Flowing With The Current

by Steve Brown

Cornwall is on the south western tip of England and beach combers there find normal items like seaweed, shells and sand. They also often find an odd assortment of miniature plastic swim fins, life preservers and scuba tanks. It seems that in 1997 there was a NY-bound cargo ship that passed nearby and was struck by a rogue wave. The ship did not sink but shipping containers were thrown off the deck into the sea. One of those containers was filled with nautically themed Legos - tons and tons of Legos - some 4.7mm pieces. Stories have it the Lego pieces continue to wash up on the beach of Cornwall almost 20Ys later and this seems to represent an oddity of ocean currents. Over the years, there have been other shipwrecks nearby and sea debris from those wrecks traveling on the ocean currents arrives on the shores of Florida generally about 3Ys later. Mysteriously, no Legos have made it yet to Florida.

Prime and municipal institutional money market funds probably feel like they are caught in either a rogue wave or a riptide current as they have been singled out by the SEC for a change in the way the net asset value (NAV) is calculated. Money market funds have long been a place for investors to park liquid funds with less safety than a bank account carrying FDIC insurance, but generally considered a cash equivalent. Corporations have tons and tons of deposits in money market funds.

In the past, the NAV of money market funds was held at $1 by major firms, so the yield of the fund fluctuated to reflect changes in the valuation of commercial paper or the other investments that made up the fund. Thinking back to the financial crisis and the demise of Lehman Brothers when credit markets seized up completely, you will recall that a number of money market funds' share price did break $1. This caused widespread panic, large redemptions by corporations and the whole financial system teetered until money market funds were guaranteed against default by the Feds for a period of time.

It's taken a while, but the SEC's change puts some of the risk in large prime and municipal money market funds back on the investor. The idea is that they are institutional investors and are capable of understanding the risks involved, so it sort of makes sense. The calculation of NAV is where the difference will be felt. In the past it would have required a change of 300bps to bring about a fluctuation of NAV. For these institutional funds, it will now only require a change of 3.5bps to bring about a price change, with NAV reported to 0.01 of a penny. Changing share price begs the question of capital gains treatment, as these are generally utility accounts with lots of transactions. As a result, aggregation of transactions will be allowed by the IRS to simplify tax treatment as well as exemptions from wash sale rules. Nonetheless, this represents a big change in cash management for all industries and non-retail investors, so it could drive some back towards banks (although most corporate deposits are far above the $250K FDIC limit, so rate will matter).

The new rule is a part of an 869 page document and the implementation date is 2Ys out, and plenty could change between now and then, so stay tuned. In the meantime, retail money market fund investors won't be affected at least for now, so be certain your staff is educated should customer questions arise. Community banks that have a sweep program with corporate customers could be affected so our advice is to pay attention as more information washes up over the next few months.

BANK NEWS

Risk Defined

Regulators define risk as the potential that events (expected or unexpected) can have an adverse effect on bank earnings, capital or franchise value. Common risks regulators focus on are credit, interest rate, liquidity, price, operational, compliance, strategic and reputational.

Risk Officers

Bank Director reports a survey of chief risk officers at the 50 largest banks finds 62% have a credit risk background and 24% have a market risk background. Meanwhile, 90% were internally promoted and 50% have worked at their company for 15Ys or more.

Technology

A BAI survey of small business owners with annual revenue between $1mm and $5mm finds the following technology product usage at their primary bank: online banking (66%), online bill pay (38%), debit card (24%), mobile banking (19%), mobile bill pay (10%), remote deposit capture (9%), peer to peer payments (9%) and debit card with rewards (9%).

Risk Management

The Financial Stability Board (sets Basel standards) has indentified the following principles around risk management that boards of directors of banks should seek to establish: risk appetite (aggregate level and type of risk a bank accepts to achieve its strategic objectives), risk capacity (maximum level of risk before regulatory capital, liquidity or other obligations are breached), risk profile (point in time assessment of net risk exposures after adjusting for mitigants), risk limits (quantitative measures using forward looking assumptions to allocate risk) and the risk appetite statement (aggregate level and types of risk the bank is willing to accept).

Capital Planning

Regulators indicate effective capital planning will consider both short and long term capital needs and use a forecast horizon of at least 2Ys.

Bench Strength

Deloitte reports 50% of CFOs have a direct report who will be CFO-ready within 1Y and 90% have at least one who will be ready in 1Y to 3Ys.

Fraud

Smart Card Alliance reports the U.S. loses $5B annually as a result of credit card fraud.