Bank Asset/Liability Management

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The Changing Landscape of Liquidity – *5 Steps to Exceeding Regulatory Expectations and Creating More Flexibility in Your Balance Sheet*

Loan growth has outpaced deposit growth over the past few years and on-balance sheet liquidity has been declining. Wholesale funding levels are on the rise and deposit attrition continues to increase. Undeniably, liquidity is under pressure and regulators are taking notice. Now is a good time to take your liquidity process to the next level.

Based on experiences gleaned from working with banks throughout the country and valuable interaction with regulators, we have identified solid ways to improve your liquidity process. These improvements will help you to exceed regulatory expectations and, more importantly, give your bank greater flexibility in managing the balance sheet to improve margin.

Follow these five steps to develop a stronger, more strategically focused liquidity process:

1. Identify Your Liquid Asset Cushion

Shifting cash and security cash flow into loans can be a fruitful strategy to protect and increase margin when rates are low. However, doing so can inadvertently trigger a regulatory concern. Management teams must identify what liquid asset *cushion* is appropriate for their business model and risk appetite. This has been a recent focus in many exams.

So, how low is too low? A starting point for discussion could be 10% — a number that has been introduced by examiners. Please note that this is not a hard stop or required minimum. It is a starting point. In fact, Darling Consulting Group has clients regularly operating with liquid assets below 10%. At these levels, it means the regulatory rigor and the modeling/reporting/communication expectations will be dialed up. Here are some initiatives to improve your position and process:

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- Reallocate pledging for municipal/sweep deposits away from securities
- Pledge every possible dollar of loan collateral to the FHLB
- Tune up your Contingency Funding Plan and Stress Tests (more on this later)

The following are two exercises to help define your liquid asset cushion. First, review how well your liquidity position fares under various stress levels. If liquidity levels are under pressure during a *mild* stress event, you may lean towards holding more on-balance sheet liquidity. Second, review the strength of your total liquidity position. If your bank has a substantial amount of available loan collateral at the Federal Home Loan Bank and established/tested funding lines, you may feel more comfortable running liquid assets a bit tighter (more on this in section 2).

The liquid asset discussion has not only regulatory implications, but also such strategic ramifications such as:

- How do we plan on funding loan growth over the next 90 days?
- How aggressive do we need to be with deposit pricing?
- What is our strategy for redeployment of excess cash and upcoming bond cash flow?
- What are our comfort levels with wholesale funding?

2. Focus on Total Liquidity

Liquid assets are just one component of a liquidity analysis. Banks must look at the total liquidity picture inclusive of available collateral established at the FHLB, brokered deposit availability and other funding lines (e.g. Federal Reserve, Fed Funds lines, etc.). Take inventory of available liquidity from each source and determine your comfort level (i.e. policy) for each.

It is important to discuss comfort levels with wholesale funding at ALCO, as we find that in some instances there may be internal pushback. We have found it helpful in ALCO meetings to discuss the benefits of wholesale funding (e.g. marginal cost of funding discussion), as well as get any concerns out on the table.

3. Revisit Your Contingency Funding Plan

A recent focus of regulatory feedback has been on the shortcomings of banks' contingency funding plans (CFP). A well-structured CFP should identify early warning indicators that can *trigger* potential liquidity stress, assess the risk severity, and establish a response plan to preempt a liquidity crisis. For example, how would the bank react if funding lines were shut off and there was a *run* on deposits? If one option is to reallocate collateral to the Federal Reserve, be sure that this funding source is documented within the policy and is tested at least annually.

4. Build a Robust Stress-Testing Framework

Step 1 is build out a dynamic liquidity forecast—the timing is perfect as you can incorporate your 2020 budget into your liquidity plan. Be sure to complement the projected cash surplus/deficit with all of your alternative funding lines to understand how potential funding gaps can be supported.

Step 2 is build out the stress tests. This doesn't have to be overly complicated. A blend of macro-level and bank-specific stress tests should suffice. Be sure to elevate the level of stress in multiple scenarios with assumptions that make sense for your risk profile and business model. Eventually, you will build a scenario in which you fall below the well-capitalized point. Tell the story for each stress test (i.e. what stress environment are you trying to emulate?).

We have found the following key assumptions should be included in your stress-testing process:

- Deposit runoff referring to your bank's recent deposit study
- Reduced/removed funding lines
- Increased utilization of customers' lines of credit

Looking for bonus points? Here are two ideas we have helped clients with to improve their process and status with stakeholders.

First, add a well-documented assumptions and results report to your liquidity package. It doesn't have to be glamorous. However, it should strengthen communication lines between senior management, the board, and regulators. Outline the intent of each scenario, the assumptions used and the overall results.

Second, build out a remediation plan to alleviate liquidity stress. This has been extremely effective for banks that are running tight on liquidity. Put the CFP into action by running specific scenarios to showcase strategies that would help fill the liquidity gap in times of stress.

5. Develop a Risk Monitor

The primary intent of a CFP is to identify a liquidity problem before it arises. We have found that a risk monitoring system allows banks to avoid having too many liquidity policies, while still having a platform to track liquidity

Exhibit 1: Sample Risk Monitor

	Risk Level 1	Risk Level 2	Risk Level 3	Current Value	03/31/2019 Value	Risk Level
Indicators - Liquidity/Funding Ratios						
1. Liquid Assets	8.00%	6.50%	5.00%	7.50%	7.20%	Level 1
2. Basic Surplus w/FHLB Loan Collateral	12.00%	10.00%	8.00%	11.60%	9.00%	Level 1

threats through a robust set of early warning indicators. Determine risk levels that are commensurate with your bank's risk tolerance.

Track bank-specific early warning indicators (e.g. liquid assets) and develop triggers that act as a warning system to detect a liquidity issue before it becomes a problem. Furthermore, provide insight to all stakeholders on indicators that have been triggered, the level of stress caused and action items, if necessary

Liquidity levels are tightening in our industry and regulators are taking notice. Building and using a robust liquidity management platform will provide a level of comfort to the examiners and, more importantly, provide key strategic information to help manage the balance sheet to improve margin.

— Joseph Kennerson
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