

## 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 unprecedented 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 as 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 twelve-month period, a battle for deposits has ensued. Most are playing defense when it comes to deposit gathering, meaning they are focused on the retention of existing deposits rather than focused on 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 and sometimes they have not. 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 twelve months have drastically changed their level of balance 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 (FHLB) system and pledge various assets as collateral to borrow money from the FHLB. 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 a portion 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 (such as a liquid asset ratio) to assess their liquidity position. Static liquidity measures can provide valuable information but cash flow forecasting

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(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.

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