Learning To Swim In Liquidity – What Can Bankers Do?

hedging deposits business customers liquidity

Summary: Financial institutions are awash in cash these days. How long will this situation last and what is a banker to do about it? We cover the economic indicators affecting liquidity, such as inflation and employment, and how to manage the effects of inflation with revenue protection.

We heard recently about a survey, conducted for the Red Cross, that found that while 80% of Americans said they could swim, only 56% of the self-described swimmers can perform all five of the basic skills that could save their life in the water. As you build your post-pandemic plans, this may be up for consideration as many bankers are swimming in cash these days.

Thanks to continued injections from government actions and low loan demand, many financial institutions are awash in cash. But for how long will this last? We lay out some of the economic indicators to try to answer that question.

Inflation. Longer-terms rates are moving up. GDP forecasts for the second half of this year are double what we've historically called positive growth. Many expect that with this strong growth, inflation will come. With the opening up of the economy, we are already experiencing overheating in certain sectors, such as housing.

One indicator of this is the Total Capacity Utilization index (TCU). The Federal Reserve Bank of St. Louis (FRED) publishes this index, which measures the percentage of resources used by corporations and factories to produce goods in manufacturing, mining, electric, and gas. The TCU reached an all-time low (since the start of the index in 1967), in April 2020 and 4 points below the average for 2019.

Employment. Furthermore, looking at employment, the Employment-Population Index, (FRED EMRATIO), measures the ratio of those employed to the civilian labor force. It improved from April 2020's low of 51%, but is still 3 points below the average for 2019. Clearly, our economy has at least some capacity to absorb the additional $2T coming from the American Rescue Plan.

In addition to the individual payments, the American Rescue Plan is bringing $350B to states and cities, swamping financial institutions with more liquidity. With this additional liquidity at the state and local level, the capacity to handle it will likely vary, based on current economic situations in different geographical areas.

With this in mind, ALCO/MALCO committees are busy these days focusing on how to protect the community financial institution (CFI) balance sheets, working with various hedge programs, and taking other actions to neutralize interest rate risk. But as interest rate risk is neutralized, the need for revenue continues. What is a smart banker to do?

Revenue protection from inflation. The best protection against inflation is to move from CFI's dependency on NIM to fees. While some community bankers consider this nickel and diming customers, others are concerned about the regulatory risk. For most CFIs, there are legitimate opportunities to be found and leveraged to increase fee income.

1. Review all of your cash management products. Look at all of your products and take a page from the larger institutions. Talk to your clients and plan on raising fee income in 2021.
2. Consider hedge instruments as a source of fee income. Many customers have already refinanced; however, you can offer a program to selected customers who could not refinance late last year but can now. Consider hedging 5Y deals to capture fee income today. If you don't know where to start, contact us for more information.
3. Try out employee reward programs for ideas to increase fee generation. While we wouldn't want to follow in the steps of a large bank, there are creative ways to incentivize employees for ideas on fee generation strategies and products. Make it fun and the creative ideas will flow.

While no one has a crystal ball, there are ways to prepare for inflation. Turning as much of that extra cash into fee-generating opportunities is an important way to do this, as you'll be truly inflation-resistant.

HAVE YOU TESTED YOUR LIQUIDITY TODAY?

After stress testing your loan portfolio, it is time to test your liquidity. We have a solution that allows you to validate your contingency funding plan, so you are ready for your next exam. Learn more about liquidity stress testing today.