Rising Rate Preparedness: Liquidity Preparation Is Critical ahead of Rising Rates

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While uncertainty around the timing of the Federal Open Market Committee's rate hike persists, we have clearly entered the zone of: on your mark, get set, and . . . are now waiting on "go!"

Global challenges and downside risks to economic growth persist in today's environment, but the U.S. economy as a whole has improved from the lows of the Great Recession. At the same time, language continues to come from the FOMC indicating that short-term rates will be rising in an attempt to prepare the markets for the "go" on rising rates.

Let's agree to disagree on the precise timing for the first rate increase, but subscribe to the idea that we are closer with each passing day. As such, every credit union needs to proactively manage the potential liquidity challenges that may arise.

Change of Mindset?

Currently, many ALCO-related articles and discussions center on rising interest rates and the impact on future earnings; however liquidity risk is receiving notably less focus.

Most credit unions have, appropriately, been discussing the changes in projected earnings when rates rise, while incorporating the stress to earnings from potential deposit migration and/or paying up more than historically to retain member deposits.

Best-practice ALCO practitioners take this one step further and discuss available strategies—such as loan growth or utilizing borrowings—to remedy the stress associated with this change in member deposit behavior.

However, the underlying assumption that one can "grow out of it" or "replace member deposit runoff with borrowings" hinges on having the liquidity flexibility to do so at a point in the future. Consider:

- Could rising interest rates negatively impact access to funding?
- What if members chase higher rates more so than in the last rising rate cycle—ten years ago—and at the same time loan demand accelerates?

Liquidity planning is critical. You should elevate it, and incorporate it into your ALCO discussions related to rising rate risks—today.

Action Items

Whether your credit union is still flush with cash or has strategically decreased its investment portfolio to grow loans, the following action items will better serve you when interest rates begin to creep higher

1. Look at the impact rising rates will have on the market value of your bond portfolio.

If funding is needed quickly (inside of a 30-day window) as rates are rising, one should not have to offer a high cost CD or MMDA special nor be in a position where assets need to be sold at a loss to bring in funds. Most high-performing credit unions recognize that they can readily utilize their bond portfolio as collateral to secure funding in the form of wholesale borrowings (e.g. the Federal Home Loan Bank or Federal Reserve Bank) to offset any outflows of member deposits. The amount of liquidity readily accessible will be a function of the market value of the bonds utilized as collateral.

So frequent review of the market value assigned to various segments of your investment portfolio under a variety of interest rate scenarios is warranted. As an example, look at the change in collateral values if rates were to increase 200 basis points.

What impact will this have on your liquidity measures? How about relative to board-approved policy minimums?

Also, if redeploying investment cashflows is a key component of your contingency plan (or perhaps your budget) to address changes in loan and/or member deposit balances as rates rise, review the projected reduction in cashflows when rates rise (driven by prepayment and/or call optionality).

Changes in value and cashflow will likely produce materially less liquidity at some point in the future.

2. Increase your ability to borrow from the FHLB.

If your credit union has strategically reduced the size of its investment portfolio and excess cash to fund loans and improve earnings and net worth, wholesale avenues may be required to support funding needs to a degree when rates rise.

Accessing the FHLB for funding as needed is no different than a manufacturing company that utilizes a just-in-time inventory control system.

Under this system, materials are purchased and units are produced only as needed to meet actual customer demand, making it unnecessary to have raw materials sitting idle (i.e. in cash) and not generating a return. Your ability to readily access a variety of funding sources will be critical to controlling costs and ensuring that changes to loans and member deposits can be funded when rates rise.

Review the percentage of your total loan portfolio that is currently pledged as collateral to your FHLB (the most readily available outlet offering a variety of funding options) and the resulting borrowing capacity.

Discuss whether or not your current borrowing capacity provides a sufficient buffer against member deposit migration. If possible, refer to credit union specific volatility analysis from the last rising rate cycle as a starting point (note: over 10 years ago). Then, review your current borrowing capacity to your board approved policy for accessing wholesale funding.

Ensure that your policies allow for meaningful borrowing flexibility and that you have the outlets and collateral pledged to secure it, if needed. Many credit unions have put their lenders on the “hot seat” to grow loans, but have fallen short on utilizing these assets for collateral and liquidity purposes.

3. Update your stress testing.

The downturn beginning in 2007 that resulted in banking industry failures, were driven by deteriorating credit quality that destroyed capital levels and earnings. Ultimately this dried up access to funding and liquidity for credit unions and banks when they needed it the most.

Robust liquidity planning, policies, and stress testing allowed many to navigate around and even out of near failure or a forced merger. Subsequently, contingency liquidity planning became a best-practice approach and a regulatory requirement.

Most credit unions (regardless of size) have successfully adopted contingency liquidity planning as part of their ALCO processes and have been analyzing numerous liquidity stress events and proactively discussing action plans. However, as credit unions approach a changing interest rate environment, they should discuss recalibrating their liquidity stress-testing scenarios.

Stress scenarios centered on deteriorating asset quality and the resulting reductions in borrowing flexibility, coupled with member deposit outflows, are likely being monitored at your credit union.

You may even have a stress scenario analyzing a “black swan” event, where your credit union’s net worth deteriorates below regulatory requirements and liquidity access becomes increasingly limited.

Consider incorporating an additional scenario that highlights the funding pressures potentially associated with a rising interest rate scenario where funding demands arise on both sides of the balance sheet.

As a starting point, utilize the member deposit volatility experienced at your credit union during the last rising rate cycle. If this data is not available, select a percentage that would be considered stressful (e.g., 15% of non-maturity deposits (i.e. member shares), as an example).

Also, layer in an acceleration of loan growth. For example, consider doubling your loan growth forecast for 2015. In a rising interest rate environment where the economy improves and loan growth opportunities expand, ensuring that you do not find yourself on the sidelines due to a lack of liquidity will be critical.

Deposit Landscape Is Changing Today

Deposit outflows and pressure to increase deposit rates can be seen in some markets already. The competitive landscape for member’s deposit dollars is becoming elevated already as groups seek to reposition their balance sheets for potentially rising interest rates. As such, clearly understanding the mix, relationships, demographics, account-level trends in balance and historical behaviors of your member deposit base will be critical to managing your deposit base when interest rates rise.

Of equal importance, each credit union must recognize that member deposits are just one piece of the liquidity equation, which may become increasingly expensive. Having a wide array of reliable funding flexibility ready-to-go when short-term interest rates rise will ensure future resilience at your credit union. Allocate time now and ahead of rising rates to ensure you have strong funding flexibility and have sufficiently stressed your liquidity position.

About the author

Keri joined the DCG team in 2002. She presently consults directly with ALCO groups and boards of directors at banks and credit unions in the area of asset liability management with the goal of enhancing high performing institutions. She takes a hands-on approach at developing strategies to best fit the risk profile for each bank’s balance sheet, while also balancing trends and pressures alive in the current industry.

Additionally, Keri remains actively involved in advancing Liquidity360°, DCG’s proprietary liquidity risk management software, and is a frequent author on balance sheet management topics.

Keri received a B.S. in business administration/finance from the University of Massachusetts at Lowell and currently resides in southern New Hampshire with her family.