

McQueen

Financial Advisors

LIQUIDITY STRESS TESTING & SOURCES USES REPORT

3 Minute Read



Liquidity Stress Testing & Sources Uses Report

Beginning in 2022, the Federal Reserve's decision to raise interest rates led to a decline in liquidity. This has prompted examiners to intensify their scrutiny (on liquidity) to ensure that financial institutions maintain adequate liquidity levels and to safeguard the stability of the entire banking system. The swift pace of Federal Reserve rate increases we have recently experienced has not been observed for over 40 years. Back in the early 1980s, the Fed Funds rate rose by a remarkable 9 percentage points, in less than a year, peaking at 22%. Since then, there has been no more than a 4-percentage point increase in the Fed Funds rate during any 12-month period, until now. Shifts in consumer behavior and a rapid decrease in investment values are further aggravating the situation. We would like to share our industry experience and suggest some action steps that can be taken now.

Field Experience

Our advisors regularly receive feedback from clients across the nation regarding their stress points, concerns, and examiner comments. Additionally, we evaluate unrealized portfolio losses, liquidity stress, and interest rate risk for hundreds of clients, giving us a unique industry-wide perspective. We have observed a definitive change that began in 2022 and has persisted, with liquidity being affected by several factors:

- **Unrealized Portfolio Losses:** Pandemic-related stimulus programs led to a surge in investment portfolios due to an influx of deposits. Our recommendation to clients was to keep their portfolios short. However, many institutions invested in longer-term securities with maturities of 5 years or more. As interest rates rose dramatically, the values of bonds have come under strain and turned negative. The Federal Reserve has indicated its commitment to maintaining high rates until inflation recedes, so we anticipate volatility to persist for a while.
- **Deposit Run-Off:** Beginning in 2022, industry-wide deposit balances declined for the first time in years. Initially, most of our clients did not raise deposit rates significantly in response to the Federal Reserve's rate increases. However, as rates continued to climb, almost all clients raised their non-maturity deposit rates and CD rates.
- **Loan Demand:** Some of our clients have experienced a significant increase in loan demand. Industry-wide, loan growth recently outpaced deposit growth for the first time in approximately 4 years.
- **Borrowing:** Financial institutions under liquidity stress are likely to resort to wholesale funding before selling securities at a loss. Borrowing has become increasingly prevalent, even among institutions with moderate loan-to-deposit ratios.
- **Core Deposit Funding Costs:** Core non-maturity deposits are the primary funding source for many financial institutions. When interest rates are extremely low, term deposits usually account for less than 10% of total funding. However, as interest rates climbed, depositors began moving from money market accounts to CDs. This drives up funding costs but doesn't always bring in new money.

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Measurement Methods

Liquidity stress can be caused by various factors, both internal and external. It's vital to regularly assess these potential risk factors and maintain robust measurement methods and contingency funding plans to manage liquidity risks. Each institution's risk profile will vary based on its customer base, the local economy, its business model, and the broader market environment, among other factors. The importance of liquidity risk management has gained renewed significance. More than ever, it's important for institutions to hold adequate levels of liquidity and conduct robust and comprehensive stress tests to review their ability to handle liquidity stress events and changing market conditions. Essential tools for this analysis include liquidity stress testing and sources and uses analysis.

Liquidity Stress Testing

Liquidity stress testing, at its core, simulates various liquidity stress scenarios, models their potential impact, and measures the ability of an institution to handle various stress factors. Whether it be deposit run-off, slower loan pre-pay speeds, a run-up of unfunded commitments, a drop in the value of investments, reduction of counter-party loans or other factors, McQueen's liquidity stress testing reports allow institutions to identify vulnerabilities and develop mitigation strategies beforehand. This process is not just a regulatory requirement but a foundation of sound risk management. McQueen starts its liquidity stress tests by defining a baseline, representing normal or non-stressed conditions. Subsequently, stress levels of escalating intensity are applied. The objective of this method is to assess the institution's capacity to withstand a range of adverse market conditions or stress events. We measure liquidity stress using various possible events and time horizons. These scenarios can be thought of as severe yet plausible, capturing a range of adverse circumstances.



Liquidity Stress Testing & Sources Uses Report



Sources and Uses Report

A Sources and Uses report is a fundamental financial tool used by financial institutions to analyze their liquidity position and cash flow. This report offers a thorough review of where cash originates from (sources) and how this cash is allocated or spent (uses). The sources generally include customer deposits, loan payments, and maturing investments, while uses may involve loans made to customers or purchases of securities.

Regulatory Guidance and Examiner Expectations

While regulators lay down the framework for stress testing, it's the responsibility of each institution to choose robust liquidity stress testing methods tailored to their unique business model, risk appetite, and market focus. Examiners are more frequently expecting that financial institutions will implement comprehensive liquidity stress testing using a variety of methods. Depending on the complexity of your institution, this could involve a daily analysis of liquidity conditions, as well as forward-looking scenarios that consider various "what-if" conditions. In an era marked by uncertainty and rapid change, the need for robust liquidity stress testing is vital. It equips you to handle liquidity risk head-on. Our approach and model methods are forward-looking and regulatory-compliant.

Action Steps

Get in touch with a McQueen advisor to discover the advantages our liquidity stress testing and sources and uses reporting can bring to you. Also, you can request a sample report to get a firsthand understanding of the value we offer to your institution.