

Financial Managers update

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Liquidity risk management

Heightened scrutiny by examiners continues

Liquidity risk management is getting heightened scrutiny from examiners, due to concerns over the impact of market volatility and a fragile economy.

The FDIC recently issued guidance warning financial institutions that they must effectively measure liquidity risks and have contingency funding plans in place for the current volatile environment.

Examiners are evaluating the ability of institutions to maintain access to funds and to liquidate assets in a “reasonable and cost-efficient manner.”

Underestimating problems

The FDIC cautioned that many institutions have underestimated the difficulty of obtaining or retaining funding sources. Other regulators, including the OCC, OTS, and NCUA, are also closely monitoring liquidity concerns.

Brokered deposits

In its guidance, the FDIC instructed institutions to be particularly wary of risks related to brokered deposits and high-rate deposits. The guidance restricts the use of brokered deposits for some insured institutions, no doubt reacting to the high concentration of brokered funds in the recent bank failures.

Mike Guglielmo, Managing Director, Darling Consulting Group, Newburyport, Mass., said that the portion of the FDIC’s policy

that addresses brokered deposits, much of which has already been in effect, is probably intended as a strong reminder to institutions that are bordering on “less than well-capitalized” levels.

“It’s not the brokered deposits that put the banks under—it’s what they’re supporting with the brokered deposits,” Guglielmo explained.

He noted that in some respects the FDIC’s regulatory enforcement has recently toughened, however. Over the past year, the FDIC appears to have tightened its stance based upon the significant amount of denied requests for waivers.

Guglielmo said that in previous years, if an institution dropped below the “well-capitalized” threshold and requested a waiver, this would often be granted provided the institution had a well defined plan and process in place. However, on a percentage basis, the number of approved waivers this year is significantly less than in years past, indicating either a toughening stance on enforcement, or perhaps the failure of institutions to articulate an effective funding plan.

Liquidity pool

“Look, the game’s different—the ability to access funds easily through various alternatives has changed,” he said. “The whole liquidity pool has shrunk, due to tightening standards and supply-

demand factors.”

The overall liquidity situation has become more serious over the past year, due to the credit crunch weighing down on institutions, he added. “Credit is clearly the number-one focus of examiners—but a close second cousin is liquidity.”

He explained that large industry players are now hoarding liquidity, thus putting pressure on prices and also on the smaller institutions in terms of the liquidity avenues available to them.

“You’ve got a number of the big players who are also concerned about the stability of their funding sources and the safety of their principal—right now, cash is king,” Guglielmo said.

Many institutions also are being challenged by Federal Home Loan Banks, as some have been tightening standards, increasing haircuts, and widening spreads. While much of the trend involving tightened liquidity is due to the big players’ issues, it generally is affecting everyone, he said.

“They (FHLBs) want to ensure they are managing in a safe and sound fashion as well, and are therefore being cautious to make sure they are lending to stronger banks and that banks can afford the borrowings,” he said.

Also, due to the current housing crisis in the U.S., market values of some underlying securities that banks were using as collateral

with the FHLBs have declined, causing in some cases margin calls and reduced borrowing limits, he explained.

To be sure, regulators have pointed out that the challenge of managing liquidity risks has become increasingly complex for community institutions in recent years, due to significant changes in the capital markets, consumer behaviors, and international market factors.

Most banks, thrifts and credit unions regularly use wholesale funding sources and off-balance sheet sources of liquidity, and nearly all have had to adjust to a decline in core deposit growth.

Significantly, in its guidance, the FDIC also placed some restrictions on high-rate deposits. Institutions that are “less than well capitalized” are precluded from offering deposit interest rates that are significantly higher than the prevailing rates in an institution’s normal market area or the national rate.

Institutions that use volatile, credit sensitive, or concentrated funding sources are generally expected to hold capital above regulatory minimum levels to compensate for the elevated levels of liquidity risk present in their operations, the FDIC said.

Individuals responsible for managing an institution’s liquidity should be familiar with all aspects of such restrictions and limitations set forth in FDIC regulations, the agency said.

Further, the guidance said that institutions must have contingency funding plans that outline practical and realistic funding alternatives which can be implemented as access to funding is reduced. The plans must include provisions for diversification of funding and capital-raising initiatives, and incorporate events that could rapidly

affect an institution’s liquidity.

It pointed out that funding decisions can be influenced by unplanned events, such as: the inability to fund asset growth; difficulty renewing or replacing funding as it matures; the exercise of options by customers to withdraw deposits or to draw down lines of credit; legal or operational risks; the demise of a business line; and market disruptions.

“The key issue is to make sure you understand your liquidity needs, your liquidity sources, and how they can be affected by various factors,” Guglielmo said.

Ensuring effectiveness

He said it’s prudent for institutions to evaluate the effectiveness of their liquidity risk management process. The ALCO should ensure that it has adequately determined:

- The amount of operational, reserve, and contingency liquidity that is available
- The accessibility of that liquidity and its relative cost
- The change in the need for liquidity and cash availability, in the event that economic or market conditions change
- The type of crisis or events that could affect operational needs
- Actions that would be taken during a liquidity crisis, and whether there is a sufficient early-warning system
- The adequacy of current controls and processes to ensure that action plans are successfully implemented

Guglielmo said that many community institutions are unprepared for closely adhering to the FDIC’s liquidity risk management guidelines.

“A lot of banks don’t have the

sufficient diversification of funding sources,” he said. “Right now, I think they’re kind of waking up with a hangover.”

Such institutions may have relied traditionally on one or two alternatives for obtaining liquidity. For example, some community institutions don’t utilize the repo market or Federal Home Loan Bank advances for funding, he said. “So as a result, they are not as well equipped as others who have more diversified funding sources.”

“There are a number of institutions that really don’t know how much liquidity they have available to them--so a lot of them don’t realize they have a problem until late in the game,” he added.

He suggested six steps that institutions should take to strengthen the liquidity risk-management process: determine how much liquidity you have; estimate how much you need; establish an early warning system; stress-test funding needs and availability; outline management’s response for liquidity events; and document your process and periodically test liquidity sources.

“Surprisingly, a lot of community institutions have not thought through this exercise,” he said.

Also, institutions must recognize that when they need liquidity the most is precisely the time when it’s most difficult to obtain. So it’s imperative to develop an effective liquidity contingency crisis plan. “A lot of banks are under-prepared,” Guglielmo said.

Interested FMS members may review the guidance on liquidity risk management in the FDIC section of the News Archive on the FMS Web site at www.fmsinc.org. 