PUMPING UP LIQUIDITY RISK MANAGEMENT

by Steve Brown

You may not know it, but there are more than 30k fitness clubs in the US. That is interesting, but what is even more interesting (particularly with the gluttonous holidays coming up in the next few months) is that only 16% of people belong to a gym. We guesstimate that of those, only about half are regulars. That leaves lots of room to improve and get in shape (now, where did we leave that donut lying around?). As with staying in shape, it isn't enough to just get involved in liquidity management, you have to get actively involved to see the greatest results.

Many bankers probably think they do a good job of forecasting liquidity needs already, but to do so also requires thinking about your own customers (since their money movement impacts your liquidity). You might be interested to know that a new study finds 80% of small businesses have trouble forecasting mid-term cash flow to within 5% accuracy and only 33% can accurately forecast their earnings over short periods.

That isn't surprising when you think about the uncertain nature of liquidity flows into and out of both businesses and the community banks they do business with, but there are some things bankers should consider when thinking about creating a robust program of liquidity risk management.

While things are still evolving on the regulatory side worldwide, it is evident that more liquidity will be required to be held on the balance sheet. This requires bankers to hold more short-term funding and more securities with a shorter duration; that are highly liquid and are probably government guaranteed.

If you want to do a quick test, look to the FRB Discount Window (DW). If the FRB DW applies a haircut of more than 2%, the security probably isn't liquid enough to be considered "core" liquidity. After all, haircuts are applied as a proxy to protect against margin calls, which occur mostly due to price movement. That means the smaller the haircut, the more the lender (in this case the FRB) will lend to the borrower (in this case your community bank). Haircuts below 2% are 'core", while those of 5% are probably best characterized as "strong" liquidity and anything above that should be stratified all the way out to "illiquid" (cannot borrow at all at the DW). The FHLB is another collateral check to apply, but the FRB takes more collateral types than the FHLB, so to save time you might just want to go there.

Next, bankers need to figure out where they are going to get reports showing dynamic cashflow analysis. While 100 to 300bp immediate and parallel shocks on the investment portfolio are commonplace, these now need to be done on all bank cashflows (loans, deposits, etc.). In addition, parallel shocks aren't good enough to satisfy regulatory requirements (or many boards these days), so bankers will need to develop dynamic shifts (curve flatter, curve steeper, smile, frown, etc.) to get a truly robust picture of risks already inherent in the balance sheet. Then, once you know how the current balance sheet will perform, apply probabilities to each expectation (to get rolling, just use your own judgment and don't get hung up on collecting hundreds of economic projections).

Then, once you have stressed the cashflows under each probability, focus efforts on areas that would cause the most damage to the bank (profitability, capital erosion, losses, etc.). Ask yourself where the problem is coming from and whether or not there is something that can be done to reduce or eliminate it.

As with any workout program, start small, don't try and lift too much weight the first time you go to the gym and you stand a good chance of making slow and steady improvements over time. Managing liquidity risk takes time and effort, but it can be done and bankers don't really have to change all that much to get moving down the path for success.

BANK NEWS

Earnings

US Bank reported 3Q profits up 4.7% (to $603mm) due to increased interest income and higher fee generation. While margins increased, so did credit losses (by 4%). KeyCorp posted a $397mm loss, up from a loss of $36mm a year earlier. The loss was a result of lower revenue (by 9%), higher net charge-offs (up 4%) and higher non-performing loans. Bank of NY Mellon restructured its investment portfolio over the 3Q, taking a $4.8B loss and posting a 3Q net loss of $2.5B. However, this may be temporary as it has reduced the amount of one-off charges for the company in the future. State Street reported an 8.2% YOY rise in 3Q profits (to $516mm) and a turnaround from a $3.3B loss in the 2Q.

TLGP

The FDIC has voted to end the program on Oct 31st with all debt issuance to expire by the end of 2012. A 6-month emergency facility will remain available (upon approval), for issuing debt past the 31st of this month (and guaranteed through April 30th next year) at a cost of 300bp.

No Hike Soon

Counter to recent articles, Fed President Yellen said bankers should not expect a tightening for the next several months and the time for the Fed to start withdrawing its monetary stimulus is not close at hand.

Economic Predictions

A new survey by the Association for Finance Professionals finds 69% of CFOs expect the recession to remain "well into 2010." Meanwhile, JPMorgan economists predict GDP will rise to 3.50% through the end of this year, but will slow down again next year.