Are Rising LDRs a Sign of Liquidity Problems?

deposits liquidity management

Summary: Loan-to-deposit ratios rose throughout 2022, with average CFI rates nearing 80%. Banks are also borrowing more from alternative sources to make up for lagging deposit growth.

Jim Rohn was a successful businessman and motivational speaker, becoming a millionaire by age 30 and providing personal development workshops worldwide for over 40Ys. Rohn had insightful observations about lots of things and creative ways of expressing them. Here's one of his thoughts: *"If you do something often enough, a ratio will appear."*

Banks do a lot of things repeatedly, and thus they generate plenty of ratios. One of those bank ratios that's a subject of some concern these days is the loan-to-deposit ratio (LDR). A loan-to-deposit ratio that's not too high and not too low is considered a sign of good health. But lately, the LDR has been climbing at many banks, particularly community financial institutions (CFIs), and that could be a sign of future liquidity problems.

The Atlanta Fed office noted that falling cash balances are driving community banks in its district to borrow more from other sources like the Federal Home Loan Bank. CFIs have been high on the list of those taking advances to bolster cash balances — and not just in the Atlanta district, but around the country. Much of that rise in borrowing lately has been in response to the collapse of Silicon Valley Bank (SVB), which enhanced liquidity concerns throughout the banking sector. However, rising LDRs at CFIs actually predate the SVB collapse.

SVB: The Bank With Too Many Deposits

Interestingly, an LDR that is too low can be an indication of possible problems as well. Before its failure, SVB was awash with deposits as tech startups and their venture capital supporters parked billions in cash there. SVB deposits soared from $49B in 2018 to $175B by the end of 2022.

Loan origination could not keep up with the trend. So SVB invested billions of that extra cash in long-duration bonds, which turned out to be a very bad bet when interest rates began rising rapidly. Bonds held by SVB just as quickly dropped in price, and when the bank had to sell to raise cash, it suffered billions in losses.

Would a better LDR have helped SVB? That's debatable. The fundamental problem for SVB was how it deployed its excess deposits, not whether it held too many.

Slowing Deposit Growth

Most CFIs, meanwhile, face the opposite situation these days: their deposit growth now trails loan growth. The result is a steady rise in LDR. According to the FDIC in its latest Quarterly Banking Profile covering Q4 2022, the average LDR for all FDIC-insured institutions was 62.6%, with CFIs with assets of $1B to $10B carrying the highest LDR, at 81%. The average LDR at the end of 2021 was 56.2%, with CFIs valued at $1B to $10B once again leading LDR at 73.1%. The YoY change is significant.

Do high LDRs lead to liquidity problems? That's a question that federal regulators have pondered for some time.

The "New Normal" for CFIs

A report from the Federal Reserve Bank of Philadelphia that was released a few years ago called the LDR a *"relatively crude measure of an institution's liquidity."* It also found difficulty in defining a proper LDR for a CFI.

Back in 1990, a CFI with an LDR of 80% would have raised concern from regulators. By 2017, 80% was considered the "new normal" for small banks. As the SVB case showed, the quality of assets is equally important. A bank with too many bad loans or cash deployed in risky ways may be of more concern than one with a relatively high LDR.

In fact, the speed of the rise in LDRs to the 80% range may be more worrisome. If the upward trend continues and rates gallop past 80%, regulators may need to take a closer look.

Rising LDRs at CFIs are worth keeping an eye on as one sign of liquidity problems. However, they should be considered in conjunction with other measures that offer a better window into an organization's liquidity situation.

LOOKING TO GROW YOUR LOAN PORTFOLIO?

ECONOMY & RATES

Rates As Of: 04/19/2023 05:39AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.20	0.35	0.78
6M	5.09	0.15	0.33
1Y	4.81	0.21	0.11
2Y	4.25	0.22	-0.18
5Y	3.74	0.17	-0.26
10Y	3.63	0.16	-0.24
30Y	3.83	0.18	-0.14

FF Market	FF Disc	IORB
4.83	5.00	4.90
SOFR	**Prime**	**OBFR**
4.80	8.00	4.82