

Bank Asset/Liability Management



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Examination Spotlight – Liquidity Management Issues

Regulators are increasingly concerned about perceived high levels of risk in the liquidity profiles of banks. The old saying: “Those who do not learn from the past are doomed to repeat the same mistakes” comes to mind as financial institutions have reached loan/asset levels (roughly 70%) that mirror those from the peak period before the Great Recession. Also, increasing trends in wholesale funding usage have been coming under scrutiny. Regulatory concerns about liquidity are not new. That said, the bar has been raised for what constitutes best practices in liquidity risk management. Examiners have widened the scope beyond discussions focused on the maintenance of higher levels of on-balance sheet liquid securities, to also include levels or adverse trends in an institution’s reliance on non-core funding. There is now an expectation that banks do a deeper analysis into their funding risk profiles.

A key component of liquidity risk management that is now getting a great deal of attention is *Potentially Volatile Liabilities* (PVL). Analysis of PVL is expected to go further than just stress testing cash flows. To be successful by today’s standards for liquidity exams, it is also important to have a strong knowledge of your largest and/or potentially rate sensitive customers, including analysis and documentation.

Potentially Volatile Liabilities (PVL)

PVL include borrowings, brokered deposits, municipal deposits, usually need pledging, CDARs/ICS and Listing CDs (national boards). These are not new elements to liquidity stress testing programs. Additional elements of PVL that are increasingly becoming key points of liquidity risk analysis are large depositors (>\$250,000 and those

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relationships greater than 2% of total deposits) and *high rate deposits*, which, as explained in greater detail later, are those deposits that are paid a rate higher than the FDIC Rate Cap. These seem to fall into a *blind spot* for many in examinations. Many bank A/L managers do perform a fairly detailed monthly review of activity on large deposits. However, in many cases this review is not documented in a structured fashion. In the absence of documentation and rationale that speaks otherwise, having high levels of large deposits, over the \$250,000 level, is presumed to be a potential threat to liquidity in a troubled or stressful situation. Additionally, *high rate deposits* and the National Rate Cap (NCR), which also fall under the PVL definition, are gaining more attention in examinations.

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National Rate Cap

This is a regulation that banks must comply with should they become less than *well capitalized*. (Note: this can occur due to a regulatory order, as well as actual degradation of capital levels.) The FDIC computes the NRC by taking the average of the rates on NMDs and CDs, not including specials, for each bank *branch* in the US and then adds 75 basis points to arrive at the rate cap level. Most bankers view this computation as flawed, particularly in the most recent rising rate cycle, as the rate cap levels have not kept pace with competitive deposit pricing in nearly all U.S. markets. The lack of inclusion of special pricing, the overweighting of regular rates of large institutions, by computing by branch not institution, and the omission of credit unions, all contribute to large gaps between the computation and a bank’s local competitive market. Earlier this year, regulators asked for comment on the computation, the definition of local markets, as well as other liquidity-related issues and definitions. However, until there is a formal change, the regulatory expectation is that you are aware of the current rule, how it is computed and how it may affect your institution in a troubled situation. Bank management should track and review trends of deposit balances in excess of the rate cap. (*If these are customers that require higher*

rates, why will they stay with your institution if you can no longer be as competitive with rate?)

As a starting point, it is advisable to perform a comprehensive analysis of your actual competitive market rates. Regulators are looking to see that you are aware of the NRC, understand how it is calculated and know that it may potentially restrict deposit gathering activity. When you run relief scenarios as part of liquidity stress testing, you may have to plan to get a waiver from the NRC in order to attract deposits or to stem anticipated outflows. It is also advisable that this analysis makes its way into your assumption support for deposit runoff in liquidity contingency cash flow forecasting.

Large Deposits (>\$250,000) and Depositors >2% of Total Deposits

Executives and sometimes even board members are quite knowledgeable about large depositor relationships in their financial institution. If this knowledge and internal review is not accompanied by a documented analysis, this is likely to be problematic in current exams. Having a large amount of deposits over the insurance limit has typically been indicative of customer trust and lack of concern over losing their money. In today’s exams, there is a presumption of risk until proven otherwise. Therefore, it is imperative to have an understanding of these relationships that is documented and analyzed as part of your overall risk assessment. Large deposit customers, particularly any over 2% of total bank deposits, should be individually reviewed and written up with support such as deposit age, customer history with the institution, numbers of services, connection to the institution, etc. It is important to document your arguments as to why these accounts might not represent a greater risk than something with less depth of connection. The same goes for the general analyses performed on deposits >\$250,000. Even if they are not individually reviewed as the largest deposits would be, it is still imperative that the risk be further analyzed with accounts stratified by risk profile. The highest risk relationships, higher rate, shorter term relationship to date, single accounts, etc., should be quantified and also factored into deposit runoff assumptions in liquidity stress testing forecasts.

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Liquidity Contingency – Cash Flow Stress Testing

These analyses of PVLs and other potential environmental stresses should be incorporated into liquidity stress testing. Regulators are emphasizing cash flow forecasts and liquidity stress testing more now than ever. Loss rates on loans (non-payments), deposit runoff, including the impact of PVL, reduction and/or elimination of wholesale funding, e.g. increased haircuts on FHLB collateral, loss of access to brokered or to CDARS/ICS, should all be factored into stress scenarios driven by credit problems. Stress scenarios mimicking a CAMELS 3 or 4 rating should be run at a minimum as *meltdown* scenarios. Corresponding relief strategies should be run when the institution falls below the acceptable available liquidity levels based on a 12-24 month horizon. It is also advisable to stress *budget or rolling forecast* scenarios for a non-credit stress which shows deposits falling short of targets while loans exceed originally forecasted levels.

The quality of these forecasts may also be due for a review. Are you truly creating a *perfect storm* that considers partial and/or complete loss of these funding sources, the need to re-collateralize municipal deposits, the need to exit the FRB Borrow in custody program, becomes the discount window with a CAMELS rating of 3 or lower, and other like items? As a practical matter, would you really execute the *Stress Relief* that you are running or are you demonstrating that you *could* do something to rectify it? Is your institution using this tool to truly be thoughtful and proactive in a worst case scenario or are you *going through the motions* to get the cash flow to mathematically balance out by taking short cuts in your relief strategy. If you are doing the latter, expect to be challenged.

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Monitoring Liquidity Conditions

How do you know that liquidity stress may be on the horizon? It could be via asset growth, particularly if deposits are not the primary source of funding and you have PVL concentrations, credit conditions or public perception. Again, as part of best practices after the

Great Recession many institutions adopted some sort of liquidity risk monitor. This monitor tracks trends and levels of key ratios that may impact liquidity, as well as less quantitative elements that may signal increased environmental risk. Too often these monitors have not been reviewed for quite some time. For example, review the monitor for triggers that we have set off numerous times without action. Are these triggers really relevant to your liquidity environmental assessment? Should the trigger levels be moved up or down? Also, it is expected that stress level triggers are set at levels that are not too far from where your institution is today so that trends or movement can be more easily captured and assessed. In many cases, these monitors got a lot of attention 10 years ago in the wake of the Great Recession and associated liquidity crisis, but have not been critically reviewed in some time. A full critical review should be completed at least annually.

Conclusion

Regulators are looking at on-balance sheet liquidity trends across the industry and seeing what appears to be a return to banks making the same mistakes they did in the last cycle. Liquidity cash flow and stress testing models are being used which generally didn't exist before 2008. Tools have been added but have management practices really changed? Is actual thought and analysis taking place to measure and assess the potential risk to the safety and soundness of your institution? It would appear that not only is the bar being raised for your next liquidity examination but the incorporation of a more thorough, thoughtful, and robust analysis may be the new thing in best practices and likely is here to stay. If the issues we have discussed here are not fully addressed at your bank, you might be in for a wake-up call at your next examination.

— Bob Lallo
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