Bank Asset/Liability Management

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Liquidity Management in Focus

A comprehensive liquidity measurement and management process allows management to ensure near-term cash flow needs are met, as well as to understand what would be required to withstand potentially adverse scenarios in the future. Does your process assess how much liquidity can be accessed quickly? Does it provide an indication of what kind of stress could potentially cause a strategic disadvantage? How was the liquidity measurement and management process received at the last exam? As rates have risen and industry liquidity has tightened, has your process become more robust? The answer to all of these questions should be yes. Otherwise, it is time to refocus a bit.

Operational Liquidity

Are metrics such as loan to deposit or non-core funding dependency ratios being used to determine liquidity levels? Looking at these ratios in isolation as the primary way to measure liquidity will most likely limit effective liquidity management. How much funding can be accessed when you need it, at reasonable rates, i.e. wholesale market rates) and without principal loss (meaning no requirement to sell assets)? Having a detailed approach to measuring operational liquidity that includes a hierarchy of liquidity sources will help answer that question. Focusing on traditional ratios will not.

A heightened focus is being placed on maintaining certain levels of cash and/or unencumbered security collateral (*on-balance sheet liquidity)*. Securities can be pledged and/ or borrowed against, so maintaining cash is not necessarily required. On-balance sheet liquidity is the starting point for liquidity management, but what is the right level of liquid assets?

This is not an easy question to answer and there are a number of variables that need to be considered in determining liquid asset levels. A good starting point requires quantification of all alternative funding sources. How much borrowing capacity is available based on loan collateral? Can funds be accessed through the brokered deposit market? Both are very reliable funding sources that can supplement the on-balance sheet liquidity to determine total liquidity levels. Calculating the total liquidity position will help answer the question of appropriate on-balance sheet liquidity based on your risk profile/appetite and growth plans. Once an inventory of liquidity resources is calculated, the next step is to project future loan growth/contraction over the near term (e.g. 90 days). With regard to the loan portfolio, what are the net funding needs over the quarter? Will this add or subtract from the current liquidity position?

What are the expectations for deposit activity? Understanding your depositors is not an easy task with the recent rise in rates and increase in deposit pricing pressure required

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just to retain funds in many markets. Analyzing potential volatility, recent inflows/outflows and balance changes within the deposit base is a good place to begin. Tracking account closures and attrition rates is another area to focus on and will give you a better understanding of the characteristics of your depositors.

Do you have significant amounts of large deposits or other concentrations? What are your plans for upcoming wholesale funding maturities? Answering these questions and calculating funding needs will determine if there will be excess cash or if cash is needed, which in turn impacts loan, investment and deposit pricing strategies.

Focus Through a Different Lens

As mentioned on the *Interagency Community Bank Teleconference: Liquidity and Funding Risk Management* in November 2017, first and foremost an institution must understand and be able to quantify its "cushion of liquid assets." This includes unencumbered and readily marketable securities that can be sold at little/no discount, FRB and correspondent bank deposits. Why is this important? Because of the perceived volatility of funding sources such as deposits in excess of insurance limits, deposits subject to prompt corrective action restrictions, deposits that are above national rate caps, and funding concentrations.

Contingency Liquidity Planning

Having a contingency funding plan (CFP) is imperative to total liquidity management and should complement the operational liquidity measurement process. The CFP will give you a clear understanding of the ability to withstand potential stresses. A robust CFP should have an early warning system to provide an indication of:

- The current liquidity position
- The trend of each component of liquidity
- A comparison of each ratio to policy, as applicable
- An overall risk assessment

Are the appropriate metrics monitored within the CFP? Are quantifiable metrics such as loan growth less deposit growth or wholesale funds to assets tracked? Is there a system in place to document recent events that could be detrimental to the liquidity position of the bank (e.g. negative publicity in local newspaper)? Again, the answer to these questions should be yes, or additional focus is needed.

Additionally, there should be documentation supporting your assessment of the liquidity position so all stakeholders understand if action needs to be taken or if the situation requires more frequent monitoring.

Stress Testing

Start with operational liquidity and incorporate projected cash flow on a forward-looking basis. This will provide a baseline to stress from. Some factors to consider in stressing your position are:

- Deposit decay, volatility, erosion of deposits or seasonality (make sure you can support!)
- Impact of restriction to wholesale funds
- Increased haircuts on collateral sources/lines of credit
- Balance sheet growth

It's also best practice to understand what it takes to *break the bank* from a liquidity perspective. Equally as important is having the flexibility in your CFP to model what it would take to survive that stress (i.e. modeling a remediation scenario).

Contingency Liquidity Focus Through a Different Lens

Per the *Interagency Guidance on Funding and Liquidity Risk Management* all plans must include:

1. A liquidity event management process – identifying key personnel in the event of liquidity stress
2. An early warning system with event triggers – biggest pitfall here has been lack of support for triggers
3. Stress Testing/Forecasting that includes:
   a. Bank specific scenarios
   b. Systemic or industry wide risks
   c. Appropriately timed stress – given nature of event
4. A periodic review process to ensure the CFP is appropriate

Other CFP Expectations

Stress tests need to be tailored to the institution. For example, if you regularly sell loans then there should be a scenario in which you model the liquidity impact of a market dislocation.

The CFP should also reference the sequence of funding usage for each stress modeled. Keep in mind, that sequence may differ based upon the projected stress. Periodically testing of funding sources is also expected.

Conclusion

The key to having a robust liquidity measurement and management process lies within the details of the operational and contingency funding plan. Taking inventory and quantifying all liquidity sources is the first step. Stress testing paints the picture of how strong your liquidity truly is and what steps would be taken in advance of a crisis occurring. Keep in mind, understanding the characteristics of the deposit base and having a handle on future loan demand is imperative to understanding liquidity. Robust liquidity management will allow for more informed strategic decisions and improve the overall strength of the institution. ***Focus on liquidity and improved liquidity processes will lead to improved earnings.***

— John Demeritt
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