WINE, COFFEE AND A GOOD CFP

by Steve Brown

You may not have known it, but coffee is about 1,000Ys old, there are 24 steps in the coffee process and the name coffee comes from an Arabic word meaning wine. While we cannot drink wine early in the morning, in this final day of our analysis of the recently proposed liquidity and funding risk management regulatory guidance, we will brew up an outline to help you drink in all of the steps needed to create a good contingency funding plan (CFP).

Any good CFP should start with stress testing and any good stress testing program should include an analytical way to incorporate a variety of bank-specific and industry/economic events based on multiple time horizons and scenarios. The goal of the stress test is to identify and quantify sources of potential liquidity strain to ensure risks are controlled within established tolerances. The stress testing process and results should be discussed and any actions that may need to be taken to mitigate unacceptable stress should be addressed. Stress testing is one of the most critical components of contingency planning.

The goal of the CFP is to set out strategies to address liquidity shortfalls in stressed situations. It is critical that banks periodically test and update the CFP to incorporate changing conditions or bank structure. Regardless of the environment, the CFP should incorporate analysis that takes into account an inability to fund asset growth; an inability to roll over maturing liabilities; unexpected deposit withdrawals; unanticipated loan commitment draw-downs; problems with payment/settlement systems due to disasters; a shift in market value or price volatility of various asset types and a change in customer perception of the organization or significant market dislocations.

In short, the purpose of the CFP is to test such events from the bank's perspective and to have specific plan(s) in place to make sure liquidity is sufficient to fund normal operations in spite of these events. Banks should not only build high probability/low impact events into daily liquidity risk management, but also consider the impact (and contingency plan) for low probability/high impact events.

Here are the 6 basic components the CFP should include as indicated by the proposed guidance:

1) Identify Stress Events. Banks should have a way to analyze and manage events that could impact liquidity. Such events could include deterioration in asset quality, Prompt Corrective Action/CAMELS downgrades, operating losses, a drop in stock price, negative press coverage or widening credit default spreads. Identification includes any potential event that could result in an inability to meet funding needs.

2) Assess Level of Severity/Timing. Banks should define various levels of stress & different stages (temporary, intermediate and long-term disruptions) that may occur. Levels of severity should be assigned, early warning indicators developed and liquidity needs assessed at various stages in a crisis environment. The time to find out a plan doesn't work is before it is needed.

3) Assess Funding Sources & Needs. Here, banks should analyze potential funding that may disappear or be reduced at different points in a crisis. This should include an analysis of cash inflows, outflows and funding availability.

4) Identify Sources. Recent events clearly point out how liquidity pressures can quickly spread. As such, banks should identify alternative sources of funding, conduct advance planning and periodically test to ensure these sources are ready when needed.

5) Establish Processes. Banks should have a crisis management team, structure, action plans and communication process to handle stressed situations.

6) Establish Monitoring Framework. This portion of the CFP focuses on having early warning indicators and event triggers tailored to specific liquidity risks. This could include negative publicity, increased potential for deterioration in the bank's financial condition or increased funding concerns.

Liquidity crises are not fun, but having a flexible plan in place that delves into even the detail of how press inquiries will be managed, where to find specific sources of funding and built around multiple scenarios goes a long way to reducing concern and increasing preparation. Getting started early is critical, because as we have all seen, liquidity problems can spread about as fast as spilled coffee flows over the desk.

BANK NEWS

Loan Loss Letter

The SEC released a sample letter the contains disclosure statements relating to loan loss allowances that public banks may want to consider to use within their management statement and footnotes. The letter can be found at http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm

Branch M&A

Union Bank & Trust ($143mm, WI) will purchase 2 branches from Amcore Bank ($5.23B, IL) for an undisclosed sum. The deal includes $36mm in deposits & $21mm in loans.

FDIC Deal

BBVA SA, the 2nd largest bank in Spain, has reportedly won the bidding to take over Guaranty Bank ($14.4B, TX), according to the WSJ. Guaranty has indicated it was not able to raise capital required by regulators.