TOILETS AND LIQUIDITY RISK

by Steve Brown

Can we talk about our toilets for a second? You see, 2Ys ago we put in low-flow, automatically flushing Johns in our building and then patted ourselves on the back for helping out the environment. We were proud of our lavatories right up until our water audit last month. It turns out, that not only were we not saving water, but we were actually wasting it by 30% over our baseline year. Upon research, it turned out that those low-flow commodes required more flushes to get the stuff down. Further, the automatic flushing sensor trips the flush more often than compared to the traditional manual version. This is awkward to talk about, but suffice it to say, you never really know what is going on until you analyze it. The same thing is occurring for bank liquidity. Many banks don't have liquidity as their top risk, but it should be number 1 or 2 on everyone's radar screen (only credit risk can come close). While interest rate and credit risk gets the bulk of the analysis, it is only liquidity risk that can close the lid on a bank in the next 24 hours. Unfortunately, banks are not very good at predicting when a sudden rush for cash will take place. Moreover, liquidity is an asymmetrical risk, as the bulk of a bank's liabilities can be immediately called, yet the assets cannot. Maybe it is an employee brought up embezzlement charges, it is a BSA C&D or it is a credit problem with a large borrower, but whatever event acts as a catalyst, a run on deposits can ensue within hours. Our fractional reserve system guarantees a liquidity problem anytime depositors have doubts they can't get their money out tomorrow. In these situations, we have learned, logic and crises control plays very little role. The need for self-financial preservation is so strong that even if it is in the depositors best interest to keep their money in the bank through a financial crises, time and time again, we see large outflows of money when major negative news is made public. In the last month, you have to look no further than recent liquidity runs at Countrywide and Northern Rock in Britain as examples. Both these institutions just taught us that Basel 2, with all its complexities, did not provide a suitable risk-based framework for dealing with liquidity risk. Given that we just had 2 community banks fail in the last week (the first time this has happened since March of 2004), the topic is ripe for review. Fed funds and Home Loan advance lines can only take a bank so far before they are cut or reduced in a crises. The single best thing a bank can do to mitigate much of this risk is to create more of a liquid investment portfolio. The more credit risk embodied in a bank's loan portfolio, the more liquid and large their investment portfolio should be. Up until the late 1980's, investment portfolios made up 30% of a bank's total assets. Now, that figure is closer to 15%. Unfortunately, loan concentration risk has also increased during this time. Because of this low figure, banks are less diversified. Because of this low figure, banks have higher cost of funds, as there is little "buffer of liquidity" to protect core deposits. Because of this low figure, banks have very little liquidity options should financials start to go down the drain. A majority of banks have pledged up what little liquidity they have in their investment portfolio, thereby imparting leverage on the liquidity risk. Banks continue to be under the false assumption that liquidity is sufficient in all cases. In many of the institutions that we review, it is not. We are not sure where the risk sensitivity exactly is, but somewhere when a bank takes a 30% reduction in its capital due to credit or operational losses. It is at this level, banks can expect a significant portion of their liquidity to disappear. When credit quality problems start to rise as they are doing now, banks would be well served to increase the amount of liquid investments and sacrifice earnings in the process. As the industry is just learning, liquidity could be the largest, unspoken risk we have in our industry - fact that just stinks.

BANK NEWS

Shut Down

Ohio's Superintendant of Financial Institutions shut down Miami Valley Bank ($125mm, OH), the 3rd FDIC-insured bank to fail this year. Citizens Banking Corp ($769mm, OH) will assume $62mm of the failed bank's deposits.

Bank Secrecy Act

Regulators ordered American Metro Bank ($80mm, IL) to beef up its Bank Secrecy Act compliance procedures by improving its personnel training, providing better records of foreign customers, and making more timely reports of suspicious activity.

Subprime Woes Not Over

S&P's chief economist said that the subprime mortgage crisis is not even "halfway" over and doesn't expect housing prices to hit bottom until next summer.

Slower Growth

The International Monetary Fund cut its 2008 growth forecast for the US to 1.9% from 2.8% due to the fallout in the subprime mortgage market and subsequent credit squeeze.

INVESTMENT PERFORMANCE

Community bank investment performance moved in positive territory for Sept., as yields moved 14bp lower. The average bank lost 0.03 in duration, kept their book yield steady, increased their market price by 25bp and raised their total return by 36bp for the month.