Preparing for a New Era in Liquidity-Risk and Funds Management

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2009 is clearly emerging as a year of tumultuous change in the financial services industry. It seems like new problems, issues, challenges, and concerns emerge every day—many from unintended consequences driven by the bevy of political, accounting, regulatory, and auditing activities, rules, pronouncements, laws, and commentary.

More than ever, financial institution executives need to be engaged in the daily events and activities taking place throughout the industry and must proactively participate and react to the many debates and discussions taking place. Choosing to sit by idly on the sidelines and wait out the storm could prove disastrous. But with all the changes occurring, even the most resourceful are finding it hard to keep pace with the many twists and turns happening each and every day.

One of the areas in which significant change is afoot is in liquidity risk and funds management. The recent liquidity/credit crisis has led to a profound change in the wholesale funding landscape and an institution's ability to manage liquidity from both an operational and contingency standpoint.

As Wall Street works to overcome its problems and Washington continues to enact and implement changes meant to stabilize the industry and the economy as a whole, liquidity-risk managers are faced with an ever-changing landscape that requires constant attention and adjustment.

The bottom line: traditional operating philosophies, measurements, and management practices will no longer suffice, and the industry and regulators are actively developing and adopting more robust liquidity-risk management standards. Now is the time to become engaged in the process or become subject to potential unintended consequences.

New interagency guidance is here.

On June 30, 2009, the OCC, FRB, FDIC, OTS, and NCUA, in conjunction with the Conference of State Bank Examiners, issued a request for comments on a joint statement titled, *Interagency Guidance on Funding and Liquidity Risk Management*. This guidance represents a comprehensive expansion of the liquidity-risk measurement and management process, and institutions of all sizes and levels of complexity are going to be doing more than they ever have in the past.

So what does this new regulatory guidance call for? Here are the highlights:

- Projection of your future funding capacity and liquidity needs through detailed sources/uses forecasting
- Implementation of a stress-testing process that will allow your organization to quantify how your funding needs and availability might change under various states of duress
- Changes to traditional investment portfolio strategy, collateral management, and wholesale funding practices
- Adoption of an early-warning monitoring system that will allow you to identify issues before they become problems
- Expansion of policies, procedures, and risk guidelines along with documentation of liquidity-risk management strategies
- Development and more frequent review of a contingency funding plan
- Internal controls and independent validation of the liquidity-risk management process

While few institutions are experiencing a liquidity crisis at the moment, adoption of these new guidelines is going to take some considerable effort. And of course, the best time to fix the barn door is before the horses run out.

Fundamental changes in liquidity-risk management practices are expected.

As you reflect on your own process and the changes that are likely required, there are eight fundamental questions you and your ALCO should be able to answer:

1. *How much liquidity do we have for both operational and contingency purposes?* If you are relying on traditional (regulatory) ratios and measures, you are unable to really know. An effective measurement process will quantify your available liquidity and the various sources.
2. *How accessible is it and what are the relative costs?* It is important to maintain an up-to-date summary of funding availability, the level of accessibility, and the relative costs. Accessibility and pricing, especially in volatile times can vary dramatically, and it is crucial that you and your ALCO stay well informed of these issues or, consequently, find yourself without funding when you need it most.
3. *How much operational liquidity do we need short term and longer term?* An area where most institutions fall short is in forward-looking liquidity forecasting. It is also evident that the tools and information needed to forecast accurately need some work as well. ALM models are in need of refinement. Forecasting your future source and uses will soon become a mainstream liquidity management activity.
4. *If market conditions change, how could our liquidity needs and cash availability change?* Given the volatile marketplace within which we now operate, it is important to perform alternative simulations and "what if" exercises. Understanding your ability to withstand adverse conditions (financial, economic, reputational, etc.) needs to be an integral part of the ALCO process.
5. *What crisis or events could markedly affect our operational needs and impede our access to reserves and/or contingency sources?* Given the strong linkage liquidity now has with credit and capital, ALCOs or liquidity-risk management teams need to be cognizant of the growing list of potential events or conditions that could impede access to funding (temporarily or permanently) and discuss them regularly, as they can and will change.
6. *Do we have a sufficient early warning system that could prompt actions prior to a problem?* Adopting the use of a liquidity "scorecard" will allow you, your ALCO, and your board to keep an eye on conditions and trends that could foretell a growing liquidity

problem or crisis before it occurs. This would serve as the monitoring mechanism of your contingency funding plan.

7. *What actions would we take in the event of a liquidity crisis, and how long could we sustain operations?* Once you have an appreciation for the potential financial impact of moderate, significant, and severe liquidity events, it's time to develop a set of detailed action plans highlighting varying levels of response, expected results, and potential risks. This should be a quantitative and qualitative exercise that involves the personnel key to the execution of these action plans.
8. *Do we have adequate processes and controls in place that will ensure action plans will be executed successfully?* If your plans are not well documented, you will not only run the risk of regulatory scrutiny, but more importantly, risk poor or failed execution. Specific actions, contacts, individual roles and responsibilities, timelines, and communication protocols are some of the things that need to be documented.

You cannot be over prepared.

We have clearly entered a new era in liquidity-risk management, and now is the time to prepare yourself and your institution. In fact, it is not possible for you to be over-prepared. Liquidity forecasting, stress testing, collateral management, funding diversification, contingency planning, back-testing, documentation of processes and controls, accessibility testing: all are at the foundation of an effective liquidity-risk management process in today's environment.

The efforts and activities surrounding liquidity-risk management are destined to rival that of interest-rate risk management. Those institutions that properly invest the time and resources required will be best prepared for a future liquidity event, while those that don't may not be around for a second chance.

Looking forward.

While liquidity risk, credit risk, capital preservation, and earnings are at the top of financial institutions' and examiners' lists of concerns, a growing unease over potential increased exposure to rising interest rates is also brewing. It is important that the industry does not take its eye off the ball and one day wake-up to an interest-rate risk problem. Your internal or external

resources should already be preparing you and your institution for this next potential event. If they are not, they need to be directed to do so.

The world of financial services is changing rapidly, and the consequences of mistakes can be catastrophic. The role of your ALCO has never been more important. Its members must stay focused and become fully engaged in the growing labyrinth of challenges and changes taking place in the industry. To borrow a quote from Charles Darwin, "In the struggle for survival, the fittest win out at the expense of their rivals because they succeed in adapting themselves best to their environment."

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