mutual funds getting hit first and getting hit very hard and we happen to be one of the top five mutual fund lenders in the world, so we saw a lot of activity in that area. Fortunately, most of our clients were in very good shape because they had prepared and they had set themselves up with liquidity lines prior to the crisis. Other types of firms lower down in the liquidity stack, let's say a private equity firm, had a lot less going on at the beginning of the crisis.

Now, how the different types of clients were impacted was also a function of the shape of this crisis. In other words, we had a very steep decline as the markets reacted very hard. The Fed came in and things stabilised. So we have a little bit of a V-shape in the capital markets. If we had a prolonged period or more of a U-shaped capital markets experience, then some of the other asset classes farther down in the liquidity stack would have been impacted as well.

James: Brenda, I'd just like to pick up on something you mentioned when you were speaking earlier about the responses being different and the regulations being different in different jurisdictions. Did that make a slightly different set of challenges for institutions within those different regions and jurisdictions?

Brenda: I think that wherever you are, as is typical in these types of environments, we saw clients all over the world immediately going for a flight to safety. What we saw regulators doing in all the regions, was collaboration with the industry. So, industry participants like us, as well as clients, could really understand what were the challenges that were being faced and how they could be addressed. And that collaboration proved to be very beneficial.

A few things that we saw them do very early on that were very beneficial were we saw a loosening of some of policies. For example, we saw some changes coming out from the Federal Communications Commission (FCC) that gave more flexibility to our clients that are regulated by the FCC, which was terrific. We also saw several Fed programmes that were released very early,

providing liquidity to the market. Those Fed programmes were structured in such a way that they could hit a number of different market participants to provide liquidity. There were lessons that they learnt from back in 2007 and 2008 that they quickly put into action, which were beneficial to the industry.

Paul: I would just say that as a participant in the capital markets, we're obviously very grateful to the Fed. They clearly learned a lot during the last crisis and their response was both swift and massive. As you mentioned, Brenda, the Securities and Exchange Commission (SEC) granting exemptive relief, allowing affiliate loans has made a big difference to many of our clients. But also, on the point about differing issues in different regions, I actually think it was the coordination of regulators around the world that was commendable. We work with regulators all over the globe and the policy response and the coordination, as you mentioned, has really been textbook perfect this time.

Varying Liquidity Needs

James: To what extent is meeting the challenges that we've been discussing here been a question of simply providing cash for these institutions? And to what extent is it an operational challenge based on investors and managers getting access to accurate information around things like pricing usually liquid securities in an illiquid environment, valuing hedges and derivatives, that kind of thing?

Gino: It was probably a convergence of all those factors. The stress in the fixed income market was

more pronounced and even more pronounced than it was in 2008. So, what it really showcased was optimisation. This convergence of collateral management and the ability to create liquidity in a stress environment, became really pronounced.

What I mean by that is, if you have an abundance of margin calls that are hitting a client all at once and they're in a very stressed environment, it challenges your ability to allocate securities to meet those requirements, while still maintaining high quality liquid assets like the US treasury or other high quality sovereign bonds, and also allocate to raise cash. For example, if you preserve US treasuries in that capital allocation approach and then use those treasuries to raise cash, you're really meeting the needs of an optimisation portfolio.

Now the ability to see your securities in real-time settlement mode, being able to price those securities and be able to allocate those securities, are what you're looking for your custody bank to provide to you in a very seamless way. So, as we work holistically across the globe, those fundamental principles come to the top of our equation in terms of helping clients to creatively solve problems. Time is of the essence in that portfolio. They're thinking about what could we, as a provider, do better in that stress environment. We're looking to take the lessons learnt and apply because this is not going to be the last time that we see a stress environment and being able to apply that methodology to clients is something that we're looking to partner with them on further.

Brenda: One thing I would add is that one of the other challenges that the industry saw was just the sheer volume of transactions that we're going through. So the volume of transactions that had to be processed and consumed by custodian banks and other service providers increased significantly. The valuation impact was significant as well. So we saw late day valuations coming in and couple that with the volumes for a few weeks there, it was pretty tricky in terms of processing all those operationally.

Paul: I would agree. We saw activity volumes spiked to two to four times the normal during the first several weeks of the crisis. The key was being able to apply both human and technological resources to the situation to meet our clients' expectations.

Precautions for the Future

James: Paul, picking up on something you said earlier about the V-shaped nature of the capital market recovery from the crisis, it does appear that valuations and volatility have improved significantly since March-April. But there are obviously various things that could quite plausibly happen that could create a second sell-off. What do you think institutions need to do to position themselves for these risks while also obviously benefiting from the recovery as it continues?

Paul: You're right. Obviously, the risk of the markets dipping again is tied to at least two major factors. One, obviously, the risk that the virus curves bend back upwards as US states and

countries reopen this summer and also the risk that global, national and local economies take a protracted period of time to recover from the damage that was inflicted on the economy during the recent crisis.

In the US, we currently have an unemployment rate north of 15 percent, depending on how you measure it. It could be higher. We have millions of people out of work. We have never had a crisis in modern times when nearly every person in the country went home all at once, so this was something that almost no one had in their models. So how quickly can people get back to work? How soon can we get the unemployment rate back down? These are going to be important issues as we move ahead.

We continue to see this, where markets have historically systematically underpriced both political risks, think of Brexit and black swan events like the subprime crisis. So having backup liquidity lines are like having a form of insurance. Some people don't like to buy insurance. They don't like to pay the premiums. Their plan is simply to hope for the best. Our clients are some of the most sophisticated in the world. In large part, they are very prepared but it may be time at this point to check your coverage, much like you would on your own insurance and think, is this enough? Do I understand how my lines work? Do I know exactly what those documents say and how quickly I can get access to liquidity?

Whether you're banking with us, or another bank, you really want to make sure you understand what

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your access is to liquidity and to think about how large your redemptions can be. We’ve had this series of rolling crises every five or ten years in the capital markets. At some point, participants, especially large, sophisticated ones; have to say, golly, there just could be another crisis down the road so it is best to be prepared.

James: Thank you Paul. Brenda, Gino, do you have anything to add to that?

Gino: I will just follow up on something Paul said too. It showcases that your modeling needs to assess more black swan events, probably, than you expected before, and to be prepared. Maybe to add to something Paul said: just to have a primary liquidity provider and a backstop because you can never fully anticipate what the next stress event is going to be. Just simply, who do I contact? What is their contact information? What is the sequence of my inventory? How do I pull the reports together? It is about being able to do all that proactively and hit the ground running when a stress event

occurs, because the first 12 to 24 hours are critical in terms of positioning.

Brenda: I fully concur. Now is the time to write your playbook. Think about what your options are and play out different scenarios and have that playbook ready. There may be a curve ball that is thrown at you but at least you can plan for an orderly adjustment if the adjustment is needed. If you look at what happened with the regulators, as we referenced earlier, they went to their playbook and they pulled out a lot of the plays from the 2008 period and it worked well for the industry. So now is the time to prepare and learn from what we just went through.

For more information, go to our [Liquidity Solutions Page](#)
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