Financial Managers
update
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Liquidity strategy

Institutions currently awash with liquidity

Many institutions are currently awash with liquidity, but most still don't have adequate mechanisms in place to react if liquidity suddenly becomes difficult to obtain again, an industry strategist warns.

The current environment is significantly different from just six months ago, when large industry players were hoarding liquidity, putting pressure on prices and smaller institutions' liquidity lines.

But community-based institutions still face significant liquidity-related risks today, and because of this examiners are "coming loaded for bear," says Mike Guglielmo, Managing Director, Darling Consulting Group, Newburyport, Mass.

"What we are finding is that a lot of institutions aren't prepared for the next potential liquidity event," Guglielmo said. Such crises could include significant pressures requiring banks, thrifts and credit unions to obtain additional funding in a hurry.

Lending opportunities

The current excess of liquidity is due in part to limited opportunities at institutions for making loans or investments.

"So they have a lot of cash building up—a lot of deposits are actually flowing in from a "flight-to-quality" type of situation going on right now," Guglielmo pointed out. "Given the state of the economy, people aren't necessarily knocking on their doors for loans these days, and a lot of institutions have tightened up their credit standards."

Significantly, the large volume of cash buildup in itself isn't necessarily beneficial for institutions experiencing such excesses, he said. "In many instances it's at a negative carry."

As a result, some institutions are looking to restructure their balance sheets, while others are trying to pay off borrowings and shrink. Still others are finding some "pockets of opportunities" to put the cash to work, he added.

Not surprisingly, the challenges of liquidity management and continuing credit risks in the current environment are "interconnected like never before," Guglielmo explained. "Credit risk issues haven't gone away—in fact, in some areas of the country, things could get worse before they get better."

"We're definitely not out of the woods yet," he added.

Commercial loans

While some of the problems that have been affecting residential loans don't seem as dire as they were a year ago, the situation involving commercial real estate (CRE) and other commercial and industrial loans remains questionable at best, Guglielmo said. "That could be the other shoe that drops—-and it could be ugly."

So, given such uncertainties, banking examiners are "taking it up a notch," as regulators issued interagency guidelines at the end of June, essentially establishing new standards for liquidity risk and funds management.

"The examiners are coming loaded for bear," Guglielmo said. For example, in recent months they've been spending a lot more time with institutions, evaluating liquidity risk management and funding practices. "And we're finding a lot of them expecting a lot more—what institutions were traditionally doing is no longer acceptable," he added.

A major concern of examiners today is aimed at the need to have some kind of forward-looking liquidity processes in place. "And a lot of institutions out there just don't do that—a lot of them rely on traditional, backward looking metrics," he said.

Examiners stress that institutions must more vigorously address:

- Liquidity forecasts
- Stress tests
- Robust liquidity contingency plans
- Risk monitoring

Regulators have indicated that specific areas of deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, a lack of meaningful cash-flow projections, and inadequate liquidity contingency plans.

continued on page 2

Liquidity from page 1

The recent interagency guidance also cautions that institutions which have had their liquidity supported by temporary government programs administered by the Treasury, Fed, or FDIC should not base liquidity strategies on the belief that such programs will remain in place indefinitely. (See *FMU*, July 21, 2009 for related details.)

Guglielmo said that given the emphasis by examiners on forward-thinking management, the first major item they want is effective liquidity forecasts—and many institutions have been falling down in this area.

"There are lots of institutions that don't forecast their future liquidity needs to the degree that they ought to," he said. They're not forecasting with sufficient detail, and they might not be looking out far enough into the future.

While examiners are saying that forecasts for needed cash must be projected a year into the future, Guglielmo believes that most institutions aren't equipped for that with any degree of accuracy. "I think, minimally, institutions need to look ahead about 90 days—and six months would be a decent time frame," he said.

While attempts by institutions to forecast more than six months into the future are difficult, he said that examiners nonetheless do make a good point in wanting a one-year timeline for evaluations. "But there are very few institutions, I think, that forecast out a year with accuracy and reliability," he added.

Secondly, once institutions adequately understand from the forecasts what their use of cash will be in the future, they must conduct a liquidity stress-test. "But for those that are doing liquidity forecasts, very few are actually stress testing those forecasts," Guglielmo noted.

However, due to the impact of recent exams, more are doing so, and he predicted that the role of liquidity stress testing could gradually take on significantly more importance within the industry.

"I think the liquidity-risk stress testing is going to take on as much importance as interest rate risk," he noted. "It's going to become one of the primary functions and discussions at ALCOs."

Third, institutions need to develop more robust liquidity contingency plans, based upon their forecasts and stress tests.

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Guglielmo noted that this issue remains very high on examiner priority lists, and while many institutions have been strengthening their contingency liquidity and funding plans, they still need to have "more meat on the bone." For example, such plans must be more substantive, and need to have more clearly defined responsibilities, timelines, and key internal and external contacts.

In addition, contingency plans also must include appropriate responses to different liquidity stress levels. For example, such plans need to be integrated with some form of monitoring process that provides an early-warning with "triggers."

Thus, if certain triggers are tripped off, this would prompt action of some form—such as a heightened level of discussion, heightened reporting, or corrective action. And the responses need to be more clearly defined, once a trigger goes off, Guglielmo said.

Fourth, liquidity risk monitoring systems must be improved in substantive ways. "From a risk management and monitoring perspective, institutions really need to get their house in order and make sure that they have updated processes in place that are going to minimally meet regulatory expectations—but more importantly, are prepared for the new business environment that we're now in," he said.

He explained that in addition to the challenges involved in terms of monitoring processes and controls, there is also the strategic side of how institutions best use liquidity—and thus, the next element involves being more proactive and implementing robust strategic funds management, policies and procedures.

Finally, Guglielmo offered CFOs and others some additional tips on best practices for liquidity risk management.

He said institutions that are most successful in meeting current examiner expectations will: maintain a detailed measuring and monitoring process that includes a comprehensive collateral inventory management process, accurate forecasts, and diversity in alternative funding sources; implement a liquidity stress-testing process that quantifies the ability to withstand both moderate and severe liquidity events; develop and monitor an early warning system that can detect issues before they become serious problems; and document and maintain a workable liquidity contingency plan for crisis implementation.

He suggested that senior managers should receive liquidity risk reports at least monthly, while the board should receive them at least quarterly—but institutions should have the ability to speed this up on short notice if the need arises. FMU

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Editor: Tom Lanning
toml@fmsinc.org, 312-630-3421