

The Great Liquidity Squeeze of 2017

Cash dries up as loan demand continues to grow

By Jim Reber

This article is in the be-careful-what-you-wish-for category: Community banks have returned to their traditional business model, after being in a figurative bunker for nearly a decade, and old issues have begun to arise.

Nationally, community banks' loans have expanded nearly eight percent since last year. This is over twice the rate of banking in general. Loans as a percentage of assets are at their highest level since 2009. What has been the result of these developments is that, in addition to improved earnings, the means for funding this demand is becoming a challenge.

To be sure, these are issues that a community banker would prefer to tackle compared to a slowdown in loan demand, or worse, a deterioration of credit quality. Still, since this is the first time in a decade that liquidity management has focused on finding adequate sources, instead of employing suitable uses, it's a worthwhile exercise to review the expectations and make some suggestions.

Rules are the same

The last time the coalition of bank examiners, the FFIEC, saw the need to publish a joint policy statement on the matter was way back in 2010 when it issued guidance on Funding and Liquidity Risk Management. In that Financial Institution Letter, the council identified six components of effective liquidity management:

- *Accurate cash flow projections
- *Diversification of funding sources
- *Stress testing
- *A formal contingency funding plan
- *A cushion of liquid assets, and
- *An early warning system

There is a good chance that your community bank has access to help in measuring your compliance with, or creating policies and procedures for, each of these criteria. For example, a sample liquidity policy is a standard document that any full service broker-dealer or consultant should have ready for your use. Also, interest rate models should assist in quantifying how much cash flow will naturally be available from the current mix of assets and liabilities, given an assumed future interest rate path.

Bonds for cash flow

If your community bank finds itself in a situation in which it is looking for more liquidity in the near future, there are a number of strategies relating to the investment portfolio that can be easily employed. And, we hasten to add, without any incremental risk to credit quality, your asset/liability posture, or your earnings.

First, you could purchase investments that have a high likelihood of being called within a year. These will be investments such as agency securities whose stated interest rates are above current levels, and have call dates in the near future. You will probably have to pay a price above par for them, in which case you will have bought a “cushion bond.” When the call date arrives, if your bond doesn’t get taken away from you, your investment yield will rise. Hence the cushion against rising rates.

A variation of this recipe is to buy a mortgage-backed security (MBS) that has a high enough borrowers’ rate (“Gross WAC”) to improve the chances that there will be some prepayment activity. Currently, a 15-year MBS with a Gross WAC of 4.00 percent or higher could see some near-term refinancing. Your brokers can find some candidates that check these boxes.

Other home-grown sources

You also may be surprised to learn that there is an active secondary market for high quality non-conforming loans. Many sellers of these loans have accumulated some type of concentration risk in their loan portfolios—interest rate, loan sector, and geographic are some examples. If your community bank has a homogenous set of \$5 million or more in performing credits, my recommendation is to have an intermediary work up an estimated price for your consideration. These transactions can be structured for the seller to either retain or release the servicing.

And don’t forget the wholesale funding option. Recently there have been opportunities to lock in rates on brokered deposits that are longer in duration and lower in cost than a lot of community banks can accomplish in their traditional footprint. And from the looks of the FHLB’s balance sheet, which now has more outstanding advances than at any time since 2009, a lot of your fellow community bankers have been availing themselves of that option once again.

To conclude, liquidity management has really come full circle in a decade. No longer are community banks awash in idle funds. We have, finally, found ourselves in a part of the business cycle in which a comprehensive liquidity policy should be ready to complement the needs of the core earning assets of the balance sheet.

[Sidebar]

Liquidity Policy Makeover

Vining Sparks, ICBA Securities' exclusive broker, is equipped to assist any community bank in developing a robust liquidity policy. Included is a policy template, customized cash flow reporting, and consultation on a contingency funding plan. For more information, contact your Vining Sparks sales rep or visit www.viningsparks.com.

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