NATIXIS
GLOBAL ASSET MANAGEMENT

Market Insights

Finding water in the desert

New regulations raise the bar for liquidity management

Olivier de Larouzière
Head of Interest Rates, Senior Portfolio Manager
Natixis Asset Management

The thorny challenges of liquidity are about to become a little thornier. If you work in the treasury department of a major bank, the acronyms LCR and NSFR are by now well known to you.

For everyone else, here's a very brief crash course. As a direct consequence of the liquidity disasters of the financial crisis, capital requirements for banks have been overhauled. The latest Basel Committee measure (Basel III) contains two entirely new liquidity requirements – the Net Stable Funding Ratio (NSFR) and the Liquidity Coverage Ratio (LCR).

These are landmark requirements that will apply to all banks. LCR demands that banks can meet their liquidity needs over 30 days, and NSFR seeks to ensure that needs are met over a year.

> As a direct consequence of the liquidity disasters of the financial crisis, capital requirements for banks have been overhauled.

They will be implemented slowly over a period of three to four years, but the impact is being felt right now, and is severely testing the ability of treasurers to find sufficient and stable liquidity.

The elusive nature of liquidity

The trouble, as treasurers are well aware, is that European policy is pulling the market in two directions. On the one hand, it wants large European institutions to create a liquidity buffer by holding significant quantities of "safe" assets. At the same time, monetary policy – primarily QE - is driving down bond yields, making it all but impossible to secure positive returns on "safe" bonds.

Many core sovereign debt issues now have negative yields and covered bonds have become expensive too. Even peripheral debt and investment grade credit are becoming prohibitively expensive and prices are only likely to get richer as Basel III is rolled out.

In short, treasurers are struggling to find sovereign debt, covered bonds, or investment grade credit at the ideal maturity of one to three years.

The need for diversification

Banks are now searching for a solution to this challenge. A number of larger banks manage their liquidity buffers inhouse through their own traders. They typically adopt an active trading style with high turnover of mainly sovereign debt, while avoiding all credit risk.

However, with negative returns on core sovereign debt and with the difficulty of sourcing suitable assets, many banks are now starting to seek more diversified strategies. They often choose to do this via third-parties to diversify operational risk given how stretched their asset-liability management (ALM) departments already are.

Third-party managers can move investments up the yield curve extending duration and invest in a wider range of assets. If rates rise, investors naturally invest in shorter maturities, making those assets expensive. Natixis Asset Management's diversifying approach is to invest in maturities up to 10 years. To offset interest rate risk, the strategy may be executed using swaps. The swaps market is deep and liquid with the advantage of reducing the volatility of the bank net income.

Other assets suitable for the strategy include Residential Mortgage-Backed Securities (RMBS), investment grade credit, and even equities.

One of the big advantages of a fully diversified approach is a reduction of turnover compared with the trading approach, so the overall costs of the strategy should be lower.

Stockpicking is important but, for very liquid assets, a topdown view is at least as important as stockpicking.

Diversification requires skill and resource

In order to generate investment ideas, Natixis Asset Management's Interest Rate team draws on expertise from a variety of specialist groups. There is plenty of leeway on duration and few limits on country and credit risks.

The G4 Interest Rate, Credit, Covered Bonds and Inflation Committees, for instance, produce views on market trends while the Euro Sovereign Debt & Agencies Selection Team publishes an opinion on each country, by maturity bucket, in order to select the best securities. The investment management team then ranks and selects the best strategies for the portfolios. Finally, portfolio managers then have a pre-defined leeway for implementing their strategy.

Stockpicking is important but, for very liquid assets, a topdown view is at least as important as stockpicking. At both ends of the spectrum, large and experienced teams of analysts and portfolio managers are required to unearth the best strategies and implement them efficiently.

It's not just about strategy

While investment expertise is critical, banks also view the risk management of their liquidity buffers through the prism of operational excellence. For many banks, the first questions to a third-party liquidity manager centre on systems, transparency, reporting and operations.

Not only do they want to know that their assets are safe, but they require metrics quantifying the extent to which the instruments used impact their capital, how this may impact the P&L, and how quickly the assets can be sold. They may ask whether the performance of the strategy can be reset every year. They may also impose a large number of constraints on the types of assets employed and how they are traded.

So liquidity managers must be able to customise not only their portfolios, but the reporting of them. After all, in an ever-changing regulatory and market environment, the reliability of the investment process is the minimum requirement.

ADDITIONAL NOTES

Past performance is no guarantee of future results.

The analyses and opinions referenced herein represent the subjective views of the author as referenced, are as of 31 March, 2015, and are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material.

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request.

In the E.U. (outside of the UK): This material is provided by NGAM S.A. or one of its branch offices listed below. NGAM S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of NGAM S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. France: NGAM Distribution (n.509 471 173 RCS Paris). Registered office: 21 quai d'Austerlitz, 75013 Paris. Italy: NGAM S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: NGAM S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: NGAM, Nederlands filiaal (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. Sweden: NGAM, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: NGAM, Sucursal en España. Registered office: Torre Colon II - Plaza Colon, 2 - 28046 Madrid, Spain.

In Switzerland: This material is provided to Qualified Investors by NGAM, Switzerland Sàrl. Registered office: Rue du Vieux Collège 10, 1204 Geneva, Switzerland.

In the U.K.: This material is provided by NGAM UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not to be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). To the extent that this material is issued by NGAM UK Limited, the fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: NGAM UK Limited, Cannon Bridge House, 25 Dowgate Hill, London, EC4R 2YA.

In the DIFC: This material is provided in and from the DIFC financial district by NGAM Middle East, a branch of NGAM UK Limited, which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Hong Kong: This document is issued by NGAM Hong Kong Limited and is provided solely for general information only and does not constitute a solicitation to buy or an offer to sell any financial products or services. Certain information included in this material is based on information obtained from other sources considered reliable. However, NGAM Hong Kong Limited does not guarantee the accuracy of such information. Past performance information presented is not indicative of future performance. If investment returns are not denominated in HKD/USD, US/HKD dollar-based investors are exposed to exchange rate fluctuations.

In Singapore: This material is provided by NGAM Singapore (name registration no. 5310272FD), a division of Natixis Asset Management Asia Limited, formerly known as Absolute Asia Asset Management Limited, to Institutional Investors and Accredited Investors for information only. Natixis Asset Management Asia Limited is authorized by the Monetary Authority of Singapore (Company registration No. 199801044D) and holds a Capital Markets Services License to provide investment management services in Singapore. Registered address: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315.

In Taiwan: This material is provided by NGAM Securities Investment Consulting Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C and a business development unit of Natixis Global Asset Management. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777.

In Japan: Provided by Natixis Asset Management Japan Co., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 2-2-3 Uchisaiwaicho, Chiyoda-ku, Tokyo.

In Australia: This document is issued by NGAM Australia Limited ("NGAM AUST") (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only and does not constitute any offer or solicitation to buy or sell securities and no investment advice or recommendation. Investment involves risks. This document may not be reproduced, distributed or published, in whole or in part, without the prior approval of NGAM AUST. Information herein is based on sources NGAM AUST believe to be accurate and reliable as at the date it was made. NGAM AUST reserve the right to revise any information herein at any time without notice.

In Mexico: This material is provided by NGAM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment advisor and is not regulated by the Comisión Nacional Bancaria y de Valores or any other Mexican authority. This material should not be considered investment advice of any type and does not represent the performance of any regulated financial activities. Any products, services or investments referred to herein are rendered or offered in a jurisdiction other than Mexico. In order to request the products or services mentioned in these materials it will be necessary to contact Natixis Global Asset Management outside Mexican territory.

In Latin America (outside Mexico and Uruguay): This material is provided by NGAM S.A., a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of NGAM S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg.

In Urugay : This material is provided by NGAM Uruguay S.A. NGAM Uruguay S.A. is a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay ("CBU"). Please find the registration communication issued by the CBU at www.bcu.gub.uy. Registered office: WTC – Luis Alberto de Herrera 1248, Torre 3, Piso 4, Oficina 474, Montevideo, Uruguay, CP 11300. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627 dated December 2, 2009. The units must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The units are not and will not be registered with the Financial Services Superintendent of the Central Bank of Uruguay. The units correspond to investment funds that are not investment funds regulated by Uruguayan law 16.774 dated September 27, 1996, as amended.

The above referenced entities are a business development unit of Natixis Global Asset Management, the holding company of a diverse line-up of specialized investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Global Asset Management conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of services. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material.

Although Natixis Global Asset Management believes the information provided in this material to be reliable, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.