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By Shawn O'Brien

The Aftermath: Managing Risk in the New Liquidity Landscape

WITH THE LIQUIDITY crisis behind us, community banks have turned their immediate attention to credit quality and getting 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 are expected to be regularly performing 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 continually and proactively managing 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, such as 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 expect you to regularly perform cash flow analysis, model risk scenarios and conduct stress testing. In addition, you need to routinely evaluate funding sources, identifying how much you can count on the source providing and determining under what circumstances those funds would and would not be available to the bank – then document all of this in your CFP. By incorporating these key elements into your CFP, you can be sure to satisfy regulatory requirements and instill confidence in the examiners for years to come.

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Understand Your Funding Sources & Diversify

In general, examiners are looking for banks to have more asset-based liquidity. However, if you are funding from the liability side, you must be diversified with access to multiple existing and potential future funding sources – this is one of the most 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 appropriate. Additionally, regulators are placing greater emphasis on the board's involvement with the bank's liquidity policies. Your directors must understand 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 certainly should be.

Know Your Interest Rate Risk (IRR) Exposure

One of the most 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.

Understandably, the temptation for many banks right now is to raise funds that have shorter durations (i.e. money market accounts) because of the low interest rate environment. If you are closely monitoring this, that's okay. However, if rates begin to rise and you aren't keeping a close eye, your cost of funds can change drastically and quickly, leaving the bank exposed to greater risk. Regulators have gone to great length to provide you with guidance in this area and expect you to heed it. Be sure you know your IRR as defined in the joint Advisory on Interest Rate Risk Management (January 6, 2010) and demonstrate that you are following the supervisory expectations regarding sound practices for managing it.

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.

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