Lesson 2:

The Strategic Framework of Liquidity Management

Learning Objectives

At the end of this lesson you should:

- be able to distinguish between strategic, operational and short-term tactical planning.
- understand how liquidity planning is connected to all levels of the planning process.
- understand the distinction between the source of liquidity requirements and active liquidity management.

Pre-Test  (Solutions are at the end of the lesson)

P1  Asset-liability management and product development are part of the

   A) operational plan  
   B) short-term plan  
   C) strategic plan

Refer to the following list of activities for questions P2 and P3

a) The MFI introduces a new, very attractively priced loan product.
   b) Compulsory savings requirements are abolished following a market study on the needs of microfinance clients.
   c) The MFI receives cash from a capital increase.
   d) Excess cash is invested in money market deposits.
   e) A credit-line for short-term, inter-bank borrowing is negotiated with a commercial bank.

P2  Which of the items above represent factors that determine the liquidity requirements?

   A)  a) and b)  
   B)  a), b) and c)  
   C)  a) and d)

P3  Which of the items above represent active liquidity management transactions?

   A)  d) and e)  
   B)  b), c) and d)  
   C)  c), d) and e)
2.1 Overview

The challenge of liquidity management is that it represents the final cap-stone in a pyramid of inter-connected aspects of bank management. Liquidity is the ultimate distillation of all activities in a financial institution. Everything that a MFI does eventually leads to a cash inflow or outflow and impacts its liquidity position.

MFIs have to be concerned about the liquidity implications of the core bank business of repackaging customer deposits into loans and investments. Moreover, banks must consider cash-flow consequences resulting from

- regulatory issues such as capital adequacy, minimum reserve requirements etc.,
- administrative expenses and taxes,
- off-balance sheet commitments.

Examples of typical off-balance sheet commitments that an MFI might encounter include

- confirmed but unutilized lines of credit to borrowers,
- future payments under a foreign exchange forward contract,
- solidarity guarantees granted other MFIs.

It can be useful to measure liquidity or define operating rules by calculating certain balance sheet ratios based on historic data such as those introduced in lesson 3. For the most part, however, liquidity management must be forward looking. One cannot be sure that a MFI will be able to cover all cash outflows on a specific day in the future simply by observing a 10% ratio of liquid assets to total deposits, for example. Assurance of future liquidity can only be achieved by deriving a detailed estimate of the size and timing of future cash inflows and outflows. In lesson 4 and in the software companion for this toolkit, we will demonstrate how to compile such a dynamic liquidity plan.

The question then becomes how to derive reasonable estimates of future cash flows. The liquidity manager cannot simply assume that the next year will see a continuation of the trends from the previous year. In order to make reliable estimates, liquidity management must be connected to the MFI’s strategic planning process. Likewise, the liquidity manager must take into account the short-term action plans developed by the operating divisions and assess their impact on liquidity. An example of a strategic shift in the planning basis could be management’s decision to introduce a long-term capital goods lending program serving urban micro-entrepreneurs. A raffle, for example, planned for the next month in order to attract small savers, would be an important short-term factor that the liquidity manager needs to be aware of.

2.2 Liquidity Management and the Strategic Planning Process

**Strategic Planning**

Strategic planning is not a luxury reserved only for large organizations. Even the smallest MFI regularly needs to take a step back and look at the nature and mission of its business, the needs of its customers and the changing conditions of its operating environment. Strategic planning is essentially about answering the following three questions:

1. Where is the organization today?
2. Where is the organization going?
3. How is the organization going to get there?
**Situation Audit**

The answer to the first question requires a thorough analysis of the status quo, the so-called situation audit. Before an organization can make plans about future goals, it has to understand what its current strengths and weaknesses are. Strategic planning also calls for a close look at the external environment, the business opportunities as well as the challenges that the organization faces from competitors and regulatory authorities.

**Target Scenario**

The second question should be answered by formulating a target scenario, which the organization should be expected to reach in about three to five years. A common mistake in strategic planning is to formulate the target uniquely from an internal perspective, i.e. in terms of the organization's own aspirations. Instead of saying: "We want to open 10 more branches or become one of the three largest MFIs in the region", the target should be defined by identifying customer needs and envisioning how the MFI will position itself in the market for these services.

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**The Planning Pyramid**

- **Strategic Plan**
  - Where are we today?
  - Where are we going?
  - How are we going to get there?

- **Operational Plan**
  - Specify action plans and budgets.
  - Assign responsibility for outcomes.
  - Cover all organizational aspects including:
    - human resources
    - branch network
    - information technology
    - product development
    - asset-liability management

- **Short-Term Plan**
  - Cover tactical issues such as a savings promotion, a special bonus payment to loan officers, or start-up costs for new branch.
Alternative Strategic Paths

Finally, question 3 calls for the development of alternative approaches and strategies for reaching the long-term objective. Broadly-specified action plans must be evaluated in the light of different organizational and environmental scenarios in order to arrive at a course of action that is most likely to reach the goals without excessive risks.

Liquidity Management and the Strategic Plan

How does liquidity management fit into the strategic planning process? Obviously, liquidity is not a strategic objective in itself, such as profitability or alleviating poverty. Rather, liquidity is an important operating condition, a feasibility constraint, which must be taken into account when charting a future course of action. At this "big picture" level of planning, it makes sense to represent the liquidity condition by a margin of safety rule or a target value for a particular liquidity ratio. Such basic liquidity indicators or proxies will be introduced in lesson 3.

Liquidity Management and the Operational Plan

Once the organization has committed itself to a strategic direction, the next step is to break down the proposed initiatives into detailed action plans that specify the necessary budgets and assign the responsibility for each component. This operational plan covers all aspects of the organization: human resources, the distribution channels and the branch network, information technology, product development and, most importantly, the development of the MFI’s financial assets and liabilities.

In order to maintain liquidity, all of these operational plans have to be evaluated in terms of their cash-flow implications. These future cash-flow patterns will define the additional funding requirements of the MFI. Liquidity is an important consideration in deciding from which source (equity, customer deposits, bonds, commercial lenders etc.) and under what terms this funding should be procured.

Asset-Liability Management

Among all operational planning activities, managing the development of financial assets and liabilities is the most critical process in terms of liquidity. It is here that the parameters of the bank’s financial intermediation function are defined. The managers analyze the existing mix of assets and liabilities as well as their interest rate agreements. They then postulate desired changes with a view to future interest rate movements, liquidity constraints, foreign exchange exposure and capital adequacy.

A possible outcome of such a plan might be to reduce the mismatch between short-term variable rate liabilities and long term fixed rate loans. This could be done by refinancing some of the long-term loans with long-term borrowings at a fixed rate. Such a step reduces interest and liquidity risk while also reducing the potential profitability of the loans.

Alternatively, the MFI may expect interest rates to fall in the near future. In such a situation, the asset-liability committee (ALCO) might decide to make more long-term loans and shorten the term of its liabilities so that it can take advantage of the cheaper funding in the future while locking in the higher interest rates on the asset side. In the latter example, management has increased the interest rate risk in the hope of improving the profitability of the bank.
Asset-Liability Management and Liquidity

Liquidity is affected by asset-liability decisions in several ways:

- For one, the changes in the term structure of the assets and liabilities change the cash-flow schedule from interest and principal payments over the next year.
- Second, the degree of uncertainty about the cash flows (particularly the interest payments that are determined by future interest rates) also changes.
- And lastly, the different degrees of risk preference reflected in the asset-liability strategy not only determine the liquidity requirements but also impact the opportunities to cover them.

2.3 Summary

Again, we saw that liquidity tends to disappear when you need it most. The riskier the asset-liability strategy, the more likely it is that you will at some time be compelled to cover an unexpected liquidity shortfall by borrowing from a commercial bank or even a peer MFI at short notice. An aggressive asset-liability strategy, however, will also render it more likely that the commercial bank or the partner MFI will refuse the liquidity loan.

The purpose of this lesson was to give you an initial sense of the many dimensions of liquidity management. There is indeed a liquidity aspect in every operating decision that a MFI might face. Since liquidity management is connected to everything, one may be tempted to call almost everything the MFI does liquidity management. That would not be very practical, however. We suggest distinguishing between

1. the source of liquidity requirements, i.e. all operating activities that have a cash-flow consequence, and
2. the actual liquidity management in a narrow sense, i.e. the independent short-term activity designed to procure liquidity or invest cash surpluses.

You will see this distinction applied in the structure of the following lessons, where we will first try to measure liquidity and determine cash requirements as they arise from the primary operating activities (Lessons 3-6). Lesson 7 then explores instruments for procuring liquidity and investing excess cash, that is 'ironing out the bumps' in the cash profile over time.
Comprehension Check

(Please refer to the text to find the answers)

i. Is liquidity a strategic objective?

ii. What is asset-liability management?

iii. How is liquidity management connected to asset-liability management?

iv. What are the basic action variables of liquidity management?

v. Give two examples of factors influencing the size of the liquidity requirements.
Multiple Choice Test

(Solutions are at the end of the lesson)

M1 Liquidity is

A) a strategic objective
B) an essential operating condition
C) a short-term tactical issue

M2 What might be the liquidity consequences of opening a new branch?

a) an increase in new loans
b) a loss of deposit business at other nearby branches.
c) an increase in operating expenses.
d) a reduction of erratic variations in the total loan balance.

Choose:
A) all of the above
B) a), b) and c)
C) a), c) and d)

Refer to the following list of activities for questions M3 and M4

a) The MFI raises cash by increasing the equity stake of a development organization.
b) Compulsory savings requirements are increased after a strategy planning session of the MFI's board.
c) Excess vault cash is deposited with a commercial bank.
d) The MFI introduces a new attractively priced deposit product.
e) The terms of a money market deposit are negotiated with a commercial bank.
f) The MFI sells 10-year bonds to institutional investors.

M3 Which of the items above represent factors that determine the liquidity requirements?

A) a), b) and f)
B) a), b), c) and f)
C) a), b), d) and f)

M4 Which of the items above represent active liquidity management transactions?

A) c) and e)
B) b), c), d) and f)
C) c), d) and e)
M5 What is part of active liquidity management?

a) buying and selling shares in other companies
b) selling liquid, short-term investments for cash
c) planning the amount of vault cash for each bank branch
d) taking in money market deposits from other banks
e) selling long-term bonds in the capital market

Choose:
A) all of the above □
B) b) and c) □
C) b), c) and d) □
D) b), d) and e) □
Solutions to Pre-Test

P1  A)  P3  A)
P2  B)

Solutions to Multiple Choice Test

0  B)  M4  A)
M2  A)  0  C)
M3  C)