LIQUIDITY & COFFEE MANAGEMENT

by Steve Brown

Yesterday we began a discussion about the merits of coffee drinking and sound bank liquidity risk management. Today, we continue our analysis of soon-to-be-enacted regulatory guidance related to liquidity risk as we retain the coffee theme and act as your baristas to help guide discussion for this morning.

We begin with plain black coffee as a metaphor for corporate governance. As with this most basic beverage, the board of directors has the basic underlying responsibility for the liquidity risk assumed by the bank. At a minimum, boards must understand what drives the liquidity risk of the bank; conduct periodic reviews of strategies, policies, procedures and contingency funding plans; monitor liquidity levels; ensure the bank utilizes adequate measurement and reporting systems; and clearly identify the individuals and committees responsible for making liquidity risk decisions. Whether done through asset-liability, enterprise risk management or liquidity risk management committee structures, the board is ultimately responsible for ensuring the bank has established a well-integrated and robust liquidity risk management framework into the organization.

We next move to the latte (one step more complex than the basic black coffee because it includes steamed milk), as a metaphor for the role of management when it comes to liquidity risk management. Here, it is critical that management move to create strong measurement and reporting systems; ensure the bank has a buffer of liquid and unencumbered marketable securities to handle stressed situations; strong internal controls; plainly understood lines of authority and responsibility for managing liquidity risk; clearly documented polices and procedures; robust and regular board reporting of risk positions; and have a process in place to actively manage both intraday liquidity and collateral.

Now we reach the cappuccino (which is a lot like the latte, but adds the nuance of more foam), as a metaphor for a set of decent policies. Banking is all about having decent policies and procedures to follow and managing liquidity risk certainly requires that. As part of any good policy, banks should includes such factors as identifying primary sources of funding; having strategies in place to handle adverse scenarios; addressing how the bank will handle temporary, medium and long-term liquidity disruptions; put limits in place to address liquidity within business entity or business line; incorporate liquidity risks into business continuity planning; set specific risk tolerances; employ quantitative and qualitative guidelines and incorporate cashflow projections. In addition, banks should make sure policies capture volatility dependence (wholesale funding to total liabilities, high-cost/out of market deposits to total deposits); funding concentration limits by source (maximum amount of wholesale/brokered funding, secured vs. unsecured funding sources, etc.); funding concentration limits by characteristic (instrument type, geographical area, term of funding) and contingent liability exposures (unfunded loan commitments, lines of credit, collateral requirements).

We close with the caramel macchiato as a catch-all metaphor (sticky, sweet and more complex to make) for everything else related to liquidity risk management. To truly be a top performing bank when it comes to managing risk, significant business activities and product lines should also take into account the cost of liquidity. By evaluating liquidity costs, benefits and risks in internal product pricing, performance measurement and new product approval processes; banks align risk-taking with liquidity exposure for the institution as a whole.

We will close off our discussion of how banks can improve liquidity management and meet the requirements of the proposed regulatory guidance tomorrow, as we detail specific steps to take when creating a contingency funding plan. In the meantime, consider whether you need a single or double shot this morning.

BANK NEWS

FDIC DIF

At the end of May the reserve ratio was down to 0.27%, far less than the 1.00% statutory requirement. The FDIC said a 2nd special assessment may be needed, which now appears to be a near-certainty.

Bankruptcy

For first half of this year, 1.25mm personal bankruptcies have been filed, 34% higher than the same period last year.

Fed Bets

Intrade.net puts the odds of Bernanke staying on as Fed Chair at 78%. The odds of Janet Yellen getting to top spot are 20%, with Larry Summers at 10%.

Jumbo Stress

Single family loans that cost above $750k continue to feel stress, as banks now require 30% down-payments on new loans. Sales of larger homes fell to 2.3% of all sales in the 1Q, down from 4.4% during headier times in 2007. This is not good news when you consider the top 10% of households drive about 25% of consumer spending. The supply of unsold jumbo homes increased to 17 months in June, compared to 14.5 months during the same period last year.

Business Problems

The recession has pushed business bankruptcies up 40% in May, compared to the same period last year. Biz bankruptcies are projected to rise another 45% by the end of the year, before declining slowly beginning in 2010.