The Liquidity Paradox

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The liquidity paradox:

“Pity the analyst forecasting today’s global economy. For every signal warning of stagnation there is another glowing green for go.”

– FINANCIAL TIMES – KEEP THE MONETARY PEDAL PRESSED TO THE FLOOR

Stock markets are growing with some reaching record levels; cash on balance sheets is at an all-time high; banks are more structurally sound as a result of regulations that are forcing them to de-risk their balance sheets while maintaining greater access to liquidity. Inflation is low and seems stable in the US and Northern Europe.

And yet: the Small and Medium Businesses (SMB), the engine of most economies (60% value add in Europe) are struggling to access liquidity, which is weighing down the ability of larger corporates to meet growth targets; economies are stagnating or posting disappointing growth rates; inflation has moved into deflation in parts of the Eurozone particularly in Southern Europe (Italy, Spain, Greece etc).

Liquidity shortages impede economic growth.

Economies are currently suffering from a paradoxical situation of too much liquidity while having too little. Banks, awash with cash, are reluctant to accept new deposits and have started charging for them; larger corporations are stockpiling cash reserves but running out of options of where to place them; whilst SMBs are often unable or unwilling to access funding due to its cost and scarcity. The issue has become entrenched and is beginning to have material impact on sovereign economies. So much so that it has attracted the attention of politicians, desperate to kick-start their economies to provide employment and higher tax revenues, as well as central banks, trying to inject liquidity into the real economy to ward off losing a decade to deflation by utilizing the various tools at their disposal such as interest rates and quantitative easing.

The main stakeholders have engaged in discussions to find an appropriate solution or solutions but have struggled to find a model that balances the demands of all parties to ensure a sustainable answer. Banks, who have been widely blamed for the credit crisis in 2008 that resulted in a rapid evaporation of liquidity and dramatically slowed the gears of the global economy, are trying to be part of the solution but are hamstrung by regulation and political pressure. The consequences of the credit crisis led to regulators and politicians rightly identifying that a liquidity shortage also could have a negative impact and they put in place regulations (primarily Basel III) to ensure banks would de-risk their balance sheets.

The goal was to make sure banks carried enough liquidity to cover their liabilities in case of another crisis. Overall this action is making economies more structurally sound and should help prevent any future crisis from reaching the terrifying depths the last one achieved.

The unintended consequence of these regulations is banks have justifiably shed the business loans of their riskier clients – the SMBs who represent up to 1/3 of their total balance sheet adjustment while at the same time halving their lending activity to the SMB base ($1T to $500B). This is a huge drop off that has starved an already ravaged slice of the business community. Banks who are continuing to lend to SMBs have raised lending margins to return to profitability, making borrowing for SMBs expensive.

Banks, viewed by some as reckless institutions responsible for steering us into the credit crisis, have been asked to tidy up their risk taking and have dutifully done so. Yet at the same time they are now unfairly being lambasted for not lending to the SMBs that represent a higher risk to their balance sheet.

Traditional sources of liquidity are failing to provide a solution.

This highlights another problem: banks are one of the main mechanisms used to introduce liquidity to the economy. This is especially true in Europe, where banks are the predominant source of funding. In the US, where access to capital markets is more readily available, the pain might not be as acute but it is still felt by broad swaths of the economy.
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As a result the primary feeding tube for SMBs has been restricted, resulting in longer economic stagnation. Studies by the IMF have shown that economies with a greater proportion of SMBs take longer to recover and as long as liquidity is restricted for the SMB base we should expect a long road to recovery given that 99% of all European businesses are SMBs.

In comparison to Europe, the US economy has seen a faster recovery mainly because there is broader access to alternative funding sources and SMBs aren’t as dependent on the banking sector for finance. However, these alternative sources of funding have fallen short of compensating for the decline in bank lending and overall the US recovery is still disappointing in terms of economic growth. The situation in the US may be more encouraging but there still is a shortage of liquidity available to SMBs.

Central banks and politicians have recognized this drop off and have tried to leverage the tools in their arsenal to bring the lending levels back up. Both UK and US central banks, with the ECB currently following suit, have embarked upon a series of Quantitative Easing initiatives that involve central banks buying up commercial banks’ assets in order to inject more liquidity into the monetary base. The assumed implication is the banks will then filter that additional cheap liquidity down to the SMB base.

Good idea. The problem is it hasn’t worked.

Although lending was the answer in the past, it is not the answer for the future nor will it be the solution the politicians, central banks, and SMBs are hoping for. Which should be viewed as a positive step forward considering debt levels in many western economies have been precipitously high.

Banks have recognized this and have started moving away from lending towards an alternative practice of accelerating pre-existing payment obligations from a buyer to a supplier in return for a discount by leveraging the credit rating of the buyer. Reverse factoring has seen a significant take up and seemingly provides a convincing approach to funding a cash-strapped supply base. Acceleration is the right direction although reverse factoring involving corporates, banks, and suppliers is inefficient and therefore only a partial solution. Corporates benefit because they receive a large one-off increase in cash as a result of extended terms received through the program; banks benefit because they receive the discount from the participating supplier base as compensation for their very low risk on the buyer defaulting over a short-term period. However, due to the nature of the program it only focuses on the top suppliers by volume or strategic relationship, which is invariably only 5-10% of the total supplier base. These suppliers are usually larger ones who already have access to cheaper funding rather than the ‘long-arm’ of SMBs who do not.

On the other end of the spectrum larger corporates have learned their lesson from the 2008 crisis where banks rapidly pulled back vital credit lines leaving them dangerously exposed to bankruptcy due to lack of liquidity. One of the most powerful legacies of the crisis has been a culture of fear surrounding levels of liquidity even at huge companies with virtual mountains of cash. Treasurers moved to adjust the liquidity risk weighting of their exposure to banks, resulting in record cash levels on balance sheets for major corporates while SMBs struggle to maintain operating liquidity.

“…banking sectors are widely seen as being supported by conditions of ample liquidity, thanks to measures taken by the ECB. However, these conditions of ample liquidity have not, so far, translated into a recovery of bank lending to NFCs (Non-Financial Corporations)”

— EIB PUBLICATION – UNLOCK LENDING IN EUROPE

This has created a dilemma: corporates have relied on banks to fund them in the past, but these same banks are now the source of their fear. Corporates would need to find an alternative source for liquidity that also addressed their fears. The natural conclusion was to leverage their supply chain and focus on improving working capital to drive their cash levels.

This sparked a wildfire of payment terms extensions that further squeezed the supplier base and gave early corporate adopters a competitive advantage within their sectors. As companies began to reap the benefits of extending payment terms the practice became more common as other businesses attempted to neutralize the advantage. This practice created a greater shortage of liquidity for SMBs, who were now forced to search for funding to bridge the liquidity gap only to find that their main source of funding, the banks, was unwilling to lend to them. Successful businesses that would otherwise have thrived were suddenly facing a major liquidity crisis. Rather than reducing their liquidity risk by trying to reduce their exposure to banks corporates instead shifted it into their supply chain, where far deeper and potentially more sinister risks now lie.

Businesses hunkered down rather than expanding. The results were lower employment, more stagnation, less demand, and shrinking inflation that has led economies in parts of the Eurozone into a deflationary environment. An ironic feedback loop: by fearing a lack of liquidity corporates have hamstrung the recovery of the economy and set it on a perilous course with shrinking revenues, higher debt costs, and less liquidity.

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Liquidity is not being made available despite record levels of cash.

Hence the paradox: there is more liquidity than ever before in the world, yet the largest engine of the world’s economy, SMBs, cannot access it. This means corporates with high levels of liquidity feel safe but in ensuring their own solvency they have systematically created a whole new danger. A major company may have ample cash, but it is exposed to the dangers a lack of liquidity could cause within its own supply chain.

In an attempt to incentivize banks to increase lending to SMBs the European Central Bank (ECB) recently introduced negative interest rates for surplus liquidity. The knock on effect has created a bizarre situation where banks are charging corporates to deposit the cash they have generated from the working capital initiatives funded by the very businesses currently calling out for liquidity.

“European firms rely heavily on bank lending to finance investment and working capital. This is true particularly for small and medium sized enterprises that, because of their size, have little alternative to address their external financing needs. The economic crisis has revealed the rigidity of such an undiversified funding model.”

— EIB PUBLICATION – SUPPORTING ACCESS TO FINANCE FOR SMBS AND MIDCAPS

The need to make their cash work harder for them has driven corporates into accepting more risk for more return, although comparatively that return is still meager. Corporates are slowly concluding that the financial stress within their supply chains combined with their problems in maximizing cash returns may well be a match made in heaven. The question is how to bring them together.

Current progress in finding the right solution is slow. Too slow, especially since parts of the Eurozone economy are now in a deflationary environment that will exert even greater liquidity pressure on SMBs with falling prices and mounting debt costs. The push and shove of each stakeholder’s requirements has stagnated the process and it is clear that legacy solutions are not working. The right moves have been made towards shifting the paradigm away from debt and towards acceleration of payments.

A solution whereby all parties benefit would be rapidly adopted and quickly start to negate the current economic spiral.

Acceleration is the answer, but the devil is in the details. A successful acceleration program can only be sustained if the suppliers are consistently using it and the buyers are willing to offer their working capital for a discount return that can improve their gross margins. Existing models create the opportunity for suppliers to accelerate their receivables but the methodology used is restrictive: ‘buyer push’ where buyers are currently setting the discount rate at which the suppliers can participate in their program. This places the onus on the buyer to have complete understanding of the cash
needs of their suppliers (which they probably will not) in terms of their alternative cost to borrow as well as the timing of their needs. This can only ever be hit and miss. Ultimately, the end result is lower adoption and less volume flowing through which creates less of a business case for the corporates to justify.

“In general, SMEs are particularly dependent on bank lending because of their small scale, limiting their ability to efficiently overcome asymmetric information and to access to other forms of finance such as capital markets.”

EIB PUBLICATION – UNLOCK LENDING IN EUROPE

A natural conclusion that has been emerging is the model must give suppliers control over what price should be offered in order to answer their liquidity needs quickly and effectively. At first, this approach may not appear viable as the expectation would be that suppliers will offer low discounts that would not be attractive enough to bring buyers to the table. However, by introducing a real time working capital marketplace both parties benefit as suppliers base offers for accelerated payment against their alternative cost of borrowing which allows buyers to realize returns far superior to those achieved in the short-term investment markets. Marketplaces are well-known to give both sides the fairest result as the supply and demand dynamics have to balance out. An ethical marketplace can therefore be created by removing intermediaries and creating a transparent exchange, which allows all sides to fulfill their goals.

The win for corporates is they can generate a good yield on their cash, say 5-7% APR. Perhaps as important, they also de-risk their supply chain.

The win for SMBs is they can access the liquidity they need, at a rate on par with or below where they could borrow (if they can even borrow). Immediately these businesses can improve their profitability and secure their own operation and standing. Moving forward, these businesses will then be able to expand and develop, advancing the economic recovery and benefiting everyone.

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