MOODY'S
ANALYTICS

**Chris Stanley**
Sr Dir-Ind Practice Lead
Moody's Analytics
chris.stanley@moodys.com

**Scott Dietz**
Dir-Ind Practice Lead
Moody's Analytics
scott.dietz@moodys.com

# Balance Sheet Resilience & Adaptation Playbook

The recent failures of Silvergate Bank, Silicon Valley Bank, and Signature Bank marked the first bank casualties following a year of rising interest rates. While the days and weeks to come will undoubtably uncover issues specific to these banks that could have led some to foresee this eventual outcome; bankers, investors and even depositors are left with a lingering concern for the stability of their own banking partners. Bank executives need to act quickly to reassure their investors, depositors, and regulators that they have a resilient and adaptable strategy for whatever comes next.

In a departure from the financial crisis, the issues these banks exhibited were not credit-related in nature. The fastest rate increase in recent history followed a period of easy money, excess deposits, and low loan demand—providing a stark reminder to bankers that liquidity is not the same as cash, and interest rate risk creates issues across the balance sheet. This is exemplified by the fall in bond prices when interest rates rise. A fundamental of finance to be sure, but one that seemingly caught British pension funds and some sizeable U.S. banks off guard. To confront this reality, bankers will need a mix of latent strategies and new tools that have emerged since the last rate tightening cycle in 2004 and inflation-fighting efforts of the Volcker Fed in the 1980s.

The business of banking has always been one of borrowing short and lending long. The experience of the last week is not an indictment of that model, but a reminder that it works only when bankers stay conscious of how much liquidity they need and when they'll need it, under normal and stressed conditions alike. Despite markets pressuring the Fed to slow rate increases, asset liability committees should prepare for rates to go higher and stay there longer. For CEOs and CFOs revisiting these questions under stress, we offer this playbook to guide next steps.

1. **Target Outreach to Your Deposit Base** – Using current events as an opportunity for outreach with key customers is critical for restoring stability to the system. A thoughtful understanding of distinctions between your strategy and the current market concerns is the starting point of this effort. Many components of the failed banks' deposit bases were unique—highlighting risks and opportunities that could be critical to managing your own deposit base. In the case of SVB, only a small portion of its deposits were insured by the FDIC. SVB and Signature's deposit bases had prominent geographic and industry concentrations—amplifying their sensitivity to changes in the business environment and creating a rapid feedback loop when bank runs began. Media reports of large cash balances for single firms also highlight missed opportunities to extend treasury management services that could have managed client funds more effectively and offered bankers more consistency for liquidity planning.

2. **Understand Investment Portfolio Sensitivities** – unrealized losses in securities portfolios are appropriately drawing significant market scrutiny, but asset liability management (ALM) strategies need nuance beyond this loss of value. A push for yield created a substantial duration gap and cashflow mismatch for SVB—its long duration securities were much more sensitive to rate hikes than its liabilities, leaving it unable to fund withdrawals and with insufficient capital. To manage interest rate risk and deploy liquidity effectively, it is important to understand your portfolio's duration and cash flow sensitivity to multiple rate scenarios. Resilient strategies will include contingencies for rate increases beyond current consensus forecasts for terminal rates, as well as the possibility that rates remain elevated for an extended period. Analyzing duration gaps with rate shocks can help bankers build plans for repositioning their portfolios, maintaining resilience for unexpected cash outflows, and hedging interest rate exposures. Recent accounting changes simplify and diversify strategies that qualify for hedge treatment in comparison to the last rate cycle. CECL tools are an additional advantage, as they provide a multi-scenario view of interest rates, credit and prepayment behavior that are critical inputs to hedging strategies and effectiveness.

3. **Revisit Loan and Deposit Pricing** – Deposit betas (the portion of a change in the fed funds rate that is passed on to deposit rates) and lending spreads (lending rate minus deposit rate) are key levers for managing liquidity and profitability in a rising rate environment. Having enough liquidity to support lending or deposit redemptions while also maintaining profitable margins despite rising rates is the goal. Analysis of duration gaps—differences in the timing of cash inflows and outflows as well as the price sensitivity of assets and liabilities is foundational to managing interest rate risk. Understanding your own deposit attrition and betas in prior tightening cycles is key to setting strategies for limiting deposit outflows (or attracting the right mix of deposits in the current market's flight to quality)—critical for maintaining liquidity. Deposit rates follow Fed funds rates, but betas are lower when the Fed Funds rate is rising than when it is falling. The Fed's current efforts raised rates faster than at any prior tightening cycle—a distinction bankers should factor into their deposit strategies. Building on your understanding of your deposit mix, your strategy will need to evaluate the types of behavior you seek to encourage as conditions change.

   Maintaining margin as liabilities reprice and avoiding interest rate risk in a fixed-rate loan portfolio during a tightening cycle requires careful management of lending spreads. Lending spreads have widened due to uncertainty about continued tightening by the Fed. In addition to managing interest rate risk, opportune hedging strategies and timing could also present an opportunity to narrow lending spreads before your competitors do—this also depends on calling the top of the rate cycle. Either way, pricing is one of the most effective tools for influencing behavior to transform the portfolio you have (loans and deposits) into the one you want.

4. **Enhance Customer Onboarding Capabilities** – Deposit flight to yield was widely reported throughout the current rate tightening cycle. After the recent bank failures, flight to quality is expected, adding stress to onboarding programs. Supporting new customers and meeting their expectations is business critical, but so is staying in compliance with the Bank Secrecy Act, US Patriot Act, the FinCEN CDD Rule, and all know your customer (KYC) requirements. Satisfying

increasing compliance, due diligence and monitoring requirements at scale can challenge any program. Consider evolving your current operations – with automation and robust data – to ensure the speed and volume of onboarding new clients will not deviate from your current risk guidelines and regulatory obligations. The last thing you need is bad actors to become customers because of missed steps.

5. **Analyze Credit Behavior Under Multiple Scenarios** – bond portfolios were the first casualty of rising rates, but make sure your strategy gives changes in borrower behavior appropriate consideration. Scenario analysis is needed to understand the effects of elevated rates on both liquidity (timing of cash flows, repricing of assets) and expected loss that may result if rate action produces broader market deterioration or recession. Slower prepayments and maturity risk are first-order impacts of rising rates--limiting cash inflows and slowing asset repricing. Proactive movement on maturity risk will be advantageous, especially in CRE where many properties are already facing post-Pandemic market shifts. Rising rates increase maturity risk for deals with low debt service coverage ratios (i.e., borrowers are unlikely to find alternative financing at market rates prevailing at maturity), and loan to value risks (Fed rate increases impact Cap rates, decreasing property values). Second-order credit effects could stem from rate-triggered recession, or other shifts in the market brought on by continued tightening. Wholistic consideration of the effects elevated rates (especially for an extended period) have on other macroeconomic variables relevant to credit in all asset classes (e.g., unemployment, home prices, etc.) is critical to address these broader credit concerns.

At Moody's Analytics, everything we do enhances decision confidence and enables new potential in our clients' businesses. Decades of investment in credit analytics, macroeconomic forecasting, asset liability management tools, structured cashflow analysis, prepayments, relationship pricing and know your customer compliance have uniquely positioned us to support you at this critical time and into the future.

Managing risks presented by rising rates comes down to two fundamental questions; how much cash do I need and when will I need it? While that seems relatively simple, getting to the answer can be challenging—thinking about answers for multiple scenarios is the key to a resilient and adaptable balance sheet. Whether the future holds further rate increases, prolonged periods of higher interest rates, or both, using the playbook above will provide bank executives with the analysis they need to strengthen their balance sheet and liquidity position.

## Opportunities for further reading:

- Maintaining Resilience in a Rising Rates Environment
- Positioning Firms for Resilient Financial Performance—in Any Rate Scenario
- Running the Risk: Putting Theory Into Practice
- Market Signals Inflection Point as Soaring Rates Drive a Spike in Negative Leverage

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