LIQUIDITY EXPOSURE

by Steve Brown

The doorbell rings and a man answers, fresh out of the shower, wearing nothing but a towel. It is the wife next door and she makes the offer that if the man drops the towel, she will give him $200. The man thinks about it for a second, drops the towel and receives the cash. Both smiling, the man shuts the door and returns upstairs. Once upstairs, the man's wife yells out "Watch out for Mary from next door. She will be coming by to donate $200 to the school auction." The moral of the story - If you share critical risk information, you may prevent avoidable exposure. This is not only an apt story for a Friday before a long-weekend, but it highlights the increased risk of liquidity at many banks. Given strong loan growth and tight funding, it is no wonder that liquidity concerns are starting to creep up again. During our last economic downturn in the early 1990's, investment portfolios made up 27% of the average bank balance sheet and were filled with unpledged, marketable securities. Today, investment portfolios as a percentage of assets are at a record low (17%) and many banks are nearly completely pledged. This comes at a time when leverage is not only higher, but CRE concentrations are as well. Banks should review and update their liquidity plans, because a crunch could come faster than many believe. As a starting point, it helps to know your cashflow from loans, investments and deposits under projected and shocked conditions. When running ALM scenarios, management can document the order of funding alternatives and note weaknesses. Knowing which liquidity avenues are the most vulnerable is imperative. Having board approved, written policies on liquidity are also important and can assist in both day-to-day operations, as well as during a liquidity crisis. Many banks assume that funding sources will always be available, when the reality is that a couple of loan defaults could drop a bank below well-capitalized and result in Fed Funds, repo and FHLB lines being eliminated. In order to avoid getting to that point, banks not only need to have a set of diversified funding sources, but also to articulate a set of early warning signs. Once tripped, these alarm bells should force management to enact a series of steps that might include issuing more capital, more CDs, selling loans, or unwinding existing leverage programs. This all sounds good on paper, but as the early 90's proved - many banks that tripped early warning signs failed to enact planned procedures. These banks did not recognize they had a problem, or did not want to take an additional hit to earnings that issuing more capital or taking a loss on sale might create. While some banks worked out of their problems, others quickly became illiquid. Management should develop a series of ratios and metrics that allow monitoring and are complex enough to match the sophistication of the balance sheet. These warning signs and management metrics are usually built around the following: 1) available cash; 2) projected and stressed cash flow for next 3 months; 3) available liquidity lines; 4) liquidity ratio; 5) wholesale funding/total funding; 6) loans-to-deposits; 7) core funding/total funding; and, 7) CD/high-rate promotion retention rate. By working with these factors, banks can get a better handle on their liquidity risk and spot problems before they occur. Now is the time to refresh your liquidity lines and make sure your processes are in place. By having a well-defined and understood plan from the board level down to the line staff, management can prevent having an incident of unintended liquidity exposure.

BANK NEWS

M&A

Integra Bank ($2.7B, IN) will acquire Prairie Financial ($500mm, IL) for about $117.2mm, or 3.19x book.

M&A

Whitney Holding ($10.5B, LA) will acquire Signature Financial ($258mm, FL) for about $61.7mm, or 3.34x book.

Possible M&A

Citigroup has reportedly hired a law firm to look into the possibility of a merger with a European bank, an overseas newspaper is reporting. Banks mentioned in the article as possible targets for Citigroup include BNP Paribas, Societe Generale, Barclays and Banco Bilbao Vizcaya.

Coming Soon

In an interesting approach to customers (and one that will soon reach U.S. shores), England's largest bank, HSBC, announced a service that enables customers to bank over a cell phone. The product allows clients to check balances, view statements and make deposits through mobile phone accounts.

Competition

First Horizon National Corp, the parent company of First Tennessee Bank, has opened 2 new branches in MD. The bank now has 20 financial centers in DC and MD, with plans to expand into VA in coming months.

Your Customers

As storm losses smack around insurance carriers, they have begun to drop wind coverage in many states. In FL for example, insurance agents say coverage is 5x more than it was just one year ago. Independent banks will need to work with their customers to help them find coverage.