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Three Key Liquidity Risk Management Reminders

BY DENNIS FALK



Liquidity management is always important for bankers, but especially during times like these. In addition to that, the government stimulus has created a situation where financial institutions are suddenly flush with liquidity. Yet, this is likely only for the short-term, as circumstances start to change. As such, it is imperative to stress-test your liquidity risk. You may be comfortable with liquidity risk, but it could still be helpful to review these reminders as you move forward.

Guidance. Liquidity risk refers to an institution's inability to meet its obligations, which ultimately threatens its overall safety and soundness. Regulators have provided specific guidance and resources to enable bankers to properly manage their liquidity risk. First and foremost, bankers should review the Office of the Comptroller of the Currency's Handbook — Safety and Soundness series and review the liquidity

section of that source. An excerpt from that source notes: "For all banks, the immediate and dire repercussions of insufficient liquidity makes liquidity risk management a key element in a bank's overall risk management structure."

Test various scenarios. Once you have reviewed the guidelines, it is time to stress-test your liquidity. There are several possible scenarios to consider as you do this, which will provide you with a better understanding of your bank's safety and soundness. A few you may want to include:

- Stimulus dollars will eventually shrink or dry up
- Economic times could get tougher, potentially resulting in deposit losses
- Higher use of credit lines may diminish current excess cash
- Loans defaulting and non-accrual loans could increase, resulting in decreased cash flows and risking

impairment to capital (i.e., potential defaults in balloon loans maturing in 12-24 months)

- Brokered deposits and wholesale funding may become more difficult to obtain
- Uninsured deposits may decline or start leaving the institution
- Secured and unsecured credit lines may diminish

Assess your liquidity risk. Your bank should take the time now to assess your liquidity risks. Assessing and stressing liquidity risk can be a lengthy process as you must evaluate your internal data compared to credit stressing, where readily available industry data is used. As you prepare for liquidity stress testing, remember to:

1. Understand and forecast your short-term and long-term liquidity needs
2. Closely analyze your secondary liquidity sources and stress those as well
3. Evaluate potential new or previously unused sources of liquidity
4. Use your stress analysis to develop a contingency funding plan

Now is the time to stress test not only your loan portfolios but also your liquidity. Once you have done that, you will feel more confident about the future and your next exam.

To continue this discussion or for more information, please contact Dennis Falk. [UNTY](mailto:dfalk@pcbb.com)

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