Modern Liquidity Considerations

Revisiting outdated loan-to-deposit/share ratios

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The high-profile bank failures in March 2023 demonstrated that static measures of liquidity are not accurate representations of an institution's true liquidity position. The ability to generate cash at a reasonable cost without loss of principal turned out to be the most important liquidity test. It's time to revisit long-standing, past measures of liquidity and consider whether they continue to make sense in today's banking environment.

As extensively evaluated in the white paper, Exposing the Fallacy of the Loan-to-Deposit/Share Ratio, the loan-to-deposit/share ratio has run its course as an appropriate liquidity metric. The industry is moving toward a more dynamic evaluation of liquidity that considers cash flows as they relate to the balance sheet and their role in an institution's business plan or strategy. This is a shift away from ratio analysis as the predominant liquidity measure.

Long-term and short-term trends are transforming the face of bank funding and liquidity management. Loan growth has outpaced deposit growth over the years and the availability of alternative funding sources has expanded dramatically. Consumer preferences have changed, and the number of "savings" and "investment" options have increased. The competition for wallet share has intensified with advancements in technology as the ability to move money is now almost instantaneous. Generational shifts are also challenging the historic banking model. Although the number of brick-and-mortar financial institutions has diminished, the emergence of fintech and non-bank platforms has resulted in more non-traditional competitors – on both the loan and deposit side.

The collapse of Silicon Valley Bank brought widespread attention to the banking space and ignited consumer concerns with deposit insurance. Additionally, the opportunity for consumers to take advantage of rising rates was realized as funds began to migrate to alternative high-yielding investments such as money market funds, Treasuries and money center accounts. The pressure to retain existing deposits, competing on rate while adhering to sound liquidity risk management practices, was exacerbated in an already tough funding environment.

Given the new normal of market dynamics, flexibility in utilizing traditional measures of liquidity – such as the loan-to-deposit/share ratio – is crucial. As an institution wrestles with competing for solid loan credits that lead to potentially lower spreads and/or maybe having to pass on a new lending relationship because

... continued on page 2

of a static loan-to-deposit/share ratio threshold, could hinder the possibility for future growth prospects.

On the other side, one could argue it is not prudent to promote top-of-market retail CD promotions or heavily add brokered deposits to supplement the denominator of this measure because: 1) it may not be the most cost-effective funding option, hurting the bottom line; 2) it is given a watchful eye by regulators, and 3) it may be a more volatile funding source. Additionally, the need to consider the marginal cost of funds impact in both rising rate and falling rate environments to "play defense" should be addressed. Consider some tips as you set your funding course.

Interagency guidance on funding and liquidity risk management defines liquidity as *"a financial institution's capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the institution's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution."*

Key phrases and takeaways include:

- capacity – sources of funds
- cash and collateral obligations – uses of funds
- efficiently met – convert potential sources into cash timely to meet obligations
- expected and unexpected cash flows and collateral needs – normal expected cash flows and stress events (unexpected cash flows)
- without adversely affecting either daily operations or the financial condition of the institution – reduces operation risk and has a positive or neutral effect on other forms of risk and return

... continued on page 3

Excerpt from 'More Precise Measures of Liquidity' white paper

A future Financial Intelligence article will provide an in-depth discussion on the Basic Surplus approach, Cash Flow Gap analysis and the Liquidity Coverage Ratio (LCR).

Basic Surplus Approach
The Basic Surplus (or deficit) is a measure of the cash a financial institution can cost-effectively raise from on-balance sheet sources within a 30-day timeframe, without principal loss, adjusted for the estimated volatility of liabilities and, in addition, the liquidity that can be provided or obtained from off-balance sheet sources. The Basic Surplus approach — along with a complementary cash flow gap analysis — represent the best approach for measuring and managing liquidity today.

Cash Flow Gap Analysis
To get a picture of current and prospective cash flows, a sources/uses of funds approach is used. Sources and uses of funds reports that measure liquidity gaps are one of the most important tools used by an institution's Asset and Liability Committee (ALCO) for triggering actions.

These gap reports provide a framework for measuring liquidity risk in day-to-day operations and in stress scenarios. A sources and uses forecast measures the cash flows to see the impact on the overall liquidity position. These reports generally look at cash flows month by month for the next three months and then quarterly over specified time frames.

Liquidity Coverage Ratio
The Liquidity Coverage Ratio (LCR) was originally devised by the Basel Committee on Banking Supervision. The LCR was subsequently modified and adopted for U.S. regulated institutions. The LCR as modified and adopted in the U.S. only applies to the very largest banks, those over $50 billion in total consolidated assets. However, this approach while not required for community financial institutions, provides a framework that can be used by all institutions to assess liquidity adequacy.

Net Stable Funding Ratio
In 2009, the Basel Committee proposed a second liquidity measure, known as the Net Stable Funding Ratio (NSFR), as a complement to the LCR short-term liquidity measure. The NSFR is a long-term liquidity risk measure designed to ensure a stable funding structure. It measures an institution's available stable funding sourced from capital and liabilities compared to the required stable funding for the institution's assets over a one-year time horizon.

The NSFR became effective for internationally active banks on a consolidated basis in 2018. U.S. banking regulators have proposed a similar measure, however a final measure has not been published or adopted for domestic institutions.

The loan-to-deposit/share ratio was originally designed to measure how much of an institution's stable funding was committed to assets that are not easily converted to cash. The movement to cash flow-based liquidity measurement systems reduces the reliance on historical liquidity ratios as the primary measures of an institution's liquidity. Cash flow projections can range from simple spreadsheets to detailed reports depending on the complexity of your financial institution and your liquidity risk profile under alternative scenarios. We consider the following approaches to be more precise and recommended measures of liquidity.

While static liquidity ratios can provide valued insight, more modern approaches to liquidity improve a financial institution's ability to manage and monitor liquidity risk.

A diverse mix of funding sources is a critical element of sound liquidity risk management, and we invite you to consider FHLBank advances as a stable funding alternative to brokered deposits or expensive special CD offerings. Incorporating FHLBank advance funding as a companion to deposit growth strategies may provide a more effective strategy when you consider pricing efficiency, availability, and interest rate risk management through structure flexibility and execution. **Utilizing FHLBank advance funding can and should be a primary tool in your liquidity management toolkit to help manage volatility and stressed margins.**

We're in a unique and seemingly perpetual unprecedented operational environment that makes navigating liquidity and funding that much more challenging. Flexible liquidity and funding plans are imperative to ensure your financial institution is positioned for strong financial performance and to successfully meet the evolving needs of your customer base. This requires well-documented plans be put in place that reflect both the opportunities and challenges of competing and operating in the modern new normal.

We can help you enhance your liquidity and funding plan and overall funding capacity. The Member Solutions group at FHLBank Topeka has developed a Liquidity Analysis that is available to help you with cash flow gap and basic surplus analysis.

We are available to educate your board and management team on the advantages of FHLBank.

Contact your regional account manager today for your own customized analysis and discussion.

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