FMS Update

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Staying Afloat

The importance of liquidity management

LIKE buoyancy on a boat, liquidity in many institutions tends to be one of those crucial yet simply assumed issues. "We're not sinking, so everything must be OK," is how the thinking often goes, meaning liquidity management doesn't really get discussed in much depth until there's a problem – by which point, of course, it may be too late to repair.

In the wake of the financial crisis, however, regulatory focus has once again turned to the topic of liquidity management practices in community institutions, causing many to reevaluate their procedures and practices as examiners begin to hone in on funding strategies, cash flow projections and liquidity risk policies.

"The financial crisis demonstrated the importance of liquidity risk management to the safety and soundness of the financial institution," says Christine Mills, a senior vice president and Director of Model Validations at McGuire Performance Solutions. "The key topics of regulatory guidance focused on providing a solid comprehensive framework for liquidity risk management, including sound governance, strategies and policies to manage liquidity, diversification of funding sources, adequate liquid asset buffers and comprehensive contingency funding plans."

Building the System

While every institution has some type of liquidity plan in place, the renewed regulatory attention is causing many to question whether what they've been doing is comprehensive enough. Mills says that while a liquidity model (incorporating all liquidity-related balance sheet behaviors) is generally the basis for the liquidity management function in a community institution, a more all-encompassing solution should include the following attributes as well:

- A comprehensive liquidity plan for day-to-day management
- Measures to identify both static and dynamic liquidity positions
- An early warning system to highlight potential or escalating risk
- An integrated contingency funding plan
- Stress testing

Such policies in the past may have gotten by with concise outlines, few documented implementation details and limited strategies, but Mills says that regulatory preferences these days favor far greater detail, more focused descriptions of expected conceptual and operational aspects and specific action plans. Therefore, she believes a modern liquidity policy should include key components such as effective corporate governance and lines of authority, priority-grouped liquidity sources (with a focus on diversification), an early warning system and a liquidity measurement system with well-defined static and dynamic risk limits.

"It is necessary to address both static measures for current positions presented with historical trends and also applied to forecast, along with dynamic measures such as coverage ratios," Mills says of this last component.

Mills also believes that community institutions should pay special attention to the liquidity models they employ. Like the ALM models from which they often flow, the effectiveness of a liquidity model is also heavily reliant on the assumptions that go into it, including loan delinquency and default outcomes, loan

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prepayments and paydowns, core deposit runoff, surge balances and CD changes.

Strategies and Contingency Funding

When it comes to strategies for managing liquidity risk, Mills believes the current regulatory environment is stressing the concept that more is better. Thus, an institution's liquidity management plan should not only include a comprehensive list of general procedures, but a number of pre-specified strategic responses to potential liquidity challenges as well. This is also where an early warning indicator system should come into play – a monthly look at trend analysis covering idiosyncratic quantitative and qualitative measures affecting liquidity, profitability, capital adequacy, growth and credit.

While an institution's liquidity policy offers guidance and procedures for day-to-day liquidity risk management amid normal business operations, it should also include a contingency funding plan to provide a documented framework for managing unexpected liquidity situations. The contingency funding plan will include components such as effective corporate governance and lines of authority, development of a crisis team and communication protocol, liquidity stress event severity levels, liquidity sources and an action plan for liquidity event management. Mills stresses that as important as it is for an institution to have a contingency funding plan, it should not be co-mingled with day-to-day liquidity policy – the contingency plan should only take over when a potential liquidity event has been identified.

Overall, in attempting to upgrade or reassess their liquidity management frameworks, Mills believes there are two specific areas where institutions should direct their attention.

"Community institutions should focus on one, developing a comprehensive early warning system, enabling the institution to be continuously aware of all factors that could potentially influence liquidity, and two, get a better understanding of their deposit bases," she notes. "This should include knowing seasonal or cyclical trends, distinguishing between price-sensitive and core clients and reviewing their deposit mixes to understand normal mix allocations in a pre-crisis rate environment." ■