March 2023

First Take: PwC's Financial Services Update

Recent market events highlight the importance of financial risk management

On March 8th, a bank and its primary regulator the California Department of Financial Protection and Innovation (DFPI) publicly announced the bank's voluntary liquidation. Two days later, the DFPI publicly announced it had closed a bank citing inadequate liquidity and insolvency, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver.

Balance sheet management in a rising rate environment

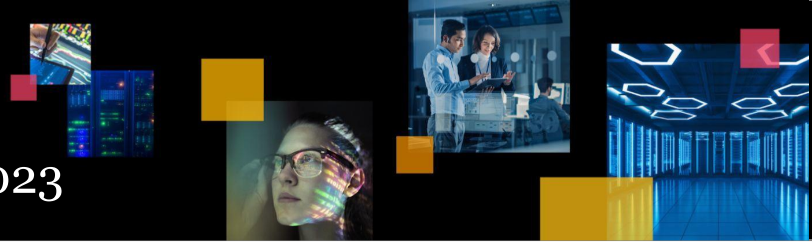
In the days following these recent events, many are publicly questioning what can cause a bank to be liquidated, voluntarily or by the government. At first glance, these could appear to be isolated incidents associated with banks concentrated in particular industries. However, they actually illustrate the importance of effective bank balance sheet, liquidity and interest rate risk management practices during challenging and uncertain economic conditions.

The first two years of the pandemic saw record increases in deposit portfolios as individuals and companies significantly curtailed spending, increased savings and received government support. Many banks looking for ways to increase interest income invested these deposits in investment securities, particularly because reduced individual and corporate spending translated into limited loan demand. The investment securities commonly selected were high-quality, government-secured debt instruments that do not require risk-based capital reserves and can be used to generate liquidity in a stress event. However, investment securities, are highly sensitive to changes in interest rates.

Since early 2022, the Federal Reserve (Fed) has raised its benchmark interest rate by more than 4.5%, which significantly reduced the value of these investment securities and produced "unrealized losses" on bank balance sheets. These interest rate increases have also driven bank customers to shift bank deposits to other products like money market funds in search of higher yields. This dynamic as well as customers' increased spending of cash accumulated during the pandemic has culminated in a loss of funding for many banks.

This combination of reduced values in investment portfolios and increased pressures from deposit outflows has led to challenges in managing liquidity risk, particularly as selling lower-yielding investment securities at a loss to cover deposit outflows erodes capital. The liquidity risk is heightened when the deposit base of an institution is comprised of larger, shorter-term, interest rate sensitive deposits. The balance sheet mismatch between long duration bonds such as US Treasuries and Agency Mortgage Backed Securities versus unstable deposits displays a classic problem in bank risk management known as the asset-liability mismatch. Banks commonly measure these mismatches and set limits to control the risk, but these limits are not always effectively managed because hedging or forgoing interest income could hurt bank profitability.

Fast forward to 2023, deposit outflows have been cited as a growing concern across the industry with the Fed considering further rate increases. These recent events demonstrate the potentially critical impact of increased deposit outflows surpassing existing liquidity buffers held in the form of cash and highly liquid securities that decline in value and highlight the need for all banks to continuously evaluate and adapt their liquidity risk and interest rate risk management practices.



How can banks manage balance sheet stress?

This week's banking announcements highlight the importance of effectively managing the risks inherent in this environment. A number of uncertainties remain, including future Fed interest rate decisions and how current market dynamics will impact bank balance sheets going forward. Banks should bring together decision makers across Product, Pricing, Marketing, Communications, Finance and Risk to consider the following:

1 Liquidity monitoring and stress testing

- Actively monitor and forecast cash movements on a daily basis with a focus on segments such as large depositors, uninsured balances and credit lines
- Increase stress testing scenarios and frequencies, understanding concentration risks and links between liquidity and capital using a variety of scenarios (e.g., deteriorating credit conditions, "stagflation" scenarios and potential Fed actions)
- Revisit liquidity impacts of key non-core/less-stable deposit outflow potential and assumptions around uninsured and brokered deposits

2 Deposit strategy

- Identify "at risk" clients (i.e., the discretionary balances that are most likely to move to safer havens) by analyzing price elasticity, depth of relationship and other silent attrition triggers
- Focus on retaining uninsured higher-balance clients and assuring them of the strength of the bank's financial condition
- Deploy targeted actions for these clients through competitive relationship pricing and drive primacy of relationships by offering additional treasury management, cards and other money movement products
- Activate new client acquisition strategies through branches, relationship managers and digital channels

3 Contingency funding

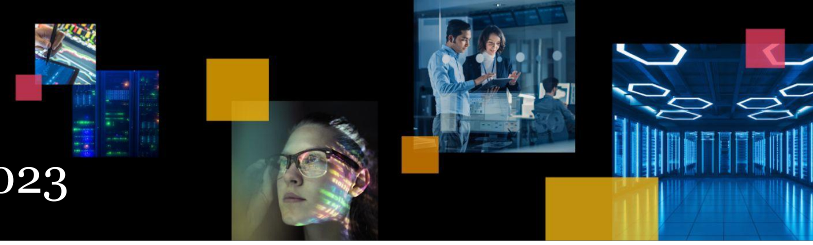
- Evaluate and test operational processes, monetization frameworks, resources and systems to confirm they are available to execute needed contingent liquidity actions by running table-top exercises to simulate a liquidity event with the involvement of senior management so they are well-versed on actions that may be required, including communicating with internal and external stakeholders
- Review levels of highly liquid marketable securities free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs

4 Communication plans

- Evaluate investor and depositor communication plans with a focus on how to prudently reassure stakeholders that the liquidity and financial condition of the firm is sound
- Prepare statements for a variety of scenarios and considerations including the potential impact of social media

5 Asset liability management

- Evaluate interest rate risk strategies using measurements such as duration, the economic value of equity and income sensitivity and revisit decisions around risk acceptance versus hedging
- Enhance interest rate risk modeling to include scenarios that test different balance sheet trajectories, including rapid deposit inflows that may be less stable than existing customer balances



Preparing for potential growth opportunities

Banks that have strong balance sheets with liquid securities, diversified deposits, multiple contingent funding sources and robust asset liability management practices may see opportunities to acquire new customers, portfolios or entire banks. They should consider the following to assess their readiness for deals or rapid client onboarding:

1 Market analysis and target evaluation

- Develop marketplace intelligence and identify banks that might be experiencing balance sheet stress
- Prepare a cursory acquisition analysis for each target, including the potential target's core businesses and capabilities and an assessment of whether those attributes are aligned to your strategy
- Embed the financial information of potential acquisition targets into your asset-liability management and liquidity scenario analysis to confirm that the acquisition can be safely executed

2 Integration readiness

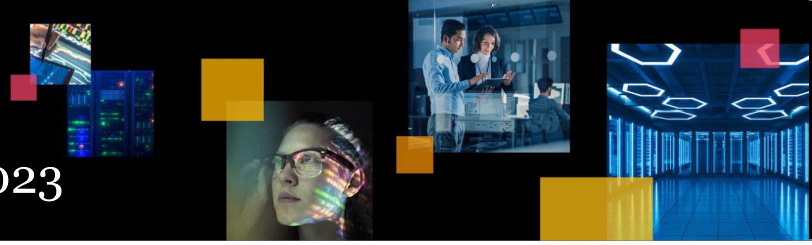
- Develop a cross-functional integration team capable of rapidly assimilating treasury, cash management and risk frameworks
- Assess operational risks and potential staff attrition
- Prepare a communications plan to respond to internal and external stakeholders including customers of the target bank

3 Customer onboarding

- Enhance client onboarding strategy and consider targeted outreach or "white-glove" capabilities to ensure newly acquired customers are retained
- Test onboarding processes and systems to ensure they are resilient to rapid customer acquisition, whether it is organic or inorganic
- Understand and manage risks associated with rapid customer growth such as consumer compliance and financial crime risks

4 FDIC cooperation

- Understand the FDIC assisted transaction timeline and unique attributes such as loss sharing
- Develop a corporate development process that can operate within the constraints of an FDIC-assisted transaction, including adjusted diligence requirements and procedures for limited data and access
- Prepare board and committee approvals to allow for a deal timeline of 1-2 weeks from initial information packet to deal closing

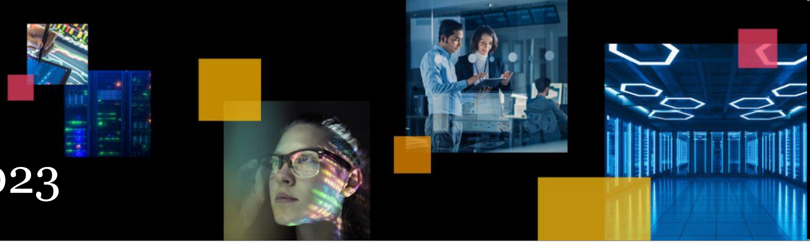


What's next?

The impacts from the recent market events, both on the banking industry and the broader economy, continue to evolve; accordingly, we are closely watching the following areas:

- **Bank, corporate and household balance sheets.** Consumer debt has increased and loan growth has accelerated, spurring an increase in loan-loss reserves. Deposits will come under further pressure if interest rates continue to rise and as some opportunistic firms employ aggressive deposit gathering strategies. Meanwhile, some longer term assets that were acquired with lower interest rates now have below-market margins and credit risk associated with leveraged commercial and industrial loans remains high. We will be watching how these dynamics affect bank balance sheets and potentially force changes in bank funding strategies.
- **Bond yields and volumes.** Declining liquidity in government and agency securities has been an issue for many months and may continue to worsen, particularly if rates rise further and more banks need to make up for deposit outflows. Trading volumes and yields may be leading indicators influencing a bank's need to generate liquidity, even if it results in a loss.
- **Central bank and regulatory response.** Central bank policy decisions and communication around changes to balance sheet reductions may have a direct impact on the pace and pervasiveness of bank liquidity challenges. Fed decisions around interest rate policy may be complicated by the competing forces of a strong economy and inflation against challenges in the financial markets and banking system. Separately, how regulators treat the voluntary and government-led unwinding of the two banks will inform how opportunistic buyers approach potential acquisitions. Further ahead, the Fed, OCC and FDIC will likely draw lessons from these events and incorporate them into supervision plans for risk management practices, as well as policies for charter and merger applications. In addition, it is possible that policy makers will reevaluate past actions that reduced the number of financial institutions that must comply with prescriptive requirements for areas including stress testing and minimum liquidity ratios.

The current environment presents notable risks but also significant opportunities for banks with highly liquid balance sheets and thoughtful growth strategies. Firms should be considering the key levers around deposits, balance sheet management and deal-making, but also evaluate overall profitability levers including client strategy, product mix and cost. Short of an outright transaction, some banks may experience growth as customers potentially shift deposit relationships. Firms should be prepared for understanding how customer growth aligns to strategy and impacts balance sheet risk. While uncertainty remains high, we are confident that complacency will not be a winning strategy.



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