SURFING THE LIQUIDITY WAVE

by Steve Brown

Surfers know that catching and riding big waves can be tricky. Bankers know that adequately managing liquidity risk can be just as tricky. The problem with liquidity risk (as with wave riding), is that it is constantly changing. Traditionally, liquidity has been defined as the ability of an institution to replace liability runoff and fund asset growth promptly and at a reasonable price. As history has shown, a bank without adequate liquidity can find their business plans negatively impacted at one end of the spectrum, while going out of business on the extreme end. As a result, examiners expect banks to not only have enough liquidity to meet daily and emergency needs; but also to incorporate a risk management process to allow management to identify, monitor, measure and control such risk. While this sounds relatively simple, funding sources have become increasingly complex, as have the assets being funded. This results in an increased risk profile, while requiring enhanced analysis to ensure adequate liquidity is readily available. While regulators still monitor traditional liquidity metrics, such as the loan to deposit ratio, non-core funding dependence and the liquidity ratio; they have increased focus on whether these metrics capture (or may even misrepresent) the true liquidity position of the bank. When it comes to liquidity, banks should be sure to capture any unique characteristics of their funding sources, capture all sources of liquidity, and accurately measure and report the liquidity available from each asset or liability. It is important to ensure metrics are robust enough to provide management and the board with accurate information to support sound and cost effective decision making. In addition, regulators will expect banks to justify assumptions made related to the interest rate sensitivity of deposits. Given the significant role these inputs play in the EV calculation in particular, examiners want to be sure management has also analyzed and documented the interest rate sensitivity of core deposits. Banks with high levels of non-core funding should not be surprised that examiners will be checking to see how well management has documented and understands the interest rate sensitivity and embedded optionality of such funding sources. To understand and control liquidity risk, bankers should be sure to incorporate the following: 1) have a process and reporting structure that provides management with information on customer and product behavior in various environments; 2) incorporate customized metrics that match the bank's balance sheet and customer base; 3) document any assumptions; 4) ensure assumptions are consistent between risk areas and modeling systems; 5) project loan draws and report historical variance from projection to refine the measurement over time; 6) revise funding strategies to avoid concentrations; 7) enhance the contingency funding plan to include triggering guidelines, metrics development, better quantification of funding sources, adequacy of projected funding sources and development of common scenarios; 8) develop and test warning signals, process and the contingency plan; 9) stress test funding plans using interest rate shocks, as well as adverse economic and competitive scenarios; 10) consistently review guidelines and policies to ensure they incorporate the banks changing strategic objectives, new products and shifting balance sheet. In short, liquidity management should be an integral part of the risk management process, as crises can and do happen at any point in the economic cycle. As with surfing, adequate preparation, suitable equipment and proper training are critical for successful liquidity risk management.

BANK NEWS

M&A

Firstbank Corp. ($1.1B, MI) will acquire the HC of Ionia County National Bank of Ionia ($234mm, MI) for $38.4mm, or about 1.75x book.

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Belvedere Capital (CA) will acquire Professional Business Bank ($184mm, CA) for an undisclosed sum.

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State Street Corp ($97B, MA) will acquire the HC of Investors Bank & Trust Company ($12B, MA) for about $4.5B, or approximately 4.73x book.

Competition

Bank of America has launched a program designed to help it acquire franchise owners. The program, called "Franchise Banking" offers a bundled package of services including deposit, cash management, merchant-card processing, specialized loan products and other services. The bank said Franchise Banking targets owners with annual revenue of less than $20mm.

Higher

Research finds higher home ownership and low mortgage rates helped pushed apartment vacancies higher in 2006. Of 79 large metropolitan markets, vacancies hit their highest level in 2Y, rising roughly 4% to 5.9% overall. At 11.8%, Colorado Springs had the highest vacancy rate, while New York City clocked in with the lowest at 2.3%.