Preparing Your Balance Sheet for Liquidity Stress

Since the onset of the pandemic in early 2020, the financial system has been flush with deposits, and the focus has been on making loans/investments with excess capital.

What has Changed in 2022?

Macroeconomic headwinds have shifted in the last several months. COVID driven impacts to jobs, savings rate, and GDP have washed through the economic system. Additional macroeconomic indicators suggest potential liquidity concerns heading into 2023. Namely:

- **Deposits have Dipped** – Based on FDIC Quarterly Assets & Liabilities reporting, Q2 2022 was the first quarterly drop in deposit volume since 2018
- **Lending has Increased** – Based on FDIC Quarterly Assets & Liabilities reporting, QoQ loan growth topped 10% in Q2 2022 for the only second time since 2008
- **Inflation is Surging** – Based on US BLS, inflation has been over 8% since the beginning of 2022, a 40 year high
- **Personal Consumption is Rising** – Based on FRB St. Louis reporting, personal consumption, which dipped during the pandemic, has rebounded, and hit all-time highs in 2022
- **Customer Saving has Dropped** – Based on FRB St. Louis reporting customer savings rates, which spiked during the pandemic, have settled below 5%, well below the pre-pandemic average of almost 10%

Furthermore, feedback from several institutions indicates that NCUA exams have had an increased focus on liquidity and preparedness for liquidity stress heading into 2023.

The Impact of Credit on Liquidity

Additionally, credit losses, another potential drain on available liquidity have begun to come into focus as a potential concern for financial institutions. Higher prices, elevated consumption, and decreased savings rates could indicate that loan demand is a reflection of financial stress as opposed to purchasing on expectation of elevated earnings in the future. If this is the case, it could be an indicator of credit losses to come. This possibility is further validated by the fact that an overview of FDIC regulated financial institutions reveals a collective increase in provision expense over the past several quarters.

Credit Loss provisions, driven jointly by charge offs and allowance reserve build, are going to be impacted in 2023 by the required implementation of CECL accounting standards. Implemented in a phased manner, the final group of FIs subject to CECL are required to being for fiscal years starting after 12/15/2022. For many smaller banks and credit unions, this means that the fiscal year beginning 1/1/2023 will require CECL compliant reserve methodologies. While the impact of CECL can significantly vary institution to institution based on options selected (mean reversion approach, reasonable & supportable period, etc.), it is likely that moving to a life of loan approach from an incurred loss approach will present upward pressure on reserve figures for most FIs. Upward pressure on allowance reserves will compound credit deterioration in the portfolio that is already driving reserve numbers to increase. This compounded effect will have an additional adverse effect on the liquidity available to financial institutions.

Where Can Financial Institutions Start?

The best approach for financial institutions to address and overcoming these challenges is to strategically test their balance sheet under a variety of likely and unlikely events to fully understand where sensitivities lie, and which available levers are most effective for managing risk. Remaining solvent in times of liquidity stress requires a well-thought-out playbook for managing the crisis. This playbook needs to be created, socialized, and agreed upon **BEFORE** the stresses occur to avoid emotional responses and debate on course of action when time is at a premium.

Best Practices in Liquidity Stress Testing

When creating a liquidity stress test, it is helpful to consider and include the following items as appropriate:

- Start with an integrated and comprehensive cashflow projection. If the starting point for the exercise does not match the reality of the situation, or significant portions have been skipped (credit losses for example), then the results of the stress test will not give a likely indication as to how the institution will perform in periods of stress.
- Stress assumptions and available liquidity sources in a separate tool or analysis. It is not enough to simply run a “credit loss up 20%” scenario, or a “decline in deposits” scenario in an ALM tool.
- Don’t forget haircuts. Selling assets can be a great way to re-introduce liquidity into the balance sheet. However, during periods of liquidity stress, it is unlikely that the sale of these assets will be near face amount or current market value.

About Chris Van Wagenen

Chris Van Wagenen is a Principal Consultant for Empyrean Solutions, a leading risk management software firm offering Financial Risk Management & Performance Solutions for Banks and Credit Unions. In this role, Chris works with clients to design, implement, and analyze results of Empyrean software solutions used for ALM, FTP, Stress Testing, and Liquidity. Chris is a subject matter expert in the field of financial risk management with over 17 years’ experience as both a consultant and a practitioner. Specifically, Chris has helped clients and organizations build, implement, and understand risk models and frameworks for ALM, stress testing (DFAST & CCAR), Allowance Calculations (US GAAP, IFRS 9, CECL), and credit portfolio monitoring/analytics. Chris has bachelor’s degree in Mathematics from Colby College and a master’s degree in Analytics from Villanova University.