SLIPPERY LIQUIDITY

by Steve Brown

The extreme market volatility of late got us thinking about a discussion we had some time ago on bank liquidity. Usually, community banks are pretty good about keeping extra liquidity on hand. In fact, roughly 50% of the average bank's collateral is unpledged and most still carry about 5% of their assets as Federal Funds sold every day. When one begins to examine the components of liquidity, what seems intuitive, however can be rather slippery. In short, liquidity for a community banker is usually defined as having the ability to provide sufficient funding at a reasonable cost for a sufficient period of time. As you read that again, you can see how slippery things can quickly become. One way to begin identifying your bank liquidity is to start with 2 very big buckets. The 1st bucket ("B1") could be labeled "stuff we own that provides our funding" (i.e. primary liquidity) and the 2nd ("B2") could be called "stuff we might be able to sell or borrow against if needed" (i.e. contingent liquidity). For community banks, B1 usually covers deposits, Fed funds sold, repo lent, investment securities and monthly P&I cashflows from assets. The good thing about B1 is that it is readily available, mostly within management control and simple. The bad thing about carrying too much is that it requires capital, may add interest rate risk, has an opportunity cost and may provide little added value beyond increased liquidity. When you need the liquidity, this is great to have, when you don't and capital costs 11% or so, it can be expensive to carry (particularly when bankers are underleveraged). For most community banks, B2 on the other hand, would likely include Fed Funds purchased, brokered deposits, FHLB Advances, repo borrowed and the FRB Discount Window. The good thing about B2 liquidity is that it does not cost the bank anything until it is drawn down. This controls costs and eliminates the capital impact. The bad thing about B2 is that in some cases, a bank that most needs liquidity will find credit lines cut or reduced, collateral values reduced and flexibility limited. Top performing banks manage their liquidity risk as they do most other risks. They actively calculate, manage and rebalance the risk-reward to maximize shareholder profitability within acceptable parameters. There is no simple and easily applied calculation, since risks constantly change. Therefore, banks must evaluate liquidity from a multi-faceted approach. This can be done by asking some questions. Is the liquidity plan reasonable and has it been tested? Do the limits make sense given changes in market condition? Has the bank's risk profile substantively changed? Has someone been specifically assigned to measure, monitor, report and manage such risk? Does the liquidity support the bank in an emergency situation and if so, what kind of emergency? Can the bank handle and has it tested a run on deposits? What about a Katrina, terrorist, or branch closure event? What about the suspension or withdrawal of credit lines or collateralized borrowing facilities? Has the bank tested a situation where the FRB pumps in TOO MUCH liquidity and the bank's earnings are negatively impacted (i.e. the bank cannot sell to anyone because Fed Funds are a 0%)? Clearly, calculating a bank's liquidity needs, risks and structure is an ongoing and fluid process. Hopefully you are testing lines, monitoring available credit capacity and doing some forward testing to ensure your bank is protected no matter the scenario. Walking carefully in liquidity puddles now can help prevent slipping and hitting one's head when unforeseen risks arise.

BANK NEWS

M&A

BB&T (NC) said it would buy commercial real estate finance company Collateral Real Estate Capital (AL) for an undisclosed sum. Collateral has 14 offices and is one of the largest privately owned commercial mortgage companies in the country. Collateral's production volume in 2006 was $5B.

Countrywide Saved

Bank of America bought $2B of preferred stock in Countrywide, providing a much needed cash infusion and giving Bank of America the right to match any offer for the Countrywide.

Mobile Banking

Royal Bank of Scotland said it will launch a mobile banking service in September for 13mm debit card customers. The bank said it will offer the service without any monthly charge. Royal Bank of Scotland owns 9 banks in the U.S. including Citizens, Charter One and RBS National and controls $162B in assets in this country).

Regulatory Crackdown

The SEC said it has found no signs global credit turmoil has undermined the financial soundness of the largest U.S. securities firms. The agency said it is closely monitoring those firms, however and also expects to probe the credit rating agencies (i.e. Moody's S&P, Fitch) and any role they may have played in the credit debacle.

Regulatory Crackdown

The ECB, which has been critical of credit rating firms for so widely misjudging the risk of bonds backed by subprime mortgages, has launched a probe into the process used by Moody's and S&P. The regulator said it will review governance, conflicts of interest, company resources and other items as it tries to get a handle on how the crisis may have been averted.