ENSURING A FOUNTAIN OF LIQUIDITY

by Steve Brown

In this, our final day of analysis of the Interagency Policy Statement on Funding and Liquidity Risk Management, we lay out the remaining items banks should focus on to be fully prepared for the next examination.

Have a strategy for managing liquidity risk, as well as policies/procedures to go with that strategy. Be sure to identify sources of funding, seasonal/cyclical fluctuations and responses to adverse scenarios. Focus on how the bank will address short, medium and long-term liquidity disruptions (be sure to tie in business continuity planning processes).

Make sure policies clearly articulate risk tolerances and periodically review and document assumptions. Guidelines to follow should include both quantitative targets as well as qualitative. Examples include tracking cashflow mismatches; targeting the percentage of unencumbered liquid assets; setting liquid asset coverage ratios; tracking the ratio of wholesale funding to total funding, brokered deposits to deposits and short term borrowing as a percentage of funding; reporting the percentage of lower liquidity assets such as BOLI or certain loans; funding concentrations; secured vs. unsecured lines; contingent liability exposures (unfunded loan commitments, lines of credit, collateral for secured borrowing). Policies should also specify the frequency of reporting (monthly for management and no less than quarterly for the Board) during both normal and stressed periods. Reports should detail exposures and limits and compare to the overall strategy.

Reporting is an area where bankers can always improve as well. Many banks have rudimentary methods for measuring and monitoring liquidity risk, but examiners will be demanding much more so be prepared. Cashflow modeling, projections, regular review of assumptions (including formal approval), deposit stability analysis, contingency testing and analysis based on deterioration related to asset quality or capital adequacy are now must-have's. In addition, banks should make sure reports address concentrations, assumptions used, early warning indicators, funding availability and the status of contingent funding sources. Finally, examiners want banks to report on any government support related to funding programs (such as TAG) and stress test liquidity provided, since these programs are generally temporary in nature (and should therefore be primarily reserved for contingent funding sources).

Other key areas to incorporate include having meaningful time horizons; factoring in deterioration of asset pricing in a stressed environment; and stress testing. Of particular interest related to stress testing, banks will need to focus not only on the test itself, but documenting what mitigating actions will be taken to limit exposure, build up liquidity or adjust the profile to handle risk.

Diversified funding is another area regulators are focused on as part of this new policy. Banks are expected to have diversification in both sources and maturity of funding. This means bank costs will likely rise, as too much of any type of funding (i.e. all non-interest bearing DDAs is not ok any longer as it is a single source) will see additional scrutiny. Banks will need to diversify funding across retail, wholesale, counterparty, type, geographic, secured and unsecured sources. This will be difficult for community banks especially, but note that funding plans will also need to consider correlations between sources of funds and market conditions. Undue reliance on any singular source will be considered unsafe and unsound.

Finally, banks will be expected to maintain an ongoing cushion of liquid assets. The size of the cushion will depend on the bank and will be supported by stress testing, but all banks will need to maintain some cushion to pass muster.

Liquidity is a complex and fluid process that is only getting more difficult as time goes by. Expect scrutiny to increase, prepare thoroughly and have detailed documentation to avoid painful consequences at the next examination.

BANK NEWS

TARP Problems

According to SNL, 74 banks did not make their TARP payment for Feb, up from 55 banks in Nov (and 33 in Aug.). While some banks issued capital and are restricted by state law for making payments their first year, most failed to make payments due to profitability. Under TARP, if a bank fails to make payments for 6 consecutive periods, the Treasury has the right (but not the obligation) to elect 2 directors.

Feelings

A Bloomberg survey shows that 70% of participants support using current bank regulators for consumer protection backing the current position of the banking industry.

Consumer Unit

SunTrust announced plans to start a consumer banking division which pulls in deposits, loans, mortgages and credit card products under one unit.

Delivering Good News

FedEx, considered by analysts as an early economic indicator (because of the products it ships for consumers & businesses), is reporting the US economy is slowly recovering. FedEx reported US average daily package volume grew 5%, as businesses shipped more packages to other businesses, while consumers were more cautious.