LIQUIDITY RISK

THE KILLER RISK NOW TAKES AIM AT THE CORPORATE SECTOR

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After spending many years in the shadows, liquidity risk has suddenly become a hot topic in risk management, having proven itself as a killer risk during the financial crisis. Banks were clearly at the center of the recent liquidity crisis, with many of the world's largest banks failing to survive due to their inability to refinance themselves. One of the unintended consequences of the new banking regulations will be that future liquidity crunches will spread beyond banks and will likely cause major damage in the corporate sector. Corporations need to start thinking seriously about their own liquidity risk position and how they can best navigate their way through a future liquidity crunch.

The most obvious link between banks and corporations is the fact that corporations are, to a large extent, dependent on banks for their financing needs. When a liquidity freeze hits the financial sector it doesn't take long for the chill to be felt in the corporate sector.

The contagion effect is likely to get a lot worse in the future because the new Basel 3 rules that are about to be imposed on banks will push the problems of liquidity risk management into the corporate sector. These new rules will make it very difficult for banks to perform their traditional role of maturity transformation, meaning that corporations will struggle to obtain long-term financing from banks. Lack of access to such funding will constrain a corporation's ability to plan ahead and leave it at the whim of the banks, which might choose to cut short-term credit lines at the first sign of trouble.

Worse still, the new clearing rules that aim to migrate derivatives trades toward centrally cleared platforms will force corporations to post daily margins against their derivatives positions, which will cause massive day-to-day fluctuations in a corporation's liquidity resources. Taken together, these two effects point toward a world where a corporation has much less control over its own liquidity resources, with the demand for liquidity looking likely to increase at a time when the supply of liquidity is being cut off.

Banks that survived the recent financial crisis have been forced by regulators to upgrade their risk management practices so that they are better prepared for future liquidity crises. One tactic has been to push much of the risk out of banking and into the corporate sector. As a result, the next liquidity crunch is most likely to rear its ugly head in the corporate sector. Corporations will need to make similar risk management upgrades if they want to avoid being the next victim of this killer risk.

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