Managing through uncertainty: recommendations for bank treasurers

The current and potential effects of the COVID-19 outbreak and associated economic impacts will likely be felt long into the future. For the time being, though, bank treasurers are fighting fires that shift throughout the day such as managing liquidity impacts, evaluating new tools being offered by the Fed and monitoring seemingly countless policy changes such as adjustments in capital rules. To effectively deal with this environment, banks need visibility into the earnings impact from lower interest rates and balance sheet changes resulting from client draws on credit lines and deposit flows.

Liquidity buffer levels at most banks will change, but not necessarily in a consistent fashion since some banks will observe net outflows while others experience net inflows given customer “de-risking” and the flight to quality. For banks experiencing reductions in liquidity buffers, difficult balance sheet decisions will need to be made around the use of available liquidity to fund renewal of revolving lines and new extensions of credit. Coordination between business, treasury, and risk management is critical to recalibrate risk appetites for the road ahead.

Once we emerge from the stressed market conditions, there will be an opportunity to take a step back and rethink how analytics and decision-making capabilities can be improved to shape the longer-term strategy and help manage future crises. But for now, here are four actions you can take:

1. **Mobilize teams to quickly gather and act on information.** The sudden downward move of interest rates and client behavior resulting from market volatility requires fast, ad hoc analysis to support decisions like revisions to loan- and deposit-pricing strategies. The effectiveness of these strategies will directly impact the bank’s ability to mitigate margin pressure in a near-zero rate environment. Models and measurement tools at many banks are not dynamic enough to adequately meet this information need. As a result, many institutions will need to assemble task forces to manually retrieve and analyze client-level information on declining credit conditions and expected liquidity needs.

We don’t anticipate liquidity problems as clients draw on credit lines — especially given existing buffers and recent Fed actions to provide market liquidity — but banks are still pressed to manage changes in liquidity and recalibrate throughout the day. A dedicated task force will support this by segmenting portfolios to provide additional visibility into industry- or client-specific liquidity issues and analyze whether or not drawn cash remains within the bank as a deposit. Given resource limitations, treasurers should be quick to reallocate resources from noncritical projects to support analysis and meet reporting demands to executive management and the board of directors.

2. **Prioritize levers in the balance sheet management playbook.** Immediate priorities are to fund the bank’s own portfolio and manage the earnings impact from the recent emergency interest rate cuts. There are immediate actions to take on both sides of the balance sheet that will vary in priority and impact depending on each bank’s profile:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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<tbody>
<tr>
<td><strong>Liquidity buffers</strong></td>
<td><strong>Deposits</strong></td>
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<tr>
<td>• Monitor and forecast cash inflows as corporates and clients de-risk portfolios and increase cash positions</td>
<td>• Reprice for the new rate environment as soon as possible, while navigating client rate sensitivity, to manage margin compression</td>
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<tr>
<td>• Create scenarios to model delayed cash inflows per client “relief” programs modifying timing of payments</td>
<td>• Closely monitor deposit fluctuations, particularly for financial and corporate deposits</td>
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<tr>
<td>• Engage front office, payment operations, and risk managers in active discussions on usage of buffer, daylight overdraft or discount window</td>
<td><strong>Borrowings</strong></td>
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<td></td>
<td>• Use increased liquidity in repo markets to fund short-term mismatches</td>
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### Assets
- Forecast available liquidity buffer after shock-related outflows to determine capacity to support lending as encouraged by regulatory agencies
- Determine trade-offs between reducing liquidity buffer limits, lending capacity, and earnings implications

### Investments
- Assess opportunities to lend into short-term cash markets
- Analyze expected valuation impacts in securitizations, such as mortgage backed securities, due to relief programs modifying cash flows
- Evaluate trade-offs in rebalancing investment portfolio (i.e., realizing gains versus changing balance sheet duration)

### Loans
- Increase agility by evaluating client refinancing deals against balance sheet strategy
- Determine how government stimulus may create lending opportunities and impact risk appetite

### Equity

#### Earnings
- Recalibrate interest rate risk measurements to assess income impacts and changes to the market value of equity, including negative rate scenarios
- Engage credit risk and accounting teams to determine how increases in expected losses will impact earnings

#### Capital
- Evaluate how relief on capital buffers creates lending opportunities and affects profitability measurements
- Revise capital actions given changes to buyback strategies, dividends, and new balance sheet forecasts

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3. **Engage in proactive communication internally and externally.** Internally, executive management and board members expect continuous updates on the impact of the pandemic on the business. Business leaders should consider liquidity and capital implications of decisions to support clients and counterparties. Decisions to change risk appetite or reduce buffers cannot be made lightly and must adhere to formal risk governance, including board-level approval where necessary. Communication channels need to be kept open between business lines, treasury and risk, particularly as plans to provide support or relief to clients translate into delayed inflows or incremental outflows for the bank.

Externally, regulatory agencies are encouraging banks to use their capital and liquidity buffers yet expecting banks to have a close handle on sources and uses of cash and collateral with clear communication on differences relative to what was previously reported to regulators. In addition, individual institutions are sensitive to being an outlier in the use of these buffers for fear of sending a negative signal to the market. Institutions should project how these buffers might evolve as liquidity and credit needs change, while staying in close communication with regulators if they plan to approach or breach regulatory minimums or draw on Fed facilities.

4. **Create and analyze bespoke what-if scenarios.** There is no playbook for managing the unfolding market stress. Given the amount of economic uncertainty, banks should be developing and analyzing possible scenarios for the weeks and months ahead. Scenarios should include broad sets of outcomes and cover key questions concerning client needs, macroeconomic conditions, monetary policy, and fiscal stimulus. As examples, scenario analyses might evaluate:
  - Demand for new financing coming from lower-rated companies
  - Low rate environment encouraging refinancing for even highly-rated companies
  - Deposit flows changing in response to consumer and business sentiment
  - Role that the bank might play in delivering government stimulus financing to businesses and consumers
  - Impact of government terms on the bank’s financial performance and risk exposure
  - Risk appetite potentially changing for industries most disrupted such as small businesses, energy, hospitality, airlines, and entertainment

The good news is that, given post-financial crisis reforms, large US banks have built ample liquidity and capital reserves designed to survive stressed conditions. However, the speed of how events are unfolding is putting this to the test and may show cracks in a bank’s ability to efficiently assess and determine optimized strategies for managing interest rate sensitivity, earnings, liquidity and capital. The conditions will also likely reveal the inadequacies of some liquidity and balance sheet planning models, and the challenges of operating in a prolonged near-zero interest rate environment. For now, take decisive measures to mitigate the risk. There will be opportunity later for a postmortem to understand what happened, and determine how to improve going forward.
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