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MAKING GOOD DECISIONS IN BAD TIMES

Critical capabilities for effective liquidity management

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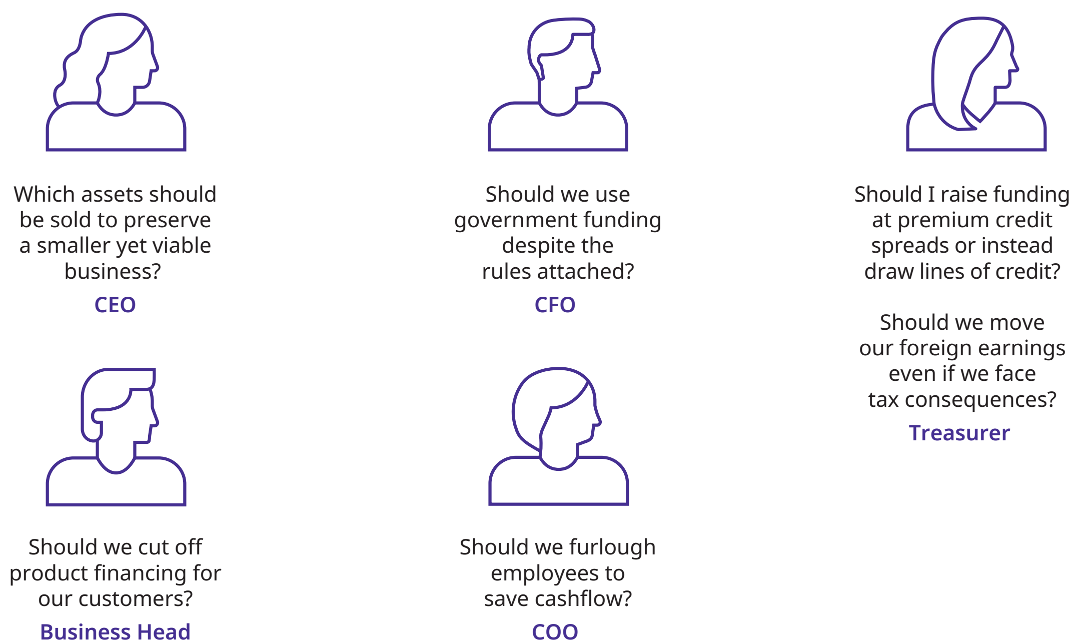
EXECUTIVE SUMMARY

Managing liquidity during COVID-19 has become both challenging and critical for businesses. The pandemic has exposed important gaps in the frameworks, analytic tools, and processes by which companies make decisions in crisis regarding liquidity. Decisions that are rapidly made today frequently suffer from a lack of robust underlying information, insufficient consideration of trade-offs and implications for the broader ecosystem (for example, suppliers), and lack of clear oversight. This challenge is exacerbated in times of crisis, where decision making needs to be well-informed and quick to avert financial distress and unintended consequences.

Exhibit 1. Illustrative: Liquidity management questions that companies need to answer



In order to make good decisions consistently over time and in the face of uncertainty, companies need to effectively develop their capabilities to answer four central questions (see Exhibit 2). For liquidity management, this translates to a set of specific capabilities that are described within this paper.

Exhibit 2. Effective decision-making capabilities needed for liquidity management

1 Where are we now?	2 Where might we be going?	3 What are our options?	4 How do we decide?
True cash visibility Up-to-date view of available liquidity vs. pre-defined required minimum **Liquidity thresholds** An ex-ante view of liquidity needs and what constitutes "stress"	**Scenario definition** Alignment on potential situations that the company may face and have to plan for **Cash scenario forecasting** Liquidity needs estimated under defined scenarios	**Liquidity lever inventory** List of actions available to raise liquidity with timing, impact, costs and benefits, and risks	**Governance playbooks** Plan for crisis response with metrics and triggers to prompt and escalate decision making with clear delineation of responsibilities

Management information systems (MIS)

Having liquidity decision-making and management capabilities in place prior to the advent of COVID-19 would have served many companies well. Looking forward, and in preparation for the next crisis, companies should begin to invest in these capabilities now to bolster resilience and profitability in the years to come. In the immediate term, closing critical gaps — especially for urgent needs like cash visibility — should be a priority considering the likelihood of multiple waves of the pandemic and a prolonged economic crisis.

CRITICAL CAPABILITIES FOR LIQUIDITY MANAGEMENT

In a recent poll conducted by Oliver Wyman, 78 percent[1] of corporate treasury professionals indicated that enhancing liquidity and cash management is a top three priority for their company coming out of this crisis. However, the prevailing uncertainty, rapid evolution of information, and the need to act quickly, make effective decision making challenging. The challenge is often significantly compounded at companies by the lack of a cohesive decision-making framework and legacy enterprise resource planning solutions that are slow, inflexible, and do not provide relevant information as well as a lack of clear delineation of governance and accountability.

As described in the following subsections, a well-defined liquidity management and decision-making framework that is supported by relevant analytics and a clear governance structure will lead to more effective, consistent, and expedient decision making in the interest of a company's shareholders, employees, and its broader ecosystem.

1. TRUE CASH VISIBILITY AND LIQUIDITY THRESHOLDS

Where are we now?

Capabilities companies need		Typical pain points companies struggle with
True cash visibility A consistent, realistic, up-to-date view of the liquidity available to the company	• Total liquidity across **all sources** considering associated **frictions** • **Real-time** views at the appropriate level of **granularity** (e.g., by currency, entity, etc.)	• **Narrow focus on accounting cash balances** — without consideration of cash trapped in legal entities/jurisdictions with tax or other implications for access, available lines of credit and collateral • Cash distributed across several bank accounts with **limited real-time view of centralized liquidity**
Liquidity thresholds An ex-ante view of the liquidity needs of the company, and what constitutes "stress"	• **Well-defined boundaries** on the minimum amount and type of liquidity required • Boundaries set based on **forward-looking and dynamic** measures	• Informal boundaries with **lack of visibility** to senior leadership and the board • Static metrics that provide a **stale view of liquidity needs** • Limited consideration of the **opportunity cost of holding too much** vs. the risk of holding too little liquidity

Central to true cash visibility is the ability to produce a real-time view of the company's liquidity position, including both readily accessible cash and cash equivalents. This includes appropriately accounting for restrictions (for example, trapped cash in entities, tax or foreign exchange implications of moving cash) as well as others forms of "near cash" (for example, assets that can be readily monetized or borrowed against). Building these capabilities can be especially challenging for large multinational corporations who may have to aggregate and reconcile cash balances distributed across many (in some cases, 1,000 or more) individual bank accounts spanning legal entities and geographies.

1 Poll conducted as part of a joint Association for Finance Professionals (AFP) and Oliver Wyman Webinar on cash and liquidity management

True cash visibility allows a company to measure its current position. However, to be fully meaningful, companies need to contextualize this measurement against predefined liquidity thresholds that have been agreed with relevant stakeholders (for example, senior leadership and the board) and calibrated considering the company's risk tolerance. More risk averse companies may choose to define boundaries at a higher level — with therefore a bigger "liquidity cushion" that provides more room for uncertainty. These thresholds also allow for consistent decision making and strengthened oversight and accountability.

2. SCENARIO DEFINITION AND CASH FORECASTING

Where might we be going?

Capabilities companies need		Typical pain points companies struggle with
Scenario definition A realistic suite of scenarios outlining a likely future state of the world, across a range of possible severities	• Ability to develop and discuss **scenario narratives relevant to the company's business activities** to frame management's view of the range of potential outcomes that could be realized • Forums to **review and challenge** scenarios to ensure sufficient breadth (e.g., is the worst-case scenario overly optimistic) • Ability to **cohesively link scenarios from real world events** (e.g., progression of the COVID-19 pandemic) to business impacts (e.g., client demand)	• **No scenario planning or discussion with senior leadership and the board** to inform the size of the liquidity buffer and to plan for possible scenarios and outcomes • **Scenario(s) considered lacks breadth** to inform the range of potential outcomes and are not linked to macroeconomic forecasts
Cash scenario forecasting A robust methodology to forecast cashflows associated with those scenarios	• **Robust methodology to forecast cash flows** considering contractual obligations, seasonality effects, historical experience, and input from business representatives • Efficient processes to **rapidly incorporate a forward forecast of business activity** to refine estimates **in actual crisis** (e.g., management actions such as liquidating collateral) • Established methodology to translate business impacts to **changes in cash flows for each scenario** • Ability to conduct **"what-if" analysis to test sensitivities** of key outputs to assumptions (e.g., "what-if" customer demand declined by 10 percent beyond forecasted)	• **Lack of rigor** in forecasting process (e.g., gaps in sources and uses of cash considered) • **Highly aggregated output** with limited granularity by time period, currency, and entity • **Siloed forecasting** by finance team with limited to no input from front-line staff • **Lack flexibility in adjusting scenarios and sensitivity testing** due to complexity of analytical toolkit

Scenario definition is a valuable tool in normal times, and especially important for planning in times of uncertainty, that allows a company to make better decisions by considering and planning for a range of potential outcomes. Choosing actions to take today can then be premised on an "expected" view of the world while aiming to mitigate or limit the downside, if things turn out worse than expected. Scenarios defined should reflect management's view on the future business outlook and can leverage industry forecasts and tools which inform the specific impacts to the company's cash sources and uses under a given scenario in cash forecasts.

While most companies have basic cash forecasting capabilities already in place, these tools often lack the rigor and granularity required to truly inform effective decision making.

Companies need to develop a forecasting framework that:

- Captures all material sources and uses of cash
- Provides the right level of granularity (for example, ability to aggregate forecasts to a company-wide level but also report by currency, legal entity, etc.)
- Includes a robust process to solicit business input on forecasting assumptions that can then be centrally reviewed and challenged
- Tracks the accuracy of forecasts over time to enable continuous improvement

3. LIQUIDITY LEVER INVENTORY

What are our options?

Capabilities companies need		**Typical pain points companies struggle with**
Liquidity lever inventory Comprehensive view of actions available to raise liquidity with timing, benefits, costs, and risks	• **Pre-defined list** of contingent liquidity and collateral levers • **Assessment of each lever** (impact, timing, trade-offs, dependencies, costs/risks) • **Linkage of levers to scenario analysis** — understanding how levers behave in different scenarios, hierarchy of actions required	• Good awareness of the "standard" means to raise cash — however, **an incomplete view** of more non-traditional means • **Limited understanding** of timing, impacts, trade-offs, and broader implications • Extended timing to enact specific levers due to a **lack of pre-preparation**

Most companies have a relatively good understanding of the standard levers available to raise cash, though these are often not documented, nor is the point at which they should be considered clearly defined. In a crisis, many of these standard actions can quickly become infeasible or prohibitively expensive to execute (for example, issuing bonds). Having a more expansive and prioritized list of levers and actions that could be considered provides options for discussion as the company goes deeper into stress.

There are significant trade-offs to be considered between the actions that need to inform decision making. A liquidity lever inventory captures these dynamics and gives a company the ability to act quickly and decisively by providing:

- A comprehensive inventory of levers including both traditional and non-traditional (for example, selling an insurance captive) means of raising liquidity
- A relative prioritization across actions considering the time to execute the action, amount of liquidity raised, as well as associated costs or risks (including non-financial costs such as impact on brand)
- An assessment of the implications of actions on the broader ecosystem (for example, suppliers, distributors, customers)
- Pre-alignment and sign-off with senior stakeholders on the relative prioritization and risks

Such a list can also ease communication with external parties, for example, rating agencies, press, debtors, governments, and regulators.

4. GOVERNANCE PLAYBOOKS

How do we decide?

Capabilities companies need		Typical pain points companies struggle with
Governance playbooks Plan for crisis response with metrics and triggers to prompt decision making and the clear delineation of responsibilities	• Clear **delineation of roles/accountability** on decision making • **Well-defined triggers** and thresholds, breach monitoring, and escalation protocols • Clear **instruction on what information to consider** in order to make informed decisions • Ability to provide required **information on a timely basis** from various sources	• **Ad-hoc and opaque decision-making** processes that are strained in crisis times, including ill-defined and untested crisis governance committees • **Lack of clarity** regarding when to discuss what options and how to decide what to do • **Slow and inflexible enterprise resource planning solutions** and/or non-robust/outdated analyses to inform decisions • Limited ability to provide views at different levels of aggregation — often **requiring manual workarounds**

With liquidity, which can deteriorate quickly, the ability to act promptly can mean the difference between survival or failure in times of distress. Governance playbooks enable a company to operationalize the capabilities previously described, with the aim of codifying and guiding how decisions are made. Playbooks are prepared in advance and are regularly updated to reflect what would happen should a crisis hit. They are also often tested in advance using management “table top” exercises.

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Exhibit 3. Governance playbooks act as an instruction manual in crisis

	Business as usual	Stress	Recovery	Critical
Actions and decisions	Normal conditions	Low risk contingent actions	Higher risk contingent actions	Emergency actions
Relevant thresholds	"Business as usual" liquidity targets	Early-warning indicators (stressed market conditions, company-specific cash crunch)	"Recovery" triggers (industry-wide cash crunch, forecasted shortfalls within X days)	"Days of survival horizon"
Governance	"Business as usual" governance		Crisis forums & emergency communication channels	
Management information	Cash visibility reports			
	Scenario and cash forecasts			
		Liquidity levers list		
		Other: Communication and engagement plans, press releases, crisis reports, employee plans		

A critical component of governance playbooks is defining the right process by which decisions are made, including:

- Having established forums that meet regularly (for example, Finance and Risk Committee, Executive Management Committees, etc.)
- A clear delineation of roles and responsibilities of key groups involved (for example, Treasury, Enterprise Risk Management, business lines)
- Mechanisms to ensure regular monitoring of liquidity thresholds whereby breaches are escalated to appropriate channels and there are required mitigating actions (tiered by the level of severity of the breach)

Furthermore, to operationalize the capabilities described above, companies need to develop and upgrade management information systems to be able to source data (often from multiple systems), conduct analysis, and generate reports in a manner that can be refreshed quickly (ideally at the press of a button). While most companies are significantly far from achieving this level of functionality — advancements in process and data transformation tools can be effectively leveraged to help companies make rapid progress.

ADDRESSING BLIND SPOTS IN THE TIME OF COVID-19

For many companies, fully developing the capabilities for crisis decision making will be a journey rather than a "leap." In the face of competing priorities, companies can use the following approach to prioritize this journey to ensure consistent and tangible progress:

Immediate term: Address any "blind spots" in cash visibility and forecasting approaches. These capabilities are critical for day-to-day liquidity management and enhancements and will immediately provide benefits such as additional headroom or the ability to better anticipate shortfalls.

Short term (within the next 3-6 months): Engage senior leadership and the board in a discussion to align on liquidity thresholds, discuss and define scenarios, and the relative costs and benefits of levers. This will enable a more informed and rapid response to a liquidity stress (such as a second wave of the pandemic).

Medium term (within the next 6-18 months): Formalize capabilities within a governance playbook and define a prioritized plan to address longer-term gaps to build out the foundational capabilities (for example, data collection, MIS upgrades, etc.) to ensure that improvements are incorporated into the company's modus operandi and can serve in future crises when needed the most vs. being a one-time build.

Developing a liquidity management approach which incorporates an effective decision framework, as described above, will help ensure that corporate entities maintain robust liquidity position and be better prepared for the next crisis. Companies that pursue such a path will distinguish themselves from competitors.

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