The Baker Group

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# Liquidity Risk Management: A Continued Regulatory Focus

It has been almost two years since the 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 unpreceded pace and magnitude. Over the last few years, the actions of the Federal Reserve quickly reversed liquidity out of the banking system and tightened liquidity levels across many institutions. Liquidity risk management and contingency funding planning remain front and center for many risk management examiners.

## Deposit Competition Has Eased

During the height of the pandemic, institutions were drowning in deposits and excess liquidity. But after 525 basis points of tightening from the Federal Reserve in under two years, a battle for deposits ensued. Alongside the 100 basis points of Fed easing in late 2024, deposit pricing and pressures have eased for many institutions. As a result, most institutions reached their peak funding costs in Q4 2024.

## Contingency Funding Planning

As a direct result of the 2023 bank failures and tighter liquidity environment, the regulators released an "Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plan" in July 2023. The guidance reiterates the need for an actionable CFP that considers a range of possible stress scenarios. Additionally, the guidance called for depository institutions to test the operational readiness of their CFP by regularly testing their borrowing lines to ensure their staffs are well versed in how to access the lines. The guidance encourages depository institutions to incorporate the discount window as part of their contingency funding planning. 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. 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 and Stress Testing

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 (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 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.

Whether you recently finished a recent regulatory examination or are gearing up for one, you will likely agree that liquidity risk management remains one of the hottest regulatory focus items. Ensuring you have an iron clad liquidity risk management program well before your next examination is critical.

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