+ frequently asked questions

Impact of ARP Funds on the U.S. banking system

1. **My bank has limited the amount of cash my entity is able to keep on deposit. Why and what is the solution to this problem?**

Answer: The actions by the Federal Reserve and government stimulus have led to domestic deposits growing by a record 23.2% or $3.07 trillion in 2020 alone[2]. As an additional $1.9 trillion flows into the banking system, your bank's balance sheets will become flush. In order to right-size their balance sheets, banks are utilizing their own liquidity data to deploy cash into the economy for them to generate interest income—the primary source of revenue for most banks. Public funds must be collateralized and compared to different types of bank deposits; this makes public funds costlier to hold.

Public entities utilizing their own internal liquidity data can be proactive with their banks as markets continue to evolve. three+one's MC Liquidity Forecast Model® produces weekly cash projections that allow for transparency with current banks on future cash needs. Public entities will be able to generate more value when they have access to marketplace and peer benchmarks, as well as data on prospective banking partners that might be able to take additional funds.[1]

2. **How can strategic liquidity planning in conjunction with my Local Recovery Funds help my entity's credit rating?**

Answer: Liquidity makes up 10% of the framework for ratings at S&P. Liquidity data can substantiate your entity's overall strength in this category, thus providing rating agencies with confidence, based on objective, third-party analyses.

Critical criteria reviewed by rating agencies in assessing municipal debt ratings include:

1. Access to cash and liquidity: what is the time horizon of funds for your entity?
2. The volatility of revenue to determine the likelihood of the availability of revenue during different economic cycles. Do you have the results of an ongoing stress test on cash?
3. Total available cash in proportion to governmental expenditures and debt service, and how this is compared to overall liquidity. What is your entity's excess liquidity after it has been incorporated into coverage ratios and debt-service payments?[2]
4. Investment strategy on liquidity.[3] Is the value being realized on cash commensurate to benchmarks and is it actively contributing to a cash-management strategy?
5. Qualitatively distinguishing weekly liquidity sources and uses.[2]
6. Maximum Annual Debt-Service Coverage.[2]

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[1] Tony Carfang and Graeme Henderson. The Carfang Group: Deposit Surge Distorting Bank Balance Sheets. The Carfang Group, March, 2021. https://f50dbc85-4ed8-46a0-9a0f-f259c94b7618.filesusr.com/ugd/61fccc_a68f30e0588f48fa8b69ddbc40561854.pdf

[2] Thompson, Geordie. "Proposed Update: US Municipal Bonds and Commercial Paper Supported by a Borrower's Self-Liquidity." Moodys.com. Moody's, May 14, 2019. https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_1146779.

[3] www.standardandpoors.com

7. "Robust and stable" cash-flow capacity compared with peers.[3]

3. What kind of deposits are my banks looking for?

Answer: Large money-center banks want transactional business and funds while regional and community banks want operating and non-operating funds. Here's why:

Operating funds and transactional business are used in day-to-day operations (e.g., payroll, benefits, vendor payments, debt payments, etc.). This type of business is most appealing to large money-center banks especially when coupled with transaction-type services like electronic payments, purchasing cards, and virtual payments, generating fee income for the bank.

Non-operating funds are held for reserve. Large money-center banks must set aside a certain percentage of their capital to meet federal liquidity requirements. These requirements ensure a bank has the proper capital in place in case of a significant economic shock. In many cases, large banks are not interested in holding non-operating funds and, if so, they are not paying interest on them.

Federal liquidity reserve requirements do not apply to regional or community banks, so they will be more apt to take non-operating funds as long as they know how it relates to a banking relationship. A strategic liquidity plan provides the expected uses and duration of the American Rescue Plan (ARP) Local Recovery Funds. This information is valuable to a public entity's liquidity strategy and its financial institutions for balance-sheet planning. More liquidity data and the sharing of data will lead to a greater appetite for funds by a bank.[4]

4. Is there a need for a strategic liquidity plan for my entity's ARP Local Recovery Funds?

Answer: There are two important cash-management highlights to note with regards to your entity's Local Recovery Funds: (1) 50% will be provided in the spring of 2021 and 50% will be provided at least 12 months after the first deposit; (2) the funds are required to be spent within 44 months.

Both of these known guidelines require a strategy to incorporate Local Recovery Funds into your entity's current cash-management strategy. This strategy should include:

1. Knowing where cash needs will be in the future.
2. A framework to invest all cash depending on the time horizon.
3. A strategy around managing compensating balances, investing funds, spending funds, and reporting on funds.

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[4] Wolfe, Christopher, Julie Solar, Bain Rumohr, CFA, and Laura Kaster, CFA. Fitch Ratings: Credit Ratings & Analysis for Financial Markets. Fitch Ratings, March 22, 2021. https://www.fitchratings.com/research/banks/us-banks-sufficiently-capitalized-to-withstand-slr-expiration-22-03-2021.