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PERSPECTIVES

The Aftermath: Managing Risk in a New Liquidity Landscape

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With the liquidity crisis behind us, community banks have turned their immediate attention to capital planning, asset quality and hoping to get back into lending. But don't be fooled into thinking that examiners are taking their eye off of liquidity management. In fact, you are expected to more closely measure and manage your bank's liquidity position and risk than ever before.

Most banks have now made it part of their regular routine to track key risk indicators such as loan to deposit and net non-core funding dependency ratios. But, that's no longer enough. Now banks must consistently perform more in-depth analysis such as monitoring cash flow (depending upon your bank's situation, this could be daily) and modeling funding risk scenarios. And, it won't suffice to simply "tell" examiners that you are doing these things and that the bank is well-positioned. You must continually "show" them that you are on top of liquidity and adequately prepared for whatever lies ahead.

Here are some best practices that you can employ today in the aftermath of the liquidity crisis to stay in step with examiners and take action to mitigate risk for the years ahead.

Maintain a Dynamic Contingency Funding Plan (CFP)
The challenge with liquidity is that you have it until you don't. It's the things that you can't see today that you must prepare for. A CFP is essential to this effort—helping the bank proactively manage liquidity and risk. However, for it to be a beneficial tool, it must be much more than a point-in-time document. Your bank's CFP must be fluid, always taking into account what could immediately impact your liquidity situation (i.e. credit loss, a plant closing and other factors that could affect your local market).

Your bank's CFP must also specifically document how the bank would respond to unforeseen events. Examiners are strongly emphasizing the importance of cash flow management in particular, and expect you to model risk scenarios and regularly stress test. Your CFP must reflect steps the bank will take if capital weakens and it loses funding sources, such as correspondent bank relationships. In addition, you need to continually evaluate and monitor funding sources, identifying how much you can count on from each source and determining under what circumstances those funds would and would not be available to the bank. All of this must be documented in your CFP.

Also keep in mind that examiners would like for banks to increasingly return to traditional asset based liquidity sources—those that can be easily accessible in 24 hours. They want to see that you have built a cushion into your balance sheet (beyond 30 days) that will enable the bank to maintain adequate liquidity at all times. Lastly, be sure that your bank's CFP identifies the individuals who are responsible for monitoring the policy on an ongoing basis and specifies who will handle different issues.

By incorporating all of the above elements into your CFP, you can be sure to satisfy regulatory requirements and instill confidence in the examiners for years to come.

Understand Your Funding Sources & Diversify
Again, examiners are looking for banks to have more asset-based liquidity. However, if you are funding from the liability side, you must be appropriately diversified with access to multiple existing and potential funding sources—and avoid being overly concentrated in any one source. These are crucial lessons learned from the liquidity crisis.

Examiners require that you have a more intimate understanding of how each of the bank's funding sources work, that you know how they will be affected by certain risk scenarios, and that all related legal and operational documents are up-to-date and suitable. Additionally, regulators are placing greater emphasis on the board's involvement with the bank's liquidity policies. Your directors must have knowledge of the bank's primary and contingent funding sources and play a role in ensuring that liquidity is being monitored and managed according to regulatory guidance. If your bank's liquidity position hasn't been a regular discussion at your board meeting, it most certainly should be. Examiners are now emphasizing that your liquidity discussion be clearly documented in the board minutes—so that they know that your directors are engaged and fully educated with regards to the bank's liquidity.

Know Your Interest Rate Risk (IRR) Exposure
One of the fundamental things that you should be doing in this new liquidity landscape is consistently tracking the key indicators of liquidity risk (i.e. loan to deposit ratio, net non-core funding dependence, net short-term liabilities/total assets, on-hand liquidity/total liabilities, reliance on wholesale funding). You must show examiners that you are aware of the impact that a rising rate environment could have on your institution and that you are adequately prepared to address that risk.

Although it may be a year or more before we see the affects of rising rates, examiners are concerned that there is a general lack of understanding in the industry of IRR and an even greater lack of understanding at the board level which means it could become an issue for your bank in upcoming exams. The guidance provided is intended to get senior management and the board thinking about what is coming on the horizon and planning accordingly. Therefore, if your board doesn't intimately understand IRR, it needs to. Beyond ongoing education, one consideration may be to place a board member on your bank's asset/liability committee. And finally, IRR discussions should also be reflected in the board meeting minutes.

Never Take Your Eye Off the Ball

Make no mistake. In this new liquidity landscape, examiners will continue to scrutinize the vulnerability of your bank's funding. It is easy to become complacent in a time when liquidity is abundant, but when economic activity picks up, history will repeat itself and deposits will inevitably leave the bank. Examiners are watching how well you are managing liquidity on a regular basis and how well you are planning for inevitable factors, such as rising rates, and other unforeseen circumstances. It may seem elementary, but thriving in the new liquidity landscape all comes down to being consistent, proactive and vigilant—never taking your eye off the ball.

For information about direct, non-brokered CDs as a prudent, ongoing source of funding and/or to obtain guidance on how to develop a dynamic Contingency Funding Plan (CFP), please contact QwickRate at 800.285.8626 www.qwickrate.com.

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