



## ***Managing Liquidity in a Volatile Rate Environment***

By Jeremy D. Taylor

Interest rate volatility is associated with the kind of unstable macroeconomic conditions that have plagued the United States over recent quarters. After a period of slow but steady rate increases between mid '04 and mid '06, the Fed has engineered over the past year sharp, uneven declines in the Fed Funds rate. This has coincided with a pronounced tightening of credit conditions, including counterparty credit concerns and real estate collateral uncertainties. Banks have seen earnings squeezed by the combination of a) increased loss provisioning, and b) falling net interest margins reflecting typical asset-sensitivity in the balance sheets of smaller institutions.

In this environment, low-cost core deposits have become even more valuable. Banks are competing not just with each other but also with non-banks to attract and retain deposit funding. In previous rate cycles, depositors have typically been less concerned with shopping around when rates have fallen to current levels. But due to bank creditworthiness concerns and related systemic issues, those dynamics have played out differently this time around. Most banks are seeing stagnant or declining core deposit balances — even lagging behind sluggish loan growth. To fund assets, therefore, as well as to bolster available or contingent liquidity in a punitive market, banks are having to place greater reliance on wholesale funding sources. FDIC data shows average loan/deposit ratios for banks less than \$1 billion in assets creeping up to 88% from 78% four years ago.

Not only does wholesale funding represent higher-cost sources, but most of them — FHLB and correspondent lines, Fed Funds purchased, repos, et al. — are also generally the fastest to re-price as market rates (such as the Fed Funds rate) change. That's fine in the falling rate environment of the past year, but obviously not as we look beyond the current malaise to the next cyclical upswing in rates — however far off that may be. And just as importantly, it introduces an unwanted channel for further uncertainty and period-to-period variability in bottom-line performance at a time when there are other such channels already working overtime.

So, what's a banker to do? One fundamental problem, best avoided, is sustained asset growth even as deposit growth eases. The loan/deposit ratio may seem like only a crude measure of liquidity, but it remains a powerful one — and the 100% ratio a meaningful threshold. As deposit growth stutters, therefore, don't expect (and incent) your lenders to go full-bore. It's not just that a weaker economy should signal rising credit-risk concerns. It's also the higher pricing required to justify rising cost of funds if deposits aren't coming in to fund the new assets. If you needed more reason to scrutinize new deals in a weakening (and falling-rate) economy, there it is.

Pay attention to the interest rate risk (IRR) profile and how it's changing. IRR is the product of two distinct things: a bank's asset/liability maturity or re-pricing (mis)matching, and the degree of volatility and uncertainty in interest rates. The greater that volatility, the stronger the case for a more neutral, rate-insensitive balance sheet positioning. Most banks will stand to lose as much from a 100 basis point (i.e., one percentage point) adverse rate change as they would from the kind of credit losses that cause management and board angst. And 100 basis point rate swings have not been extraordinary of late.

Be mindful of rate risk when setting liability pricing strategy. This includes not just the wholesale funding mix but also the resulting maturity horizon. Whether it's jumbo CDs, CDARS, brokered CDs or the everyday retail variety of CD, adjust their pricing to attract funding at the desired maturity points. While venturing into wholesale funding at the very short end provides both flexibility and, typically, lower pricing than longer maturities, step back and look at the balance sheet's overall risk profile to assess whether, and how much of, longer-term funding (e.g., longer-maturity CDs, term FHLB advances) may be called for. While replacing lost deposits with wholesale sources can moderate IRR by shortening the liability side to better match with typical asset-side profile, it can also expose the bank to a less balanced asset/liability position when deposit growth recovers or when skittish lenders pull back their wholesale funding.

Again, the key message is to manage asset growth very carefully in this environment; new loans right now are likely to be much less valuable than new deposits. There's a reason they call them "core" deposits. To the extent they're relationship-based, they're likely to be stickier through the ups and downs of the rate cycle. That low-cost stickiness is generally the largest source of divergence between book value and market (or economic) value for a commercial bank. Covet and pamper depositors now as you do borrowers when times are better.

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