

While high liquidity premiums were entirely appropriate several years ago, they now are skewing bank funding incentives and lending competitiveness at many banks.

Unlocking Liquidity Premiums

BY STEVE TURNER

At a time when banks are hungry for performance improvement, many have inadvertently handicapped themselves by placing an overly high value on liquidity. This impels the institution to pay premium rates for deposits that it may not need, and necessitates much higher rates on loans, which makes the institution uncompetitive in the market.

The problem is traceable to internal pricing metrics that got cemented during the recent financial crisis, but have not been updated to reflect current market conditions and progressive practices. Back at a time when many market funding sources were frozen, banks rightfully placed extreme high value on stable long-term deposits. This value was reflected in the “liquidity premium,” a valuation component that became dominant in determining internal funds transfer pricing at many institutions.

Banks are right to place greater emphasis on liquidity premiums in their internal pricing. The problem is that the

mechanism for calculating these premiums is crude and inflexible at many banks. That is, many institutions are simply taking the wholesale cost of term funding and directly incorporating that cost into their internal pricing.

This simplistic approach worked at a time when banks had a particularly strong need for funding. But it breaks down in the current climate, where the cost of wholesale funding remains elevated but the need for funding is low.

Stubbornly high liquidity premiums now are skewing bank funding incentives and lending competitiveness at major institutions. For example, recent Novantas research shows an enormous skew in funds transfer pricing for money market deposit accounts. Some banks have set FTP benchmarks that range from 50% to more than 200% higher than the norm for MMDAs, while other banks have cut FTP benchmarks to less than half of the norm.

There is a similar situation with certificates of deposit. For six-month CDs, for example, some banks have set FTP benchmarks that soar more than 50% higher than the norm, while others have cut FTP benchmarks to less than half the norm.

Among banks stuck at the top end of these ranges, high FTP valuations have led to instances where lending teams have felt compelled to override internal pricing metrics in order to set competitive

loan rates. Their intense motivation for doing so is reflected in statistics published by the Federal Deposit Insurance

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Corp., which show that the industry loan-to-deposit ratio, a key metric in balance sheet management, has dropped from a 94% to 95% peak range in 2006 and 2007 to less than 80% today. Banks successfully strengthened liquidity positions but now are awash in deposit funds that need to be profitably deployed into earning assets.

Rather than make exceptions to rules that do not work, banks need to address some fundamental flaws in their internal pricing frameworks to assure better equilibration through all phases of the economic cycle. One specific drawback, for example, is that most banks and regulators currently are using just one basic metric to calibrate liquidity premiums. This “cash cost of debt” in wholesale funding markets mostly reflects the bank’s credit rating, and omits differences in strategic balance sheet positions.

A much more robust set of decision factors is coming into use by the most progressive institutions, and leaders are modernizing their funds transfer pricing (FTP) and liquidity premium metrics with an eye toward long-term performance improvement. By contrast, lagging banks are at risk of lurching from one short-term patch to the next, with far more dissonance in FTP relative to actual funding needs and market stance.

CRISIS AFTERSHOCKS

Some of today’s distortions with internal funding metrics were set in motion during the global recession and financial crisis of a few years ago. During the downturn, bankers became highly sensitized to the potential for funding disruptions in a crippled market.

One issue was that the bank cost of funding was going up while the overall level of interest rates was dropping (this spread between the level of general market interest rates and a bank’s marginal cost of funds is the credit spread). Meanwhile, access to non-deposit funding was impaired or completely closed off as many markets froze up.

Having few other options, banks scurried to raise deposits and slammed the brakes on lending. Along with management fiat, banks effected change by altering the liquidity premiums paid on deposits and charged on loans, including the calculation methodologies and the way the liquidity premium metric was used in the funds transfer pricing system. In an era of record low rates and scarce funding alternatives, the liquidity premium became a dominant factor in pricing loans and deposits.

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In using the liquidity premium for decision-making today, however, feedback from the market on the cost of liquidity (embedded in the bank’s credit spread) needs to be balanced with the bank’s balance sheet position and strategies. At the start of the downturn, for example, banks had lent to the limits of their deposit resources – many even beyond. A high value of liquidity tended to discourage lending and encourage deposit-taking, in line with the objectives of most bank at the time.

Fast forward to today and the situation is quite different. Most markets have unfrozen and banks can get incremental funding from multiple sources other than deposits. Bank balance sheets have changed dramatically, meanwhile, with deposits now far exceeding loans for the industry.

Internal pricing metrics have not kept pace with these changes, still hinged on credit spreads, which remain somewhat elevated. This is a problem for bankers, who are being handicapped by one-dimensional internal pricing frameworks. At many major institutions, the pricing of liquidity continues to encourage deposit-taking and make lending difficult – exactly the opposite of what most banks want to do at this point in the recovery. Because of exaggerated liquidity premiums, growth-hungry banks are going to market with higher-priced credit, which dampens origination volume.

Meanwhile, competition is being turned upside down as banks with simpler loan pricing processes (that exclude a liquidity premium) find advantages over lenders with more comprehensive capabilities. In response, banks with advanced liquidity pricing mechanisms are either: 1) placing some form of arbitrary management overlay into the system; or 2) ignoring the information in their liquidity premiums and pricing to market. Neither response

is appropriate, as they both separate the value of management information from actions taken to build business.

Something has to give. On the one hand, the inclusion of the value of liquidity in decision processes seems appropriate and is aligned with the concept of matched maturity pricing. On the other hand, it has become somewhat counterproductive, given today's balance sheet posture. To break this logjam, banks need to modernize the manner in which the cost of liquidity is incorporated into the funds transfer pricing system.

FLAWED APPROACH

To fully understand the challenge and opportunity in liquidity pricing, it is useful to review the concepts being used today. For example, most banks start with their cash cost of debt in the wholesale funding markets. Prices and associated interest rates are readily apparent for large banks with active senior debt issuance.

For the bank whose cost of three-year money is, say, 1.90%, the translation into the internal funds transfer pricing system typically works as follows: First, embedded in this 1.90% are two components: 1) a term premium, which can be hedged using interest rate swaps; and 2) the premium that the bank must pay to generate cash at a three-year term, representing the credit spread.

If a three-year interest rate swap is paying 1.40%, then the cash value is the difference between the debt issuance rate of 1.90% and the interest rate swap rate of 1.40%, or 50 basis points (bp). This 50bp then enters the funds transfer pricing system, causing the bank to add 50bp to the internal valuation of deposits, and to charge a 50bp liquidity premium for loans with three year terms.

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The flaw in this approach, however, is that the bank's wholesale market rate for liquidity mostly reflects its credit ratings, which are largely disconnected from the balance sheet posture relative to loans and deposits. Thus a pure wholesale market-driven approach to setting the liquidity premium can ignore the bank's real needs.

Consider, for example, two banks with identical debt ratings (and a similar cost of three year senior debt) but very different liquidity needs.

Bank “A.” This institution has a loan-to-deposit ratio of 1.10, meaning it holds \$1.10 of loans for every dollar of deposits. Bank A needs to generate liquidity to improve its overall balance sheet position. In this case, a higher liquidity premium provides information and incentives consistent with the needs of the bank.

Bank “B.” Though having the same cost of three year liquidity, Bank B has a sharply different balance sheet position. It has a loan-to-deposit ratio of 0.85, so for every dollar of deposits there is only \$0.85 of loans. Effectively, this bank has excess liquidity and needs to find ways of utilizing it more effectively. However, when the wholesale cost of liquidity is dropped into the funds transfer pricing system, Bank B's cost of liquidity is identical to Bank A, despite a huge difference in strategic balance sheet position.

This type of disparity is very much in play among major banks today. In fact, most banks and regulators are using the cash cost of funding as the only source of calibration of the liquidity premium. This practice does not take into account differences in strategic balance sheet positions.

BUILDING BLOCKS

Is there a way to combine the wholesale market cost of liquidity with other factors, such that the liquidity premium is more comprehensively representative of the bank's cost of funds and its strategic balance sheet position? Let's see what is there for building blocks.

Certainly, the wholesale market cost of liquidity should remain part of any determination of the liquidity premium. The credit spread provides transparent and objective information about the financial market's view of the bank's creditworthiness. But more dimensions are needed.

A second consideration is the bank's overall need for liquidity. As shown in the example above, banks can have quite different structural positions which should be taken into account. Banks with

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excess liquidity should value liquidity differently than those that are in need of liquidity. This difference in valuation should be communicated in the bank’s financial performance measures and pricing models.

Arguably, the loan-to-deposit ratio is a rather crude measure of liquidity which can be improved upon. For example, the Basel III accord includes two ratios that will be required to be reported by all banks – the Liquidity Coverage Ratio and the Net Stable Funding Ratio. Both of these ratios provide insight into the net liquidity position of a bank and should facilitate more consistent evaluations across banks.

There are other factors which should be incorporated into the calculation of the liquidity premium as well. While a full discussion of these additional factors is beyond the scope of this

article, the point is that at many institutions, internal funds transfer pricing is in need of an overhaul, not just a patch. Banks are in need of systems that are much more anticipatory and precise, both to satisfy higher regulatory requirements and to optimize institutional performance in a continuing challenging market.

Banks with comprehensive internal pricing frameworks will have metrics that not only accurately depict the market cost of liquidity, but also reflect the balance sheet posture and implications for growth and pricing targets for deposits and loans. These banks will be able to price loans and deposits more accurately, and gain an advantaged position relative to competitors, without resorting to arbitrary management overlays on pricing. They also will be able to communicate more effectively with regulators by showing how their internal measurements align with their overall liquidity position.

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