LIQUIDITY & FUNDING STABILITY DURING UNCERTAIN TIMES

Kevin Hamilton

Regional Director

Promontory Interfinancial Network, LLC

Email: khamilton@promnetwork.com

Tel: (703) 292-3329

Web: www.promnetwork.com

LIQUIDITY RATING

Must Read …

- Summer 2017 FDIC Supervisory Insights …
  - Community Bank Liquidity Risk: Trends and Observations from Recent Examinations.

LIQUIDITY RATING

Liquidity is rated based upon, but not limited to, an assessment of the following:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undo loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on-and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

LIQUIDITY RATING

RATING	RESULT
1	indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
2	indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.
3	indicates deficient liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.
4	indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.
5	indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

LIQUIDITY RISK

- The risk that an institution's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations.

- These risks include:

  1. Funding Mismatches
  2. Market constraints on the ability to convert assets into cash or in accessing sources of funds.
  3. Contingent Liquidity Events

PAST REGULATORY OVERSIGHT

- Much of the existing supervisory guidance on liquidity dates back to 1979 when the CAMELS ratings system was created
- In the past, examiners tended to focus more on balance sheet position than liquidity management
- Liquidity measures focused on assets as the liquidity source
  - Investments-liquid and Loans-illiquid
- Deposits were considered the only stable source of funding:
  - Skepticism related to other sources of funding
  - Significant Memory of Thrift Crisis

MODERN PERSPECTIVE

- Traditional funding sources are still well regarded, but:
  1. Diversified funding is considered a positive
  2. High quality liquid assets are essential
  3. Both liquidity position and risk management are important
  4. “What If” Planning is essential

CURRENT REGULATORY FOCUS

- Reliance on Core Deposits vs. Wholesale Funding
- Holdings of liquid assets
- What is the bank's borrowing capacity?
- How stable are large depositors' funds?
  - Analyze with respect to:
    - Location
    - Tiered Pricing Breaks
    - Number of Products / Services Held
    - Existence of Surge Balances (Parked Funds)
- Does the bank have a written Contingency Funding Plan?
- Has the bank tested its Contingency Funding Plan?
- What access does the bank have to alternate sources of funds?
- Conduct dynamic cash flow analysis

MEASUREMENT TOOLS

Static Balance Sheet Ratios
Net Non-Core Funding Dependence
Large Depositors to Total Deposits
Loans to Deposits
Pledged / Total Securities
Loans to Assets

Contingency Funding Plans
Cash Flow Modeling
Scenario Analysis
Pro Forma Cash Flows

MEASUREMENT TOOLS

- Since the need for a formal CFP came into being in April 2010, all of us now have a plan. The key then is to continuously update that plan to reflect the current environment.

- On the topic of Ratios, these indicators are still important to examiners as they can be used to determine Liquidity “outliers” – our advice is to reduce these ratios to those that are important and can be reviewed on a monthly basis.

- It is our belief that Liquidity has become an easier issue for community banks especially if they have a vibrant wholesale or non-core funding strategy.

LIQUIDITY SUMMARY

- Core will always be key to franchise value and we should always try to obtain relationship-driven core depositors…

- We should also have a vibrant non-core or wholesale funding strategy to handle those opportunities where price, availability, or maturity issues are important…

- Liquidity Risk Management will always be key to a successful franchise

- But, Non-Core is also a key issue

WHOLESALE FUNDING SOURCES

Funding Without Collateral

- Fed Funds Purchased
- CDARS www.promnetwork.com
- Rate Boards (Qwickrate) www.qwickrate.com
- Brokered Deposits
- Municipal Deposits

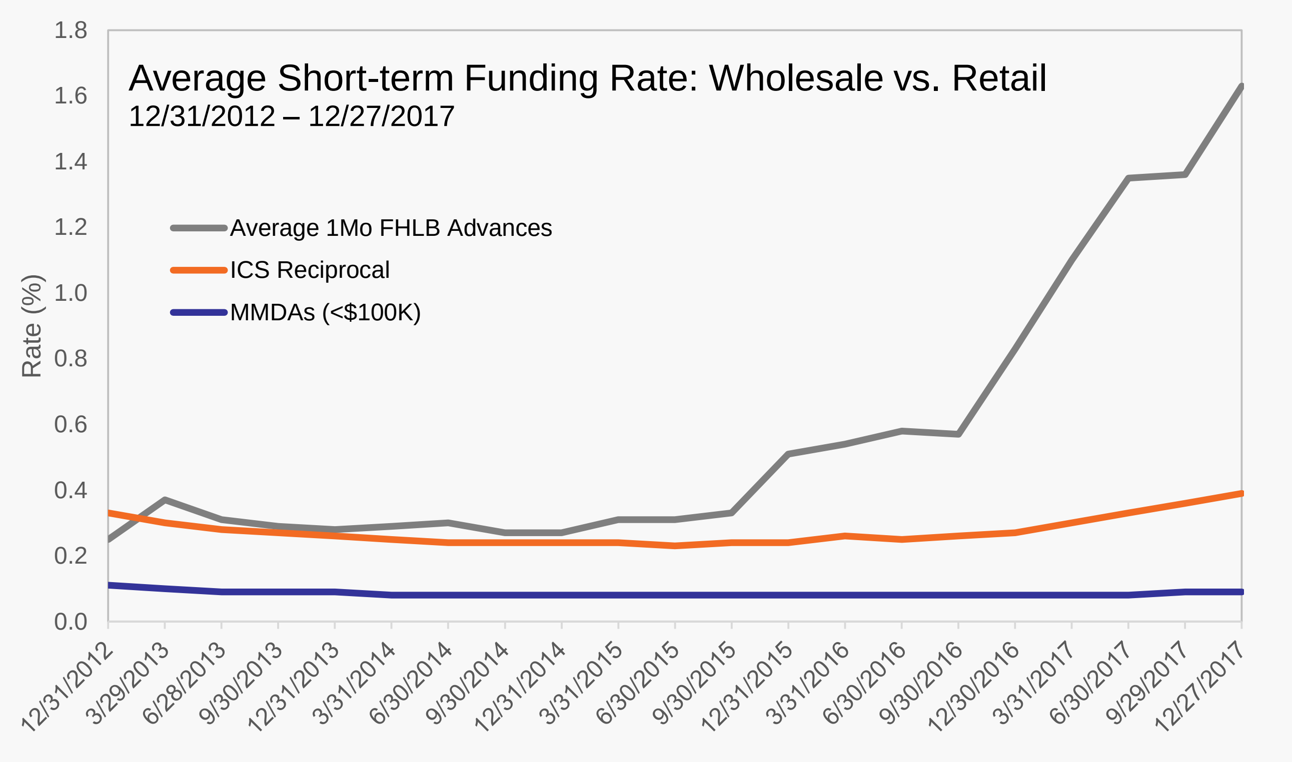
WHOLESALE FUNDING SOURCES

FUNDING WITH COLLATERAL

- FHLB Advances
- Federal Reserve Discount Window
- Repurchase Agreements

For years banks were able to use wholesale funding without paying a high premium, but that benefit has shifted away significantly

It is time to explore ways to raise customer deposits and take advantage of the delta that currently exists between wholesale and retail funding.



Sources: Federal Reserve Bank of St. Louis. Promontory Interfinancial Network, LLC internal data and research data. Data from December 31, 2012 to December 27, 2017.
Note: the average rate data above represents simple averages derived from historical rate data for each period.

The Deposit Market Is Changing

- **Competition is heating up**
  - The Fed continues to raise rates and reverse QE
  - Banks balance sheet positions continue to tighten
  - Regulatory changes are impacting how certain banks view different types of deposits
  - Large banks are spending substantial amounts of money on technology and marketing

- **What history tells us**
  - Non-maturity/time deposit mix converges after years of divergence
  - Wholesale funding continues to be significantly more expensive than retail

How can banks capitalize on opportunities and strengthen and protect valuable customer relationships?

Basel III LCR Background

- Basel III LCR generally applies to banks with at least $50 billion in assets

- A simple formula… LCR =

$$\frac{\textit{High Quality Liquid Assets (HQLA)}}{\textit{Total Net Cash Outflow during 30-Day Period of Stress}}$$

- … driven by prescribed outflow rates based on depositor and deposit characteristics:

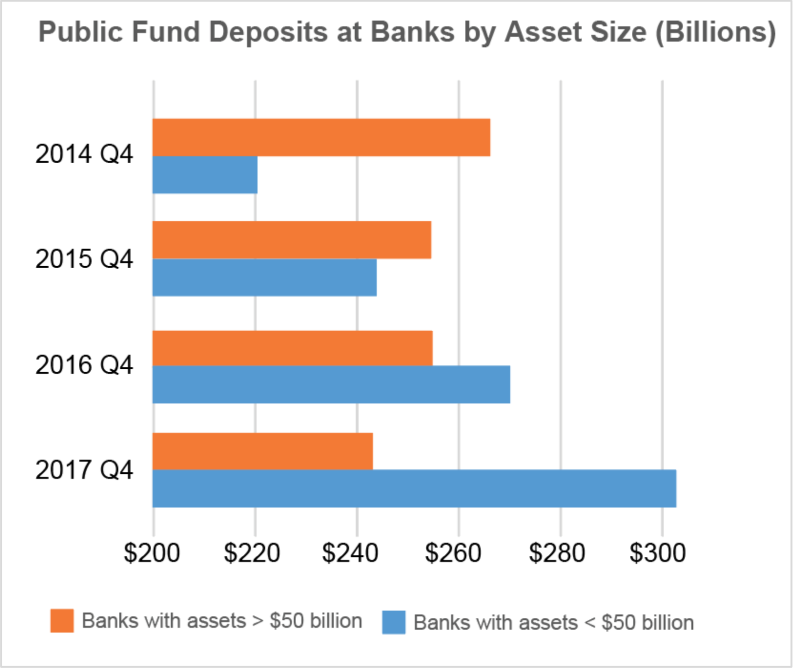
Deposit Type[1]	Outflow Rate
Retail Core	3% - 10%
Escrow	25%
Public Entity	Up to 40%[2]
Financial Institution	100%

1 Select deposit types are represented here to illustrate the range of Outflow Rates.

2 Varies based on existence of collateral (and type).

LCR Creates Opportunities and Threats for Community Banks

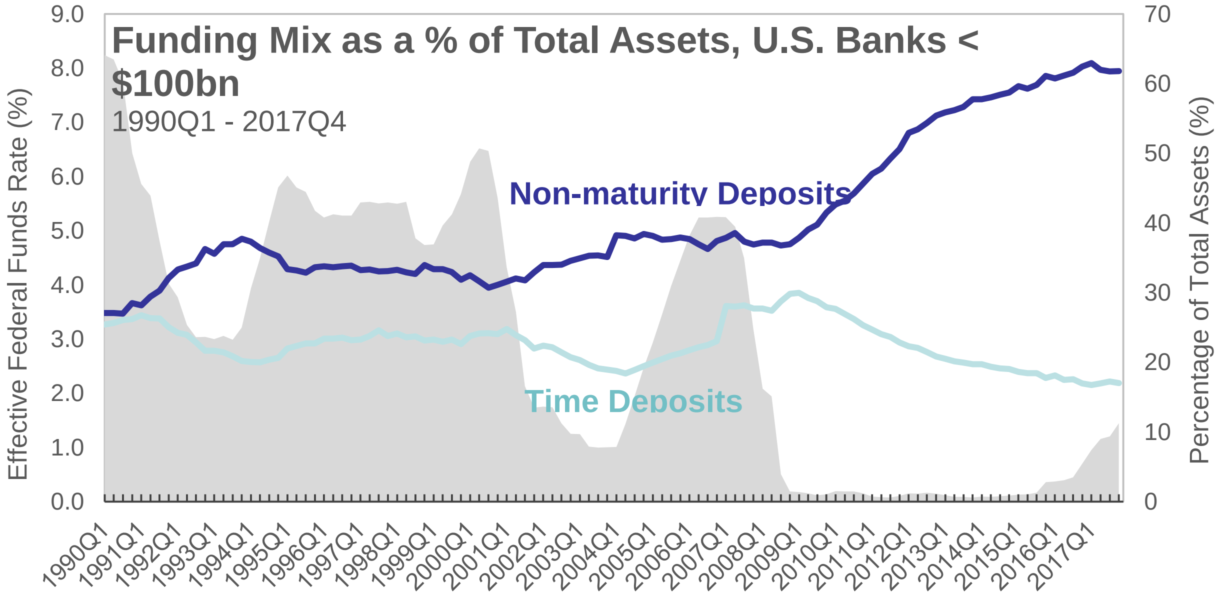
- Basel III LCR banks are incented to replace higher-outflow deposits (e.g., public entity deposits) with lower-outflow deposits (e.g., retail deposits)
- Threat: Retail deposit competition heating up for all banks, not just LCR banks
- Opportunity: Offloaded deposits represent a unique opportunity for non-LCR banks
  - Reciprocal deposit channels can eliminate ongoing collateral burdens, keeping costs low
- The response is reflected in Call Report data as shown right



Source: S&P Global Market Intelligence Platform.

Time to Evaluate Funding Strategies

As the deposit race heats up, history indicates that deposit funding strategies should be evaluated. In a rising rate environment, the deposit funding mix tends to shift from non-maturity deposits to time deposits.



Sources: Federal Reserve Bank of St. Louis. S&P Global Market Intelligence. Quarterly data from Q1 1990 to Q4 2017.

Community Banks of All Sizes Expect Increased Competition

- 80% of surveyed banks under a billion in assets expect deposit competition to increase over the next 12 months
- 85% of their $1-$10 billion counterparts expect deposit competition to increase over the next 12 months

Deposit Competition Expectation 12-Month Outlook
Promontory Interfinancial Network Bank Executive Outlook Survey

Source: Source: Promontory Interfinancial Network Bank Executive Business Outlook Survey, 2017, Q4. The survey was delivered via email to bank CEOs, presidents, and CFOs. Leaders from 370 unique banks completed the survey. Of these 370 respondents, 162 were CEOs (44%), 33 were presidents (9%) and 175 were CFOs (47%). Compared to the asset-size breakdown of the overall banking industry, the sample of respondents skews slightly towards larger community banks, banks with assets between $1 billion and $10 billion.

CONCLUSIONS

- Liquidity Risk Management Will Always be an Essential Part of your Enterprise Risk Management Process.

- Liquidity Risk is tied Directly to Understanding the Roles of Both Core and Non-Core Funding Techniques.

- Having Sound Policies/Procedures Around Both Core and Non-Core Funding is an Important Risk Management Issue.

- Setting Limits and Measuring/Monitoring the Use on Non-Core Funding is Crucial.