Liquidity Challenge

8 Questions to Ask, 6 Steps to Take

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Most banks can forecast what's going to happen on the loan side of the house fairly well, but deposit forecasting often leaves a great deal to be desired. And thus it is that liquidity, drawing strongly on deposit patterns, that represents one of the industry's biggest question marks.

That's especially because of evolutions on the funding side that have rendered liquidity harder to peg than ever, according to Michael R. Guglielmo, managing director at Darling Consulting Group, Inc., Newburyport, Mass., and speaker at a conference session entitled, "Liquidity Contingency Planning: Are you prepared?"

"Capital is the lifeblood of a bank," said Guglielmo, "but liquidity is the heart and soul."

Liquidity takes center stage

Guglielmo defines liquidity as follows: "the ability to raise cash quickly with minimal principal loss and at a reasonable cost."

Community bank funding poses an increasing challenge, Guglielmo said, at the same time that banks require greater need for balance sheet growth to sustain earnings. Banks face a limited supply of retail funding, and thus have developed a greater dependence on capital markets for funding, just as the capital markets sources have become less cut-and-dried source. Wholesale sources have grown more volatile in recent times. Regulators have become less enamored of certain banks leaning on brokered CDs and other wholesale funding sources, for example. Banks may face greater "haircuts" on collateral securing repurchase agreements, may face reduced access to Federal Home Loan Bank advances, and more.

Guglielmo pointed out that while regulators acknowledge the need and benefits of wholesale funding, they also see the necessity for more precise structuring of bank liabilities now that the blend has grown beyond traditional core deposits.

This comes at a time when the market for loan sales, notably mortgages, has been through a crippling metamorphosis. Guglielmo noted that the secondary market for many mortgage assets "evaporated in less than six month."

Eight questions to ask

As a result of shifting patterns, Guglielmo said, there has been a convergence of operational liquidity planning and contingency liquidity planning. Sources once regarded as measures for backup in unexpected exigencies are now also part of ordinary funding.

Unfortunately, he said, there is a lack of meaningful, forward-looking liquidity planning in many banks. Nowadays, he said, bankers have to conduct liquidity planning in an integrated fashion with planning for interest-rate risk, market risk, credit risk, budgeting and planning, policies, and processes and controls.

"Regulators want more formalized liquidity plans," said Guglielmo, "and you want to be able to justify your liquidity program."

The consultant presented eight key questions to ask, which lead into action steps. The questions:

1. How much liquidity do we have? Operational? Contingency?

2. How accessible is each source of liquidity, and what are the relative costs?

3. How much operational liquidity do we need, short-term and longer-term?

4. If market conditions change, how could our liquidity needs and cash availability change?

5. What crisis or events could markedly affect our operational needs and impede our access to reserves and/or contingency sources?

6. Do we have sufficient early warning systems that could prompt actions prior to a problem?

7. What actions could we take in the event of a liquidity crisis, and how long could we sustain operations?

8. Do we have adequate processes and controls in place that will ensure action plans will be executed successfully?

Six action steps to take

From those eight questions, Guglielmo moved to six steps bankers can take:

1. Determine how much liquidity you have.

Guglielmo noted that a fundamental flaw of most traditional measures of liquidity is that they look backwards.

Take the loan-to-deposit ratio—it's a historical measure, not forward looking. In addition, many traditional liquidity measures don't incorporate off-balance sheet sources of liquidity.

Guglielmo said an effective measurement process should include:

- Balance sheet liquidity—available cash and securities. This requires looking at liquid assets, such as unencumbered securities that aren't already collateralizing liquidity sources such as municipal deposits or repurchase agreements.

  This analysis must also look at short-term sources of liquidity that could disappear in a crisis, such as short-term deposits and Fed funds purchased. This evaluation must realistically consider how much of this liquidity would stick and how much would quickly depart.

- "Just-in-time inventory"—sources such as Federal Home Loan Bank funding. This analysis must consider how much is available, how much is already being used, and how much will remain available in tougher circumstances.

- A "strategic reserve"—sources tapped when necessary, such as reliable sources of brokered deposits. A fundamental measure here is the maximum level authorized by the bank's board, versus how much has been utilized already.

- "Catastrophe insurance"—sources such as the Federal Reserve. This piece also includes secondary collateral sources, such as corporate securities, equity securities, and municipal securities that can be readily sold or offered as collateral.

All of these considerations go into calculating the bank's "basic surplus" of liquidity. Compared to the bank's needs and potential needs, it will dictate what Guglielmo called the bank's "real world" liquidity.

This takes the bank's planning away from looking solely at cash-on-hand and cash flow. The bank doesn't want to have too much of its liquidity in cash, but must be able to count on realistic amounts of the other types. Furthermore, he warned, the outside sources must be based on established relationships, so the bank can realistically expect to go to those sources when needed. (He has more to say on this, further on.)

2. Estimate how much liquidity you need.

   Guglielmo said a bank must look forward, at its sources and uses of funds, to get a realistic handle on liquidity needs. He showed listeners a spreadsheet that contained both sources of cash and uses of it one month, two months, and further out. He noted that regulators nowadays like to see a six-month horizon in place. He said that at least a three-month horizon should be in place.

Further, Guglielmo said that the horizons should be considered in three contexts besides "normality." These are: "significant" liquidity crunch; "severe" liquidity crunch; and "doomsday," to use his labels.

"Examiners do want you to think about doomsday events," warned Guglielmo.

He asked bankers to consider how long their banks could maintain their activities if brokered CDs and other wholesale sources of funds went away.

3. Establish an early-warning system.

   No one ratio or approach is right for every bank, Guglielmo stressed. Banks must determine what measurements will serve as a warning to management and the board given each bank's own balance sheet and risk profile.

   In addition, no bank is an island; management must take into account both local and national market elements. He went through many potential ratios to consider. The ones that apply to the bank's circumstances should be gathered into a "scorecard" centralizing all of these factors and examining them in the three stress levels outlined above.

   "Get something on paper, and start to follow it, and learn from it," said Guglielmo.

   Among his recommendations for internal factors to consider: basic surplus ratios; borrowings-to-assets; brokered CDs-to-assets; liquidity gap; interest-rate-risk measures; capital ratios; deposit cash flows/decay; nonperforming loans/loans; chargeoffs/recoveries; growth rates; and loan-to-deposit ratio. Regarding the latter, a good point to keep an eye on is changes indicating heightened funding requirements. Also, look at deposit balances not connected to maturing deposits and at increasing usage of line of credit commitments. The speaker recommended many other such measurements.

   Among Guglielmo's recommendations for external factors to build into the scorecard: credit events; economic indicators; industry trends in nonperforming loans; market rates/volatility; credit spreads; geopolitical events; and natural catastrophes.

4. Stress-test your funding needs and availability.

   Guglielmo noted that while most banks stress-test their balance sheet for interest-rate risk, few stress-test for liquidity risk.

   Yet, he pointed out, "if your interest-rate risk process results in notable changes in cash flow and valuation, your liquidity sources and uses will change, too."

   Guglielmo covered key points to evaluate for liquidity stress.

One is potential changes in collateral values. If the market-value of a security that could be used, or is being used, to secure outside liquidity, were to fall, then this would have to be addressed to maintain or access liquidity with that instrument. Similarly, tightening standards by the sources of that liquidity must also be anticipated in various scenarios. The potential for having to sell or securitize loans at severe losses must be taken into account as well.

Another such factor: capital ratios. If capital takes a significant hit, that could affect the bank's ability to access the brokered CD market.

5. Outline management's responses to various situations.

   All the analyses outlined up to this point only matter in that they will drive preparation, and, in the event, action by management.

   Guglielmo recommended detailed action plans for various scenarios. These would include instructions on what will be done, who will handle each piece, who must be contacted internally and externally, and the anticipated timelines each plan will progress along.

   He recommended that larger organizations put together a Liquidity Crisis Team, which would meet periodically and report to the ALCO and the board on its preparations and activities.

   Through all of this, Guglielmo's watchword is: "Keep it simple and enhance the abilities over time."

6. Document your process, and periodically test sources.

   Regulators will want to see evidence of all the foregoing effort, as well as justification for the approaches taken. Guglielmo recommended using the document embodying all of this as the bank's liquidity playbook. And he suggested that key players inside and outside the bank be informed of what the bank has prepared.

And then, keep the approach real, not something on the shelf.

"I can't emphasize it enough," said Guglielmo. "Make sure you test your liquidity sources."

He warned that failing to do so will lead to what has already been seen, banks who called on their backup sources of liquidity, only to be greeted by a voice on the other end of the phone asking, "Who are you?"

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