

DALE SHELLER
The Baker Group
Associate Partner
800.937.2257
dsheller@gobaker.com

Liquidity Risk Management

More Than Checking a Box

The recent bank failures of Silicon Valley Bank and Signature Bank have shown that liquidity risk can produce a bank failure instantly versus a slower, asset quality-related failure. These liquidity-related failures put a level of fear and panic into the banking industry during a time when the Federal Reserve increased interest rates at an unpreceded pace and magnitude.

The recent actions of the Federal Reserve have quickly reversed liquidity out of the banking system and tightened the level of liquidity across many institutions. Liquidity risk management and contingency funding planning should no longer be seen as a box that needs to be checked off. The recent bank failures, the reduction of on-balance sheet liquidity and stiff competition for deposits has made liquidity risk management a priority with the regulators.

Deposit Competition
During the height of the pandemic, institutions were drowning in deposits and excess liquidity. But after 475 basis points of tightening from the Federal Reserve in a 12-month period, the battle for deposits ensued.

Most are playing defense when it comes to deposit gathering, meaning they are focused on the retention of existing deposits rather than bringing in new money. Getting a handle on the best deposit strategy for your institution is key in managing your cost of funds and protecting your net interest margin. Utilizing a prudent level of wholesale funding can and should be a powerful tool in your asset/liability management toolbox to manage liquidity and margin.

Contingency Funding Plan
A well-designed contingency funding plan (CFP) can help institutions avoid a liquidity crisis, or at least minimize the damage if one does occur.

Now is the time to dust off your current CFP to ensure it is updated for your institution's current balance sheet, risk exposure and funding needs. Many institutions bring their policies and plans to their board of directors each year for annual approval. In some instances, updates have occurred during the prior year.

Your CFP should include recent updates considering the current interest rate and liquidity environment in which the industry is operating. Understanding how the balance sheet has changed over the last year is an important consideration when starting the CFP review process. For many, the last 12 months have drastically changed their level of balance

... continued on page 2

April 14, 2023

Dale has been at The Baker Group since 2015 and previously worked for the Federal Deposit Insurance Corporation. He earned his master's degree from Oklahoma State University. Contact him today.

sheet liquidity and put increased pressure on their deposit base and overall funding needs.

Contingent Liquidity Sources

As a rule of thumb, it is never bad to have more avenues to add liquidity to the balance sheet at a moment's notice. Identification of potential funding sources for shortfalls that result from stress scenarios is a key component of an adequate CFP. Institutions that rely on unsecured borrowings for their contingency funding need to consider how borrowing capacity may be affected by an institution-specific or market-wide disruption.

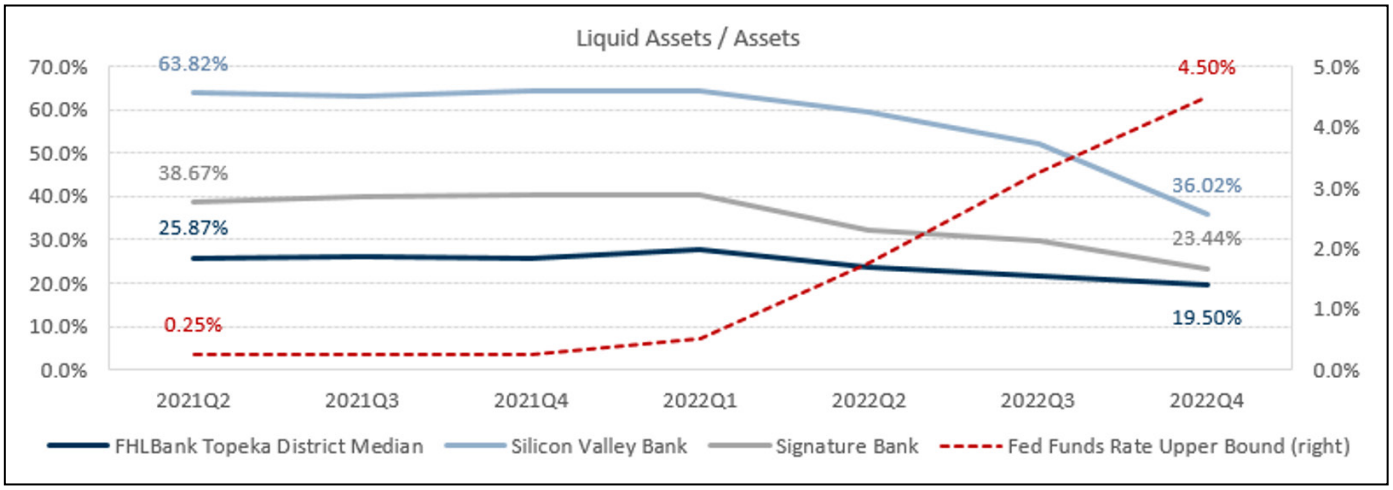
Many institutions are members of the Federal Home Loan Bank (FHLBank) System and pledge various assets as collateral to borrow money from FHLBank. FHLBank is a reliable source of funding, and many should consider pledging more collateral to increase their borrowing capacity. A best practice is to test those lines at least annually, if not more frequently in today's environment and to document the testing of those lines.

Liquidity Cash Flow Modeling

Silicon Valley Bank and Signature Bank's static liquid assets ratio looked okay on paper, but it clearly didn't tell the entire liquidity risk story. Their unrealized bond losses "locked up" a portion of their on-balance sheet liquidity as selling some of their underwater securities proved to be costly and appeared to create the initial panic.

Your institution's current liquidity reporting may not be adequate given some of the potential risks in the current environment. Historically, many financial institutions used single point in-time measurements to assess their liquidity position. The chart below shows the recent history of one of the most common static liquidity ratios, Liquid Assets to Total Assets, for Silicon Valley Bank, Signature Bank and the median for FHLBank Topeka members.

The graph shows a typical trend of declining liquidity during a Fed tightening policy. However, nothing seems to "flash red" using traditional benchmarks. In fact, both Silicon Valley Bank and Signature Bank had higher liquidity ratios than the median for FHLBank Topeka members. That's certainly the case with Silicon Valley Bank's relatively "strong" 36% ratio.



... continued on page 3

The takeaway is that while static liquidity measures can provide valuable information, cash flow forecasting (sources or uses of funds reporting) can enhance a financial institution's ability to manage and monitor liquidity risk. The complexity of liquidity cash flow forecasting models can range from the use of a simple spreadsheet to more comprehensive liquidity risk models.

Liquidity Stress Testing

You should expect a regulatory focus on liquidity stress testing for the foreseeable future. Liquidity stress testing is typically done by utilizing your liquidity cash flow model and changing various assumptions in the base case scenario. Institutions should conduct stress tests regularly for a variety of institution-specific and market-wide events across multiple time horizons.

The results of liquidity stress testing should play a role in shaping the institution's contingency funding planning. When in doubt, think about high impact and low probability type of scenarios. It isn't what you expect to happen, but what could possibly happen, even if the chance is remote.

In today's environment, liquidity risk and liability management can no longer be overlooked or ignored. Now is the time to dust off your CFP, liquidity monitoring tools and stress-testing procedures to ensure you have the best risk management practices in place.

Contact your regional account manager to discuss liquidity planning.

☎ 800.809.2733 ✉ www.fhlbtopeka.com/contact