



Liquidity Check

Rising loan demand could test cash flow management

By Jim Reber

It's interesting how community banks' balance sheets travel through cycles. It takes a nimble management team indeed to account for all the dynamics of loan demand (or lack thereof), deposit fluxes, new regulations, investment cash flows and capital needs. In the old days (defined here as pre-2008), at least the business cycle had the good manners to turn roughly every five years.

Now, however, it really, truly does look like we're into an expanding economy for the first time in a full decade, muted though it may be. The FDIC has reported that loan demand for community banks grew a healthy 8.6 percent for all of 2014, which is the highest rate since 2008.

While the Federal Reserve ponders what its next move will be with regard to monetary policy, it may be high time for you and your management team to consider the condition of your community bank's liquidity policy and procedures. If your community bank is like most of the rest in the industry, it hasn't had to put that policy to work in the better part

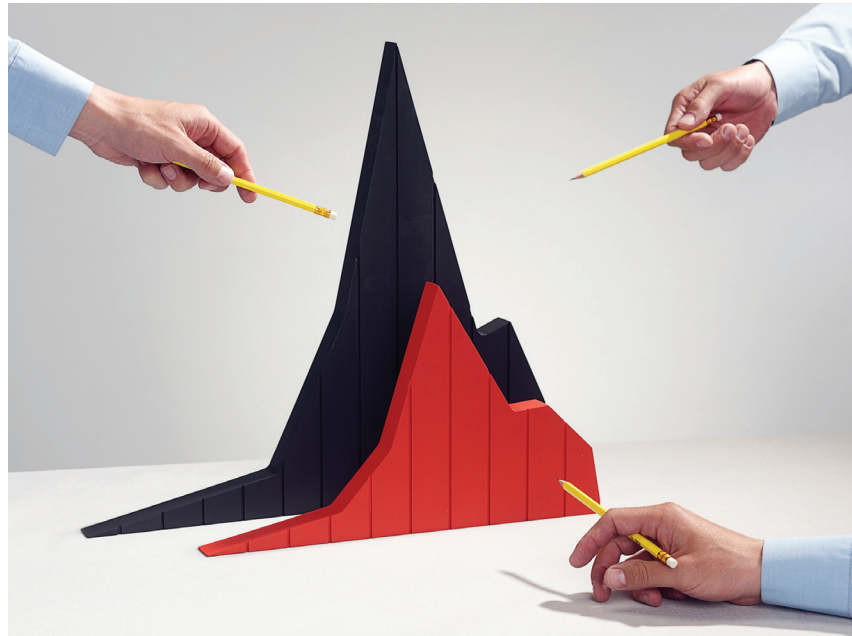


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of a decade. So let's review the best practices in brief and make some recommendations to ensure adequate funds are at your community bank's disposal.

Regulator expectations

The most recent regulatory guidance isn't recent at all. It's probably been assigned to the credenza with other middle-aged documents. The FFIEC issued a Joint Policy Statement on Funding and Liquidity Risk Management in March 2010, and it remains

the controlling document for that particular risk. The joint policy statement has two key themes: prudent liquidity management includes the ability to meet expected and unexpected cash flow needs; and a bank's financial condition can be compromised by a lack of a sound liquidity policy.

The agencies' statement helpfully also lists the five major components of effective liquidity management:

- » cash flow projections,
- » diversified funding sources,

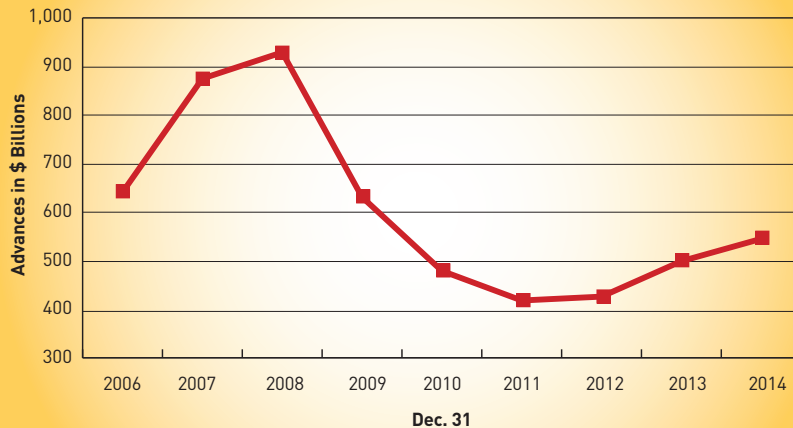
The policy should quantify what adequate liquidity means for your institution, what its sources are, and what Plans B and C are if 'contingencies' emerge.

Community Banking Matters

ICBA Securities' 2015 webinar series continues on June 17 with "Current Investment Strategies and Products." Vining Sparks Senior Vice President Greg Roll will be the speaker at 10 a.m. Central Time.

Visit www.icbasecurities.com to register for this free event.

FHLBank Advances Outstanding



Source: Federal Home Loan Bank System

- » stress testing,
- » a formal contingency funding plan, and
- » a cushion of liquid assets.

Need may be growing

As evidence that a cash crunch may be coming, we need only to consider two financial-services metrics. One is the absolute amount of mortgage loans securitized recently by Fannie Mae, Freddie Mac and Ginnie Mae. Those three issued a total of \$981 billion in mortgage-backed securities in 2014, which sounds like a lot. However, the numbers for the two prior years were \$1.6 trillion and \$1.7 trillion, respectively. The upshot of that is prepayments on mortgage-backed securities have already slowed dramatically, and they could slow even more if mortgage rates were to begin to rise. Your bank's investment portfolio could see a further drop in cash flow as a result.

The second metric of note is the volume of outstanding Federal Home Loan Bank advances. There has been adequate documentation of the collective shrinkage of the balance sheets of the various regional banks


since 2008. What may have missed your notice is that advances have actually increased for three consecutive years (see chart), and as of Dec. 31, 2014, were up a full 30 percent from 2011. What this illustrates is an industry (traditional banking) that is financing itself less with available cash and more with borrowings.

Portfolio benchmarks

What then should a community banker do about all this? The first most obvious suggestion is to make sure that a comprehensive liquidity policy is in place. The policy should quantify what adequate liquidity means for your institution, what its sources are, and what Plans B and C are if "contingencies" emerge.

As it relates to investment portfolio management, it has long been the recommendation of Vining Sparks to build a liquidity ladder out to eight quarters in the future. The aggregate cash flows from the investment portfolio in the next two years should equal about 15 percent of total assets. The number that is right for your community bank will be affected by variables such as seasonal

loan demand, stability of the deposit base, growth trajectory, capital levels and optionality in the investment portfolio.

Your asset-liability model provider and your community bank's brokers should be able to give you some handy advice regarding your bank's optimum liquidity level. Just as important, they can help construct a solid policy for any curveball that comes your way. It appears the business cycle for community banks is likely to serve one up. 

Liquidity Template

ICBA Securities' exclusively endorsed broker Vining Sparks has a number of tools available for community banks to use in building a robust liquidity policy. Included are a liquidity policy template, a sample contingency funding plan and training videos.

Contact your Vining Sparks sales rep or visit www.vining-sparks.com.