LIQUIDITY RISK MANAGEMENT

by Steve Brown

As we have indicated, the regulators are looking very closely this year at credit and liquidity risk. As such, we thought we would take a moment and provide a refresher on the liquidity portion.

In general, regulators define liquidity risk as the risk that a bank will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain funding. Also excluded from liquidity calculations would be any asset or liability that cannot be easily unwound without significantly impacting market prices.

Liquidity is so important that global banking regulators have devoted 27 pages of text around best practices they have uncovered over the years. Here, we condense these practices down to help our community bank clients zero in on areas of potential improvement.

To begin, liquidity analysis is not static. Banks should not only measure the current liquidity position, but also understand how different funding options can change under different scenarios (including adverse ones). Flexibility, dynamic measurement and projecting the impact of such changes are critical components of an updated liquidity risk management program.

Next, banks should understand that liquidity oversight is important. Banks should not only have a liquidity strategy, but also ensure day-to-day management is strong and that they have communicated the liquidity strategy throughout the company. In addition, the board of directors should review and approve the liquidity strategy, as well as any policies related to same. Regular and consistent reporting to ALCO and the board of the bank's liquidity position should be standard and any material changes in either the current or prospective position should be highlighted.

Beyond the basic strategies outlined so far and prudent bank management, executives should meet regularly to discuss the current and projected liquidity position (over specific time horizons). The responsibility for managing liquidity should be controlled by a specific, identified group within the bank (usually ALCO). Groups within the bank must also understand their own responsibility and potential unit impact on liquidity risk. In short, any group that conducts activities having an impact on liquidity should be fully aware of the strategy and operate under approved policies, procedures and limits.

Perhaps one of the toughest things a bank has to deal with related to liquidity management is having proper technology support and reporting capabilities. Liquidity positions can change quickly, so reports should be provided on a regular and timely basis. This will help ensure adequate liquidity is maintained at all times. Systems and reports should measure and monitor funding needs, utilize "what if" modeling and provide a simple way to review major assumptions. Over time, back-testing should also be incorporated to ensure assumptions remain valid.

Community bankers universally loathe selling assets, but doing so remains a critical part of liquidity management. Simply saying or putting in policies that loan sales or participations can be done (to increase liquidity) is not the same as actually doing this and tracking the results. Regulators expect banks to periodically test their access to markets, correspondent bank lines and other liquidity sources.

Banks should conduct regular independent reviews, audits and evaluations of the effectiveness of systems that backstop liquidity. This is a key step in financial reporting and should include an adequate level of disclosure to ensure investor perception of the strength of the bank is maintained over time.

Other specific limitations banks may want to consider could include tracking the cumulative net funding requirement as a percentage of total liabilities (over the next day, 5 days and 30 days); the marketability of liquid assets (including a discount to cover price volatility); outflows projected on outstanding commitments; liquid assets as a percent of short term liabilities; cash and Fed funds sold as a percent of total assets; a report of any negative information or news about the company; maturing assets; saleable non-maturing assets as a percent of assets; deposit and liability options; established credit lines (and date of last test); liabilities coming due over specific time periods; contingent liabilities and percent of the loan portfolio that has a limited market.

Once banks have the capability to capture this data, they can then put in place programs to more actively monitor, report, and manage liquidity risk. We urge banks to take extra time to review liquidity options, alternatives and contingency planning in preparation for their upcoming regulatory examination.

BANK NEWS

First 2008 Failure

The OCC closed Douglass National Bank ($58mm, MO). The bank, also rescued in 1991, is a good example that sometimes it is not one thing that causes failure; it is a lot of little things. In the end, the bank could not generate enough earnings to shore up capital and was shut down. The FDIC will take a $5.6mm hit and Liberty Bank ($327mm, LA) will purchase $55.7mm of performing assets below book.

Sallie Mae

The student loan giant secured a much needed, $31B in financing for 1Y to provide working capital.