Liquidity Needs & Borrowing Options
August 2022

McQueen Financial Advisors

The deposit surge during the COVID-19 pandemic was driven primarily by an influx of stimulus funds and lower consumer spending. Deposits at banks and credit unions grew by a whopping 36% between December 2019 and December 2021. Financial institutions deployed excess funds into investments and, to a lesser extent, loans. With so much liquidity in the system, there has been little need to consider borrowing. However, it appears that liquidity needs are changing. All financial institutions must maintain sufficient levels of cash, liquid assets, and borrowing lines to meet expected and contingent liquidity demands. We'd like to take this opportunity to discuss how liquidity needs are changing and the borrowing options available from the Federal Home Loan Bank.

Liquidity Risk

Liquidity risk is unavoidable because depositors are free to withdraw funds at any time, access to funding sources may be disrupted and borrowers with open lines of credit may freely draw upon them. Liquidity risk is simply the threat that an institution's overall safety and soundness may be adversely affected by the inability to quickly meet these demands. Liquidity stress factors may be related to deposit run-off, unplanned loan growth, a drop in the value of investments, or other factors. Traditionally, community-based financial institutions have relied on local deposits as their primary funding source. While core deposits remain a primary focus, we have seen a recent trend in funding patterns. Over the past several months, core deposits have been declining as a percentage of total funding, and some of our clients are choosing to borrow. The trend may continue as consumers spend and borrow more freely. In addition, we should consider a resurgence of money market mutual funds. Looking back to the 1990s, many savers preferred money market mutual funds and withdrew cash from their local institutions. Higher short-term interest rates may result in a reappearance of money market mutual funds as a viable option.

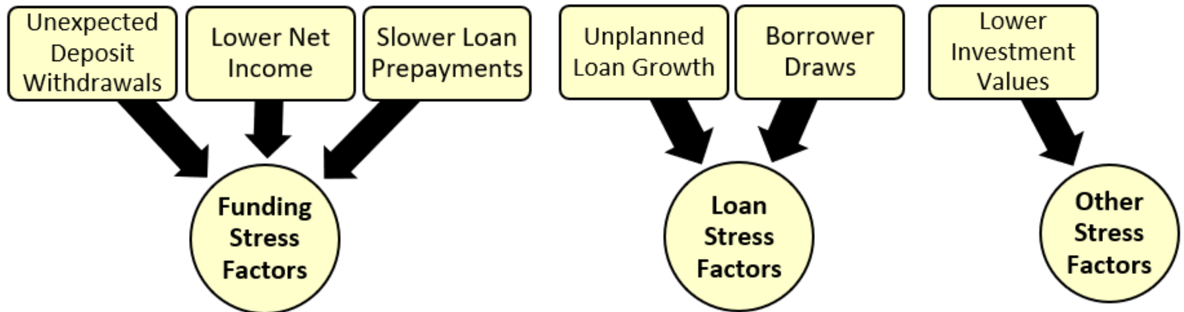
"Regulators and examiners are focused on liquidity"

Regulatory/Exam Focus

Regulators and examiners are focused on liquidity based on recent industry trends. Consumers have started to withdraw government stimulus funds that have been on deposit for the past few years. Spending is up because workers are heading back to offices. In addition, there is a great deal of pent-up demand for consumer goods and high-ticket items. Consumers want to get back to normal and are now more willing to spend and borrow. Investment values are also down, related to the Fed's recent rate increases. Regulators and examiners are concerned that some institutions may have too few liquid assets, that short-term funding sources may be volatile and that contingency plans may be insufficient to meet unexpected liquidity demands.

A Perfect Storm

The simultaneous trends of deposit run-off, loan growth, and lower investment values have created the potential for a perfect storm.



Available Options

When faced with liquidity stress, there are many options available. It may be possible to raise funds in the local market by boosting deposit rates or adjusting rate tiers. Our recommendation is to increase deposit rates only in response to the need for funds. Some institutions feel that it is part of their mission to reward loyal depositors with strong CD rates. This practice is sometimes used by smaller institutions to remain relevant in a crowded market or as a form of advertising intended to attract new deposits. The long-term goal is to cross-sell loans and other fee-based products. Paying above market rates should only be considered after ensuring that capital has been built to a sufficient level to withstand uncertain and challenging future economic conditions. CD specials are one option but may not quickly result in significant new deposits matching the desired terms.

"Borrowing may be a cheaper option than local or brokered deposits"

We suggest a careful review of non-maturity deposit rates and tiers. Boosting the rate on non-maturity deposits immediately results in higher costs for the entire balance. Adjusting rate tiers can bring in new money without paying a higher rate on the entire balance. For example, if the best-available money market rate is 0.50% for balances over $25,000, consider increasing the required balance to $50,000. Often, depositors will boost balances to earn the higher rate.

In response to liquidity stress, higher loan rates may result in slower growth.

Many institutions will consider borrowing. At times, borrowing may be a cheaper option than local or brokered deposits. Borrowing also provides the opportunity to quickly raise funds with amounts and terms that can improve anticipated cash flow. In addition, targeted borrowings can enhance an institution's asset/liability risk profile. The Federal Home Loan Bank offers several innovative options which are discussed below.

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Advance	Term	Benefit	Prepayment Terms
Variable Rate	1-180 days	Short-term market-rate funding	Prepayable at any time
Fixed-Rate Bullet	Up to 10 years	Fixed rate to protect earnings in a rising rate environment	Subject to prepayment fees
Mortgage or Amortizing	3-12 years up to 20 years amortization	Match the principal payment schedule to your anticipated cash flow	Prepayment beyond scheduled principal subject to prepayment fees
Symmetrical Fixed-Rate Bullet Advance	1-10 years	Fixed-rate funding where the member can realize a gain from a rise in interest rates if the advance is prepaid	Early termination allows for possibility of prepayment credit, based on the mark-to-market value of the advance
Forward-Starting Fixed-Rate Bullet	2-5 years	Forward settlement up to one year, or longer in some cases	Subject to prepayment fees
Adjustable Rate	Up to 10 years	Tie your advance rate to one of a variety of indices	Ability to repay on reset date
Callable	1-10 years	Protection against prepayment risk in a falling rate environment	Allows members to prepay on predetermined call dates
Putable	2-10 years	A lower fixed rate, but the advance may be ‘put’ back to you after the lockout period if rates rise	Subject to prepayment fees unless FHLB Bank exercises put option

"Some of these less-common options deserve additional discussion"

Additional Details

Many of the borrowing options on the prior page are familiar and easy to understand. However, some of the less common options deserve additional discussion.

- **Symmetrical Long-Term Fixed Rate Advances:** This is a long-term fixed rate bullet structure where the borrower will have an opportunity to realize a gain from a rise in interest rates when the advance is prepaid. The rate paid will be higher than a standard fixed-rate advance in exchange for the right to receive a prepayment credit under certain market conditions. If the advance rate is below current market rates relative to an advance with a similar maturity, the borrower would be eligible for a prepayment credit and could realize a gain when the advance is prepaid.
- **Forward Starting Long-Term Fixed Rate Advances:** This type of advance provides borrowers the opportunity to secure future, fixed-rate bullet advances at current forward rates. As an example, the rate can be locked in now for a borrowing that will occur later.
- **Callable Advance:** This is a long-term fixed rate structure with the option to prepay the advance on certain predetermined dates without incurring a prepayment fee. This type of structure will have a higher interest rate than a standard advance and may be appropriate when rates are expected to fall. The ability to prepay early gives the borrower the opportunity to take advantage of falling interest rates.
- **Putable Advances:** In many ways, a putable advance has characteristics that are the opposite of callable advances. This type of structure will have a lower rate than a standard advance. The option to cancel early is held by FHLB. The interest rate remains fixed for a predetermined amount of time (lockout period), after which the FHLB has the option to call the advance. If rates rise, the FHLB is more likely to cancel the advance, giving the borrower the option to prepay or obtain replacement funding at available market rates. There is a risk that replacement funding may carry a higher rate than the original putable advance. If rates fall, the FHLB will be less likely to cancel the advance, leaving the original terms in place.

Risk of Structured Borrowing Options
A structured borrowing includes any advance with optionality, meaning that it can be canceled by the counterparty when interest rates change during the holding period. One example is a putable advance that gives the FHLB the option to cancel the borrowing if interest rates rise. The risk with this structure is that the borrower will need to refinance at a higher rate with little protection. Potential supervisory concerns with structured advances include the following: (1) these products can have a significant impact on an institution's interest rate risk profile; (2) they often are used as part of leverage programs that tend to focus on short-term income enhancement with an associated increase in the institution's risk profile; (3) an institution may be subject to substantial prepayment penalties to retire costly structured advances before maturity; and, in some instances, (4) management may not possess the requisite knowledge and understanding of these products to manage the risks effectively.

Action Items
At the core, our industry's primary function is to fund illiquid assets (loans) with liquid liabilities (deposits). Liquidity stress has not been top-of-mind for many years, but the need for liquidity may be changing. In the event of stress, there is no such thing as too much liquidity. Consider these action items as the economy and liquidity needs to change.

"The need for liquidity may be changing"

We suggest a review of:
- All available options, even if there has been no reason to use them previously
- Counterparty borrowing agreements and brokered CD arrangements
- Various borrowing structures and the associated interest rate risk
- Liquidity and contingency liquidity policies

McQueen Financial Advisors offers two liquidity management tools:
- Liquidity Stress Testing, which identifies 'normal' liquidity needs, then applies moderate and severe stress over a wide range of scenarios and time periods
- Our 24/7 On Demand ALM Simulator can be used to quickly run what-if scenarios related to deposit run-off, new borrowings to fund loan growth or other scenarios

We encourage you to talk to us about your specific liquidity needs.