



## Liquidity Constraints Necessitate New Strategies

profitability KYC liquidity

**Summary:** Due to inflation and rising interest rates, liquidity is tight, and is expected to get tighter this year. Effective liquidity management strategies can help CFIs take advantage of a more attractive rate environment. Here are a few ideas that may help.

No one knows how to adapt to a changing environment better than the tawny owl. Tawny owls in warmer parts of the world are brown, and in colder areas where snow is more common, they're gray. This helps them blend into their surroundings. Researchers have discovered, however, that more brown tawny owls are being spotted in areas where gray tawny owls used to dominate. More owls were born with the brown coloring because winters in their habitat have been milder [due to climate change](#).

When conditions change, it can be difficult to adjust. Doubly so if those changes are rapid. While financial institutions can't alter their appearances to suit the tides of the financial market, there are other strategies they can utilize to better adapt to the recent fluctuating economic conditions.

Last year, the combination of high inflation and rapidly rising interest rates significantly changed the business conditions in which community financial institutions (CFIs) operated. Consumers spent down savings, slowing deposit growth, [while loan production remained relatively strong](#). As a result, liquidity tightened significantly. In 2023, the cost of deposits is expected to continue rising as credit losses accelerate from 2022's extraordinarily low levels, further tightening liquidity. The bear market in bonds hasn't brightened the picture. The financial industry is seeing abnormally large unrealized losses in bond portfolios, due to rising interest rates. This means any CFIs looking to sell bonds for more liquidity may find themselves in a predicament.

As CFIs shift gears from managing excess liquidity in a zero-interest-rate environment to managing tighter liquidity in a more attractive rate environment, there will be opportunities to improve net interest margins and loan-to-asset ratios — as long as CFIs have enough liquidity. Here are a few ideas that can help CFIs manage their liquidity:

- **Know your customers.** It's critical to understand who your customers are and why they have deposited money with your institution. Getting a clear picture of your customer base will inform your CFI's strategy to preserve the valuable relationships you have with current customers and [avoid critical deposit loss](#). Mining data can also help CFIs better identify opportunities for growth, as well as areas where the organization is achieving (or not achieving) its goals. Questions to consider may include:
  - Are current, former, or new customers the source of new accounts?
  - What types of accounts are customers opening?
  - What are the customer demographics?
- **Grow through cross-selling.** Identify current and target customers' needs and then communicate the services that may be relevant to them. One approach is to incentivize cross-selling by rewarding employees who identify and communicate opportunities to expand customer relationships.
- **Adjust loan pricing.** In a rising-rate environment, assets should reprice more quickly than liabilities. However, there is nothing normal about this environment. Competition for quality loans means that loan

rates may not mirror market rates. Will your current average loan yield cover 2023's deposit cost increases?

- **Compete strategically.** While customers often rely on CFIs for reasons that have little to do with yields, higher inflation and rising rates may have caused some customers to re-evaluate the options available to them. Consequently, rates on money markets and other cash deposit accounts may make a difference. If your customer profile skews older, you may even want to offer CD specials. Making sure your value-adds as an institution are in peak form is key to maintaining relationships with those who are less sensitive to the rising rates.
- **Assess liquidity metrics and policies.** Regulators are expected to focus on capital and liquidity during 2023. As a result, CFIs will want to review liquidity metrics and backup funding sources, as well as liquidity policies to make sure current planning is relevant and complete.

The shift from excess liquidity to constrained liquidity has occurred at an unusually rapid pace. Making adjustments to adapt to the current rate environment will be key to both managing liquidity and improving loan-to-asset ratios.

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## ECONOMY & RATES

Rates As Of: 03/01/2023 12:10PM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.88	0.18	0.46
6M	5.17	0.37	0.41
1Y	5.04	0.04	0.34
2Y	4.89	0.07	0.46
5Y	4.27	0.08	0.26
10Y	4.00	0.08	0.12
30Y	3.96	0.05	0.00
FF Market	FF Disc	IORR	
4.57	4.75	4.65	
SOFR	Prime	QREFR	
4.55	7.75	4.57	

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