RIPPLES IN THE POND OF LIQUIDITY

by Steve Brown

Yesterday, we provided a high-level overview of the brand new Interagency Policy Statement on Funding and Liquidity Risk Management. Today, we continue that discussion by going further into the regulation; in an effort to understand what exactly regulatory agencies will be expecting bankers to do.

The policy statement defines liquidity as "a financial institution's capacity to meet its cash and collateral obligations at a reasonable cost." That is pretty vague, but the bottom line is that regulators want banks to be able to handle both expected and unexpected cashflows and collateral needs without affecting daily operations or financial condition of the entity. As such, banks will first have to closely define their daily operations and set up processes to track ongoing financial condition.

The Statement also indicates that liquidity risk arises when banks see their cashflow change, straining their ability to meet obligations. It goes on to say that such risks include funding mismatches, an inability to convert assets into cash, accessing sources of funds and contingent liquidity events (these are defined as unexpected situations or business conditions that may increase liquidity risk, given a bank's balance sheet or organizational structure, business activities and other bank-specific characteristics). Here, banks are expected to protect against contingent liquidity events by having a strong Contingency Funding Plan (CFP). The purpose of the CFP is to assist management teams by laying out a roadmap of how to respond, given potential events or scenarios that could result in a liquidity shortfall. In so doing, the plan is designed to ensure that liquidity sources are sufficient to fund normal operating requirements, without incurring undue expense or causing business disruptions. Basically, the CFP provides the bank with a plan for responding to a liquidity crisis.

Good liquidity management starts with having a comprehensive process for identifying, measuring, monitoring and controlling liquidity risk. Banks should have a comprehensive way to forecast cashflow from all assets, liabilities and off-balance-sheet items (including contingent exposures). How banks do that can vary, but managing liquidity and cashflow can be as simple as a spreadsheet, or through detailed reports (depending on bank complexity). No matter what method is selected, cashflow forecasting should be designed to capture activities and strategies that could strain the bank's ability to generate cashflow under a specific set of time horizons. Additionally, when projecting cashflow, time horizons should be selected that relate to the vulnerability of changing liquidity needs under both normal and stressed conditions. Banks should include both short-term and long-term time horizons (common horizons include intraday, next day, weekly, monthly and up to 1Y).

In particular, examiners will be reviewing whether banks have active board & management oversight; strategies, policies, procedures and limits are in place to manage and mitigate liquidity risk; comprehensive risk measurement and monitoring systems (to include assessments of current and projected cashflows); active management of intraday liquidity and collateral; a diverse mix of existing and future funding sources; adequate levels of liquid marketable securities; internal controls and audit processes; and a comprehensive CFP to address emergency situations (plus documentation it has been tested).

Managing liquidity isn't easy, but it is also something bankers can ill afford to ignore. To do things right, it takes all areas of the bank (lending, finance, branches and managers) to make sure liquidity risk is adequately controlled. One thing we know for sure is that any pebble dropped in a pond will cause ripples to appear. Being prepared and taking an active role in liquidity risk management can jumpstart the process.

BANK NEWS

Financial Regulatory Overhaul

The Senate Banking Committee approved Senator Dodd's plan to overhaul financial regulations. The Bill is a net minus for community banks and will go before the full Senate for vote in about 3+ weeks.

Mortgage Reform

Treasury Sec. Geithner will outline the broad principals for Fannie and Freddie today at his Congressional testimony. There will be lots of talk on the availability of a mortgage credit, housing affordability, potential privatization, risk, compensation and regulation.

Compensation

Pay Czar Ken Feinberg plans to review executive pay at firms that took bailout funds to determine if any compensation paid should be returned. In addition, the NYT reports that over the last two years, 85% of the 104 executives subject to Federal review are still with their firms.

Ugly Unemployment

Things remain ugly on the job front, as 98% of metro areas saw jobless rates increase in Jan according to a new government report. Even worse, there were 35 areas that had unemployment rates at or above 15% (CA had 19 and MI took 2nd place with 6 cities above this level). The 3 worst cities in the nation were El Centro (the one city where the jobless rate fell) at 27.3%; Merced, CA, at 21.7%; and, Yuba City, CA, at 20.8%.