

Advancing Your Success

A PUBLICATION OF THE HOME LOAN BANK OF DES MOINES

Fortify Your Liquidity Management Process...Now!

Over the past 12 months, deposit flows into insured financial institutions have dropped sharply. Whereas deposit growth for 2000 through 2003 was in the 5-7% range, estimates for growth in the last 12 months, excluding brokered CDs, are probably in the area of 2-4%.



By **George K. Darling**
*First published in
 BALM Newsletter,
 November Issue
 Also published in
 DCG Bulletin,
 December Issue*

This sharp decline in deposit growth, combined with the banking industry's need for asset growth to overcome margin compression and increasing operating costs, are heightening concerns within the industry and its regulators that funding

could be an emerging issue in the months and years ahead.

Forewarned is forearmed! Outlined below are some recommendations for improving a bank's liquidity management process using the Basic Surplus (Deficit) approach as a starting template. This article will review:

- Liquidity management concepts
- The Basic Surplus (Deficit) approach
- Recommendations for strengthening a bank's liquidity management process

Liquidity Management Concepts

Before discussions of any approach for liquidity measurement and management can begin, it is essential to obtain agreement on a definition of liquidity. For the purposes of this article, liquidity will be defined as: the ability of a financial institution to raise cash quickly (within 30 days) with minimal principal loss and at a reasonable cost.

Any financial organization must be able to assess its absolute ability to generate cash as outlined in the definition. In addition, any approach to measuring and managing liquidity should also answer the following questions:

- How is the liquidity portfolio invested? Is it earning an acceptable return?
- What is the financial institution's coverage for volatility of liabilities?



- What are the implications of the liquidity position for investment strategy, deposit pricing and the need for alternative funding sources?

Basic Surplus (Deficit) Approach

Exhibit I (see page 4) is an example of a typical Basic Surplus (Deficit) schedule. The first item on the schedule is the Total Asset size of the organization. This is a reference point for measurement purposes.

The next section of the Basic Surplus (Deficit) report is the Liquid Assets Section. This section is an inventory of the assets that can be converted to cash in the next 30 days either because: 1) they are cash equivalents (e.g. federal funds sold); 2) they can be sold without principal loss; 3) they can be pledged as collateral to facilitate borrowings; or 4) they have cash flow maturities within the next 30 days.

Cash and cash equivalents could be Federal funds sold, overnight investments at the Federal Home Loan Bank, money market mutual funds, etc.

Assets that can be sold quickly without principal loss include student loans, SBA loans (guaranteed portion) and the like. Assets that can be used as collateral for borrowing are primarily U.S. government

continued on page 2...

CONTENTS

Fortify Your Liquidity Management Process...Now! 1

Three New, One Returning Director Elected to Home Loan Bank Board 4

Nominations Bring Changes to Bank's Affordable Housing Advisory Council 5

Home Loan Bank Hits \$100 Million in Affordable Housing Program Grants Projects Receive \$6.2 Million in Funds for Second Round of 2004 7

Setting the Stage: Minimize Risk & Improve Your Profit 8

Fortify Your Liquidity Management Process...Now!

continued from page 1...

and agency securities and agency issued mortgage-backed securities (Fannie Maes, Freddie Macs, Ginnie Maes and the like). These assets are considered liquid, regardless of their classification, for accounting purposes (e.g. Held to Maturity [HTM] or Available for Sale [AFS]) since use as collateral does not require or constitute a sale.

Since assets that may be used for borrowing cannot already be pledged for other purposes, the balances of each asset category must be reduced by the amount of pledges already made. In addition, only the market value of pledgeable assets can be used in the calculation since all borrowing capacity would be based upon current market value.

Exhibit I (see page 4) shows that this bank can raise up to \$241 million within a 30 day period from existing cash, cash equivalents, through security based borrowings or through the sale of selected assets. It also shows that most of the liquid assets are fully invested, but there may be opportunity to improve yields on liquidity being carried in short-term assets (i.e. money market funds and reverse repos).

Once the liquid assets have been inventoried, it's necessary to identify and categorize the liabilities that might create liquidity exposure, particularly those that would arise should customers or lenders lose confidence in the financial stability of the bank. In Exhibit I, the following are shown as "Short-Term Liabilities":

■ Federal Funds Purchased and Unsecured Borrowings

- These are overnight, unsecured borrowings from other financial institutions. Because these are unsecured, they are extremely vulnerable to runoff in the event of a loss of confidence. Coverage for runoff should always be maintained at 100%.

■ Deposit Coverage

- Percentage of CDs maturing in less than 30 days – This bank assumes that 25% of all CDs maturing in the next 30 days would not be renewed if the public lost confidence in the bank.
- Percentage of all non-maturity deposits – Although the volatility of the bank's core deposits is difficult to estimate, this bank assumes that 10% of all non-maturity deposits would be at risk if the public lost confidence in the bank.

To calculate the Basic Surplus (excess liquidity) or the Basic Deficit (liquidity shortfall), short-term liabilities are subtracted from liquid assets. In the example shown in Exhibit I, the Basic Surplus is \$199 million which equals 25.6% of the bank's assets. In the event of a liquidity run, the bank could cover outflows of deposits in excess of short-term liabilities depicted in Exhibit I by the equivalent of 25.6% of the balance sheet. Alternatively, the bank could fund balance sheet growth of 25.6% without raising new deposits and still have coverage for \$42 million of deposit volatility.

The Core Basic Surplus (Deficit) in Exhibit I reflects the liquidity on the balance sheet that could be accessed through multiple sources including brokerage firms, the Federal Home Loan Bank (FHLB) (excluding loan collateral), etc. This Core Basic Surplus can be enhanced through additional borrowings at FHLB using loans as collateral. In this example, the bank has an additional \$98.4 million of loan collateral available which increases the Total Basic Surplus to \$297.4 million (38.3% of assets).

Consider the Total Basic Surplus with Federal Home Loan Bank as the primary policy target. Think of liquidity at this level as the "just-in-time" inventory of the financial institution since the Federal Home Loan Bank has always proven its availability.

Finally, Exhibit I outlines other funding sources available to the bank. These sources include: access to the brokered CD market based upon 10% of assets (\$77.7 million), a small federal funds line of \$7.5 million and additional loan collateral of \$100 million pledged at the district Federal Reserve Bank.



Recommendations for Strengthening the Process

The Basic Surplus (Deficit) approach described above has been effectively used for the last 20 years by financial institutions throughout the U.S. and the world to manage their liquidity and funding. This measurement, when combined with a cash flow forecast of 90 to 180 days, will provide most financial institutions with the tools needed for their liquidity management process.

However, there are a number of things that can improve the utilization of this measurement tool that are outlined below:

- 1. Consider the Total Basic Surplus with Federal Home Loan Bank as the primary policy target.** Think of liquidity at this level as the “just-in-time” inventory of the financial institution since the Federal Home Loan Bank has always proven its availability.
- 2. Consider brokered CDs as the bank’s strategic reserve.** Access the brokered CD market when the “just-in-time” inventory begins to drop to levels below the policy guideline. Brokered CDs could be issued to pay down FHLB borrowings and increase the “just-in-time” inventory.
- 3. Establish borrowing arrangements with the district Federal Reserve Bank (FRB) under the Borrower in Custody program or with collateral that cannot be used to support borrowings elsewhere.** This collateral could include indirect auto loans, commercial loans, corporate or municipal securities, etc. Consider the FRB as the bank’s catastrophe insurance in the event of a systemic liquidity crisis in which the Federal Home Loan Bank or brokered CD markets are not available.

Conclusion

As deposit growth slows, operating expenses increase and margins continue to narrow, there is no question that funding the asset growth of the banking industry will become more challenging. All financial institutions need an approach and a plan for managing liquidity and funding that is practical and provides safeguards against a systemic liquidity crisis. Adopting the Basic Surplus (Deficit) approach, utilizing the Federal Home Loan Bank and brokered CD markets effectively, and having the FRB as the ultimate backstop should provide a financial institution with a liquidity management process that will allow it to avoid funding problems in the future.

continued on page 4...

Fortify Your Liquidity Management Process...Now!

continued from page 3...

EXHIBIT I
Sample Bank
Basic Surplus (30-Day)
As of June 30, 2004
(000s)

TOTAL ASSETS:	\$ 776,944
LIQUID ASSETS:	\$ 110
Federal Funds Sold/FHLB Overnight*	

Security Collateral:	US Govt & Agency**	MBS & CMOs** (less 5% haircut)
Market Value	\$ 14,430	\$ 188,410
Less Pledged to:		
Retail Repos, TT&L, etc.	(\$6,960)	(\$2,104)
Wholesale Repos	\$ 0	\$ 0
Municipal Deposits	\$ 0	\$ 0
FHLB Borrowings	\$ 0	\$ 0
Subtotal	\$ 7,470	\$ 186,306

Net Unencumbered Security Collateral	\$ 193,776
Over Collateralized Position	\$ 3,534
Govt & Agency Guaranteed Loans (SBA, SLMA, etc.)	\$ 0
Maturities/Cash Flow from Non-qualifying Security Collateral (<30 days)	\$ 38
Other Liquid Assets (Money Market Fund, Reverse Repurchase Agreements)	\$ 43,706
Total Liquid Assets	\$ 241,164

SHORT TERM LIABILITIES

Federal Fund Purchased and Unsecured Borrowings*	\$ 0	
Deposit Coverage		
25% of CD's maturing (30 days)***	\$ 4,943	} 71.1% of Deposits
10% of Non-maturity Deposits (DDA, NOW, Savings, MMDA)	\$ 37,197	
Total Short Term Liabilities	\$42,140	

CORE BASIC SURPLUS (DEFICIT)	\$ 199,024
% of Total Assets	25.6%
TOTAL BASIC SURPLUS w/FHLB	\$ 297,409
% of Total Assets w/FHLB	38.3%
TOTAL BASIC SURPLUS w/FHLB & Brokered	\$ 375,103
% of Total Assets w/FHLB & Brokered	48.3%

Other Items:	Outstanding	Available	Market Value
■ FHLB Borrowings	\$ 113,797	\$ 98,385	//////////
■ Brokered CD's****	\$ 0	\$ 77,694	//////////
■ FRB – BIC	\$ 0	\$ 100,000	//////////
■ Fed Funds Lines	\$ 0	\$ 7,500	//////////
■ Corporate Securities (MV>BV)	//////////	//////////	\$ 17,708
■ Municipal Securities (MV>BV)	\$ 0	\$ 8,406	\$ 8,406

* Use average balance if wide fluctuations in daily volumes
 ** Use market value of these securities. The entire "free" portfolio should be used regardless of maturities.
 *** Estimate volatile portion of each liability type.
 **** Based upon policy of 10% of assets.

Three New, One Returning Director Elected to Home Loan Bank Board

As a result of the 2004 director elections held in November, three new members were elected and one current member was re-elected to serve on the Federal Home Loan Bank of Des Moines' board of directors. We are pleased to announce that Randy Newman will continue his service and that Sam Bryan Cook, Michael J. Finley and Kevin E. Pietrini will join our board as new directors. Each director will serve a three-year term beginning January 1, 2005.

Sam Bryan Cook



Sam Bryan Cook
 Chairman & CEO
 First National Bank
 of St. Louis
 St. Louis, Missouri

For nearly 15 years, Sam Bryan Cook has held his current position as chairman and chief executive officer of First National Bank of St. Louis in St. Louis, Missouri. He also serves as chairman of Guaranty Trust

Company in St. Louis and president and chief operating officer of Central Bancompany in Jefferson City, Missouri. Mr. Cook serves on the board of directors of the St. Louis Club, Salvation Army, St. Louis Art Museum, St. Louis Zoo and Boy Scouts of America.

Michael J. Finley

Michael J. Finley, president of Janesville State Bank in Janesville, Minnesota, has over 25 years of experience in the banking industry. In 1982, he moved back to his hometown of Janesville and accepted a



Michael J. Finley
President
Janesville State Bank
Janesville, Minnesota

position as cashier and loan officer at Janesville State Bank. He became president of the bank in 1995. Mr. Finley currently sits on the board of directors for the Independent

Community Bankers of Minnesota and on the Minnesota Bankers Association Political Action Committee Board.

Kevin E. Pietrini



Kevin E. Pietrini
Chairman, President & CEO
Queen City Federal Savings Bank
Virginia, Minnesota

In 1978, Kevin E. Pietrini joined Queen City Federal Savings Bank (QCF) in Virginia, Minnesota. He currently serves as president, chief executive officer and chairman of the organization. In

addition to his responsibilities at QCF, Mr. Pietrini also serves as president, chief executive officer and chairman of Queen City Federal Bancorp, Inc. Created in 1995 and headquartered in Virginia, Minnesota, Queen City Federal Bancorp, Inc. is a stock unitary thrift holding company. Mr. Pietrini also serves on the board of directors of America's Community Bankers and the Minnesota League of Savings & Community Bankers.

Randy L. Newman

Randy L. Newman, chairman and chief executive officer of Alerus Financial Corporation in Grand Forks, North Dakota, was re-elected to his third, and final, term on the Bank's board. Mr. Newman joined Alerus Financial (previously First National



Randy L. Newman
Chairman & CEO
Alerus Financial
Grand Forks,
North Dakota

Bank North Dakota) in 1981 and was named chief financial officer and president in 1987 and chairman/CEO in 1997. Mr. Newman is chairman of the University of North Dakota Center for Innovation and the North Dakota Rhodes Scholar Selection Committee. He is also chairman of the Home Loan Bank's board of directors. Mr. Newman was elected to a two-year term as chairman effective January 1, 2004.

We would like to take the opportunity to say thank you to our retiring industry directors, Charles R. Brazeale, president and CEO, The Paris National Bank, Paris, Missouri and Charles L. Cavanagh, chairman and president, United Community Bank, Perham, Minnesota. We appreciated their diligent guidance and dedicated service to the Bank.

Nominations Bring Changes to Bank's Affordable Housing Advisory Council

Open seats on the Home Loan Bank's Affordable Housing Advisory Council (AHAC) were recently filled with six new members and two returning members. Vanessa Baker-Latimer, Freddie L. Davis-English, Erica A. Dobreff, Lynn Fundingsland, Linda S. Morgan and Donovan D. Mouton were nominated to their first terms on the council while Zoe LeBeau and James Schmidt will return for their second and third terms respectively.

Bank North Dakota) in 1981 and was named chief financial officer and president in 1987 and chairman/CEO in 1997.

Mr. Newman is chairman of the University of North Dakota Center for Innovation and the

Ms. Dobreff, Mr. Fundingsland and Ms. Morgan will serve one-year terms while the remaining new members will serve three-year terms.

Vanessa Baker-Latimer



Vanessa Baker-Latimer
Housing Coordinator
City of Ames Planning & Housing Department
Ames, Iowa

Vanessa Baker-Latimer has 23 years of experience working for the city of Ames, Iowa. She is currently the housing coordinator in the Planning and Housing Department. In

addition to serving as a liaison for the city, Ms. Baker-Latimer is also responsible for preparation and management of a \$2.5 million budget as well as grant writing and administration. She is a member of the National and State Association of Housing and Redevelopment Officials and the State Housing Trust Fund Advisory Group.

Freddie L. Davis-English



Freddie L. Davis-English
Division Manager
Hennepin County
Community Corrections
Minneapolis, Minnesota

For more than 34 years, Freddie L. Davis-English has been employed by the Hennepin County Department of Community Corrections in Minneapolis, Minnesota. She has held a variety of positions with

the organization and currently manages and coordinates female programming for the Hennepin County Department of Community Corrections. Ms. Davis-English is also chair of the board of directors for

continued on page 6...

Affordable Housing Advisory Council

continued from page 5...

YouthLink, Inc. and a member of the Minnesota Supreme Court Race Bias Implementation Committee.

Erica A. Dobreff



Erica A. Dobreff has 32 years of housing and community development experience. For nearly four years, she has held her current position as executive director of the Missouri

Erica A. Dobreff
Executive Director
Missouri Housing
Development
Commission
Kansas City, Missouri

Housing Development Commission in Kansas City. She is responsible for the financial strength of the organization as well as the range of programs administered by the state housing finance agency. Ms. Dobreff is a member of Missouri's Committee to End Chronic Homelessness and the National Council of State Housing Agencies.

Lynn Fundingsland



Lynn Fundingsland has been the executive director of the Fargo Housing & Redevelopment Authority (FHRA) in North Dakota for almost six years. He is responsible for 725 units of

Lynn Fundingsland
Executive Director
Fargo Housing &
Redevelopment
Authority
Fargo, North Dakota

assisted housing and 1,200 Section 8 vouchers along with various tenant assistance programs. Since 2000, Mr. Fundingsland has also served as

executive director of Beyond Shelter, Inc., FHRA's non-profit development affiliate.

Linda S. Morgan



Linda S. Morgan
Executive Director
Iowa Heartland Habitat
for Humanity
Waterloo, Iowa

After working as a volunteer for 13 years with Habitat for Humanity, Linda became executive director of Iowa Heartland Habitat for Humanity (IH HFH) in 2002. IH HFH serves a two county area

of Iowa with a population of 150,000 people. Ms. Morgan is also an agency member on the board for the Low Income Housing Coalition and a member of the City of Cedar Falls Housing Commission.

Donovan D. Mouton



Donovan D. Mouton
Director of Urban Affairs
Office of the Mayor
Kansas City, Missouri

Donovan D. Mouton has served as Mayor Kay Barnes' chief community reinvestment and housing development advocate and director of Urban Affairs since 1999. Mr. Mouton

assists the Mayor's office in developing and implementing strategies for the improvement of Kansas City neighborhoods and in resolving neighborhood-related issues. He also serves as the Mayor's liaison to various city departments, mayoral commissions and committees and several community groups.

Zoe LeBeau



Zoe LeBeau
*Co-Executive
Development Director*
Women's Community
Development
Organization, Inc.
Duluth, Minnesota

Zoe LeBeau has served as the co-executive development director for the Women's Community Development Organization, Inc. in Duluth, Minnesota for nearly six years. Ms. LeBeau's responsibilities include fundraising for on-going

organizational operations and services as well as housing and economic development projects. She also raises and manages a yearly organizational budget. Ms. LeBeau is active in the Affordable Housing Coalition's Homeless Sub-Committee as well as the At Home in Duluth Community Collaborative.

James Schmidt



James Schmidt
Executive Director
Sioux Empire Housing
Partnership
Sioux Falls, South Dakota

For almost eight years, James Schmidt has served as executive director of the Sioux Empire Housing Partnership in Sioux Falls, South Dakota. Mr. Schmidt is responsible for the overall operations

of the organization. He also recently received the South Dakota Housing Development Authority's 2004 Friend of Housing Award.

The Affordable Housing Advisory Council is a 15-member group that advises the Bank and its board of directors on housing and economic development programs and needs. The Council is comprised of a diverse group of people from across our five-state district that have an extensive housing and economic development background.

Home Loan Bank Hits \$100 Million in Affordable Housing Program Grants

Projects Receive \$6.2 Million in Funds for Second Round of 2004

The Federal Home Loan Bank of Des Moines has reached the \$100 million mark in Affordable Housing Program grants! More than 800 projects throughout the Bank's five-state district have received funds to create over 28,000 units of affordable housing since the program's inception in 1990. This equates to nearly \$816 million in total development costs for the Bank's District.

For the second round of 2004 alone, 33 projects received \$6.2 million in grants which will help fund low-income, single-family or multifamily rental or homeownership initiatives. The projects will target populations at or below 80 percent of the area median income, creating more than 1,300 housing units for very low, low and moderate-income households.

"The Affordable Housing Program is just one way the Bank shows its commitment to our members and the communities we serve," commented Home Loan Bank President and CEO Pat Conway. "We take pride in announcing that we've awarded over \$100 million in grants to help thousands of individuals and families secure safe, affordable rental housing or realize the American Dream of homeownership."

The statewide breakdown of grants for the second round of 2004 is as follows:

	PROJECTS	GRANTS	AHP UNITS	DEVELOPMENT COSTS
Iowa	4	\$454,000	159	\$1.1 M
Minnesota	14	\$2.8 M	524	\$51.5 M
Missouri	4	\$470,000	72	\$1.7 M
North Dakota	0	\$0	0	\$0
South Dakota	6	\$1.5 M	417	\$21.8 M
Out of District	5	\$994,965	149	\$18.7 M
Total	33	\$6.2 M	1,321	\$95.0 M

The statewide breakdown of grants since the program's inception in 1990 is as follows:

	PROJECTS	GRANTS	AHP UNITS	DEVELOPMENT COSTS
Iowa	221	\$24.4 M	6,865	\$258.6 M
Minnesota	283	\$37.0 M	9,922	\$307.1 M
Missouri	151	\$20.0 M	6,223	\$137.6 M
North Dakota	36	\$4.9 M	1,208	\$23.6 M
South Dakota	84	\$11.5 M	2,330	\$46.7 M
Out of District	43	\$5.9 M	1,537	\$42.3 M
Total	818	\$103.7 M	28,085	\$815.8 M

For more information about the Affordable Housing Program and the next competitive round, contact the Home Loan Bank at 800.544.3452, ext. 1173. You can find a complete listing of the most recent round of grant recipients and the 2005 AHP application on the Bank's website at www.fhlbdm.com.

2005 AHP Application Deadlines
April 1 and October 3

Setting the Stage: Minimize Risk & Improve Your Profit

Curtain up! Hit the lights!

The Home Loan Bank of Des Moines 2005 Annual Spring Regional Workshop productions are coming to a "theater" near you. Please join us at one of our assemblies featuring financial players from EPG, Incorporated and US Banking Alliance.

The cast includes performances that will help you set a profitable financial management platform. The first act features a proven strategy focused asset/liability management process. Act two shares a practical approach for maximizing net interest income and expanding your institution's core customer base. Join us and learn how to set the stage for your future financial success.

Act I

"Best Practices" Approach to Maximize the Risk/Return Relationship

David L. Thomas
President
EPG, Incorporated
Boston, Massachusetts

Janet Frankl-Lockwood
Senior Vice President
EPG, Incorporated
Boston, Massachusetts

Act II

Loan Pricing for Profitable Growth

Mitchell Epstein
Managing Partner
US Banking Alliance (USBA)
Roswell, Georgia

Dates & Locations

March 8
St. Louis, MO

March 9
Springfield, MO

March 10
Overland Park, KS

April 12
Sioux Falls, SD

April 14
Cedar Rapids, IA

April 27
Des Moines, IA

May 17
Fargo, ND

May 18
St. Cloud, MN

May 19
Owatonna, MN

Register today at www.fhlbdm.com or contact Erin Whalen at 800.544.3452, ext. 1159!



Advancing Your Success

907 WALNUT STREET
DES MOINES, IOWA 50309-3501
www.fhlbdm.com

Advancing Your Success is a publication of the Home Loan Bank of Des Moines. We encourage correspondence and communication.

Nichola K. Schissel
Vice President of Public Affairs and Communications

Madge E. Cremer
Corporate Communications Project Manager

Angela M. Richards
Public Relations Coordinator

Send correspondence to:

Angie Richards
Home Loan Bank of Des Moines
907 Walnut Street
Des Moines, Iowa 50309-3501
1.800.544.3452, ext. 1014
email: arichards@fhlbdm.com