CASH FLOW IDENTITY

by Steve Brown

The British cult classic, "The Prisoner" was as educational on human psychology, as it was entertaining. In this 1967 TV show, the protagonist is an ex-secret agent who is captured and taken to an isolated town called "The Village." On its surface, the show revolved around the main character's continual escape plots and attempts to find out who ran the Kafka-esque camp. However, one of the show's many underlying themes was how the main character attempts to assert his identity. While everybody was assigned a number, the main character refuses his "No. 6" label and terms himself "The Prisoner" in an act of defiance. Independent banks as well, struggle with the concept of identity. On the surface, many banks highlight the customer service aspect of their personality, but that only tells part of the story. As we learned in The Prisoner, a portion of identity is determined by surroundings and external influences. This is never more apparent than in banks, as many institutions take on the identity of their customer base, geography, demographic or cultural surroundings. While a whole tome could be written on the marketing aspect of this question, our interest lies in how a bank's identity affects its ALCO management. Banks that build their identity going after gaming, agriculture, professional firms, tourism businesses or seniors; all have a certain asset-liability profile inherent in their customer base. Different businesses and demographic cohorts have different cash flow patterns both on the assets and liabilities. As a result, a bank may have a natural duration on its loans and liabilities, simply because the cash flow demands of its clients. For example, technology companies (because of their extensive research and development) tend to leave higher cash balances and are less interest rate sensitive. The same is true for financial institutions that bank charitable foundations. As a result of this, banks that successfully court this type of customer base, tend to have longer liability durations and have more room for fixed rate lending on their balance sheet. On the other hand, financial institutions that go after real estate developers, or specialize in handling 1031 like-kind real estate exchanges, have the opposite profile. Here, cash flow duration is short and highly subject to interest rates. The good news, however, is that these customers also tend to be less fee sensitive. Independent banks have proven successful at creating products that are heavy on service and flexibility, in order to attract these customers. More importantly, banks have recognized their natural duration and built that identity into their planning process. Banks with this profile tend to get more out of hedge products in efficiently managing interest rate risk, as their natural customer base is not able to do that for them. While most banks have a mix of customers that carry different cash flow profiles, many have customer segments that dominate and end up shaping the institution. While The Village used a hot air balloon to keep tabs on The Prisoner, bank management should have an easier time. By monitoring the balance, management can find out what influences cash flow. The Prisoner taught us that identity is not only a two-way street, but is dynamic and changes over time.

M&A

CIT Group agreed to buy Citigroup's $2B asset business technology unit (vendor leasing) for an undisclosed sum. Insiders at Citi say the bank "got the price that it wanted" and was able to decrease its credit exposure in this line of business.

BANK NEWS

Moody's Bank Ratings

The rating agency continues to get bashed in the press, as its new bank rating methodology is meeting with less than happy fanfare. Moody's raised the ratings on about 150 banks, while dropping ratings on more than 40 others. The complete ratings analysis is expected to be complete by next week and largely affects international banks.

WARNING

The OCC warned against offers from lenders and brokers that promise cash from a Community Reinvestment Act. It is a "deceptive effort to encourage consumers to apply for a mortgage loan secured by the consumer's home." The OCC stresses that there is no such program.

FHLBs

Net income increased 4% over last year for the Home Loan System, as profits rose at 8 of the 12 banks. San Francisco produced the highest increase in profit followed by Boston and NY. Des Moines printed the largest decease in net income, followed by Dallas and Chicago. In terms of advances, Seattle produced the highest increase in volume followed by San Francisco. For 2006, the financial data shows that Banks within the Home Loan System faced higher regulatory costs, lower NIMs and lower demand for advances due to industry consolidation. On the positive side, FHLBs were able to retain more earnings (as only 3 Banks are paying out an increased dividend) and increase capital.