Dale Sheller
Vice President
The Baker Group LP
dsheller@gobaker.com

Is Liquidity Stress Testing Stressing You Out?

It shouldn't come to much of a surprise that liquidity risk management is a major focus for all the regulatory agencies. Since the financial crisis of 2008, the economy has improved and banks have steadily added loans to their balance sheets. As a result of the increase in loan demand, overall liquidity levels have decreased as more liquidity is now tied up in loan portfolios. Additionally, banks need to consider how the vast amount of surge deposits in the industry might behave as the Fed continues to raise rates and deposit competition heats up. Is it possible those depositors will leave in search of higher rates? Or will they leave the banking system altogether?

In April 2010, the federal banking agencies and the National Credit Union Administration issued a policy statement to provide for sound practices for managing funding and strengthening liquidity risk management practices. This guidance is now eight years old; however, with the renewed focus on liquidity risk management, some banks are playing catch-up to ensure they are in compliance. For years, the concept of liquidity stress testing seemed irrelevant, as most banks were flush with deposits, cash liquidity, and tepid loan demand. Fast forward to 2018 and stress testing our liquidity levels seems much more plausible.

The question becomes, "How do I stress test my liquidity?" First, take a look into the regulatory guidance. The aforementioned 2010 guidance states the following: "Institutions should conduct stress tests regularly for a variety of institution-specific and market wide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the financial institution and the level of its risk exposures." There are a few more sentences after those two, but all in all, the guidance doesn't give us a whole lot of… well, guidance.

Second, take a look at some ways to conduct liquidity stress testing. Here is where you need to start getting creative. A brainstorming starting point is to ask, "What would keep our ALCO up at night from a liquidity risk perspective?" Liquidity stress testing should address both institution-specific as well as market wide events. You should start with looking at the bank's balance sheet and its potential seasonality. Some institutions experience more seasonality than others, and seasonality can come from both sides of the balance sheet. However, there is one area that will affect any institution: the loss of customer deposits. Modeling a scenario where you lose varying levels of deposits is a must.

Stress testing a loss in deposits is just one of many scenarios to consider when running a liquidity stress test. Once again, regulators want to see both institution-specific as well as market wide stress events. Examples of institution-specific events may include asset quality concerns, reputation risk, rapid growth, and regulatory restrictions. Market wide or systemic events may include capital market disruption, economic conditions, uncertainty in industry, and changes in interest rates. A scenario that needs to be considered is one where the bank has capital issues and they become "less than well-capitalized" per the Prompt Corrective Action regulation. Falling to the "adequately capitalized" rating limits a bank's access to various contingent funding sources. Restrictions on brokered deposits and paying high rates on deposits now comes into play. Additionally, creditors such as the Federal Home Loan Bank, Federal Reserve, or Correspondent banks will demand more collateral, reduce availability, or terminate the borrowing line.

Once you have your stress scenarios well thought out, you need to run those scenarios through a pro forma cash flow analysis

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and analyze whether or not your current liquidity levels can remedy the stress scenario. If not, you then need to look towards our contingent liquidity sources and see if they are sufficient to fund the shortfall in liquidity. Ensure the results of your liquidity stress tests are discussed by the asset-liability committee and the review is documented in the minutes. Lastly, don't forget about your contingency funding plan. The results of your stress testing should also play a key role in shaping the institution's contingency planning. Therefore, stress testing and contingency planning are closely intertwined. Remember to stress your liquidity and not yourself!

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Dale Sheller
Vice President
The Baker Group LP