Sources of Liquidity Risk

The liquidity of a firm refers to its ability to meet short-term obligations using firm's assets can be quickly converted to cash. Cash is the most liquid form of asset a firm has. Different assets offer different levels of liquidity. For example, a firm's inventory is considered a liquid asset but may not be as liquid as other assets such as short-term money market securities that can be converted into cash very quickly.

Liquidity management is the ability of the firm to generate enough cash required to meet the firm's needs.

Some firms operate in industries or conditions where they always have excess cash and liquidity is not a concern. Instead, there the focus is on how to use this excess cash to maximize the shareholders' returns.

In other firms, because of the nature of the industry or the firm's financial condition, there may be tight liquidity conditions. In such firms, it's important to effectively manage liquidity to avoid problems.

The various sources of liquidity for a firm can be classified as primary and secondary sources. Let's take a look at these sources of liquidity:

Primary Sources of Liquidity

The primary sources of liquidity include the sources that a firm uses for its regular daily operations. This includes:

- Cash
    - Cash received from sales
    - Collection of receivables
    - Short-term investment, and others

- Short-term Funding
  - Trade credit from suppliers
  - Working capital loans from banks
- Cash flow management
  - The firm can also generate working capital by effectively managing its cash.

Secondary Sources of Liquidity

These are the sources of liquidity that are not normally a part of the regular operations. However, in times of need, the firm may use these sources. These include:

- Renegotiating existing debt contracts
- Liquidating short-term and/or long-term assets
- Filing for bankruptcy

Utilizing the secondary sources of funding can impact the company's financial structure and may even affect its operations. This also indicates that the firm's financial condition is deteriorating.

Liquidity is a term used to refer to how easily an asset or security can be bought or sold in the market. It basically describes how quickly something can be converted to cash.

Liquidity is a bank's ability to meet its cash and collateral obligations without sustaining unacceptable losses. **Liquidity risk** refers to how a bank's inability to meet its obligations (whether real or perceived) threatens its financial position or existence. Institutions manage their liquidity risk through effective asset liability management (ALM).

All firms seek access to lending to meet their short-term financial obligations, but also to carry out long-term strategic investments. Failure to acquire appropriate funding within a realistic timeframe could expose a firm to liquidity risk, thereby causing undesirable consequences.

Types of Liquidity Risk

There are two different types of liquidity risk. The first is funding liquidity or cash flow risk, while the second is market liquidity risk, also referred to as asset/product risk.

1. Funding Liquidity Risk

Funding or cash flow liquidity risk is the chief concern of a corporate treasurer who asks whether the firm can fund its liabilities. A classic indicator of funding liquidity risk is the current ratio (current assets/current liabilities) or, for that matter, the quick ratio. A line of credit would be a classic mitigant.

2. Market Liquidity Risk

Market or asset liquidity risk is asset illiquidity. This is the inability to easily exit a position. For example, we may own real estate but, owing to bad market conditions, it can only be sold imminently at a fire sale price. The asset surely has value, but as buyers have temporarily evaporated, the value cannot be realized.

In the context of traded markets, **liquidity risk** is the risk of being unable to buy or sell assets in a given size over a given period without adversely affecting the price of the asset. The risk will be high if, for example, a large trade is being executed over a short period of time in an insufficiently liquid market.

Factors affecting a firm's liquidity position

A firm's liquidity position is affected by how the cash inflow or cash outflow is affected.

Drags on Liquidity

When the cash inflow is reduced or delayed, it's referred to as drag on liquidity.

Examples:

1. Bad debt
2. Obsolete inventory
3. Tight credit: Less or expensive trade credit

Pulls on Liquidity

When the cash out flow increases, it's referred to as pull on liquidity.

Examples:

1. Making payments fast to suppliers, employees, etc.
2. Reduced credit limits by suppliers
3. Limits on short-term line soy credit
4. Poor liquidity conditions

A firm should identify these pulls and drags on liquidity quickly in order to improve the liquidity position of the firm.