

Liquidity Planning: Part of Your Business Model?

No term in the New Economy is more overused and under-supported than the phrase, business model...

In the Old Economy, a business model is a plan in which a company describes its ability to produce, distribute, and sell a product or service profitably (Strategy & Business. Issue 20, Third Quarter 2000, paraphrased).

The New Economy, with the advent of Internet technology and *time*, has led banks to redefine their business models. New challenges and new, less regulated challengers confront the banking sector. Bank regulators have labeled the successful bank business model *CAMELS*. The most recent addition to their model, *Sensitivity to Market Risk*, has supplanted Liquidity as the focus of asset/liability (A/L) practice and theory. As a result of this change, coupled with rapid marketplace evolution, many A/L professionals have found it worthwhile to focus on the latest advances in market risk analytics. The purpose of this article is not to denigrate recent and noteworthy developments, such as Value@Risk© and Mark to Future© methodologies, but rather to provide a gentle reminder that liquidity remains a valid funds management consideration. Suggest the integration of liquidity and simulation-based interest rate risk (IRR) analyses.

Liability Management. The industry-wide use of liability management grew considerably during the 1990s due to expanded access to wholesale funding via the Federal Home Loan Banks, Street repo, and municipal deposits. With this growth also came:

- The reduction of prospective liquidity due to the pledging and encumbering of liquid assets.
- The initial realization that “the cost of incremental funds acquired is of paramount importance in evaluating liability sources of liquidity” (FDIC Supervision Manual).
- The secondary realization that the greater the level of wholesale funding, the higher the incremental rate.
- The diminution of a unique competitive advantage, the use of low cost retail funding.

As tends to happen, short-term margin pressures led to the addition of lower rate structured (convertible, puttable, callable, etc.) borrowings to many balance sheets, often at questionable concentration levels. This increased use of structured funding resulted in new forms of options risk on the liability side of bank balance sheets. Curiously, banks that won't buy or sell derivatives now have them embedded in their borrowings.

Asset Management. Also during the 1990s, the Federal Agencies funded their growth with new funding sources. Long-term Agency debt issuance increased from \$55 billion in 1990 to \$536 billion in 1999, peaking at \$590 billion in 1998 during cyclical interest rate lows. Much of this increase was in the issuance of callable bond structures. Much of this debt resides on bank balance sheets. Again, these investment securities are bullet notes bundled with derivatives.

Callable bonds, with scenario-dependent cash flows, are considerably more complex to analyze than bullet bonds with well-defined cash flows. Traditional funds management tactics, such as laddering or rolling down the yield curve, are relatively easy to employ with bullet bonds. They are less effective with structured securities, however. As a callable bond seasons, the requisite spread due to the option component increases, whereas the traditional tactic is based on a spread and/or yield decrease. In a similar vein, the existence of option-laden balance sheets implies that more complex analytical techniques are also required for liquidity analysis.

Liquidity Analysis. In the low interest rate environment of 1998, many banks appeared to have an excess of projected liquidity, based on static ratio or interest rate analyses. Given that yield curve changes of 100 basis points per annum are normal (in the statistical sense), it is sensible to assess prospective liquidity positions in various interest rate environments. When managing their liquidity position, however, some banks ignore even single scenario analysis. Instead they prefer to rely on simplistic historical ratios, such as the virtually meaningless, and frequently misleading, loan to deposit ratio. (Interested readers are referred to *Liquidity Risk Management*, by Leonard Matz, 1999, published by Sheshunoff Information Services, for an

illuminating examination of various liquidity management approaches).

Few, if any, banks would consider a single rate scenario analysis to be sufficient to manage the IRR component of their business. However, many banks, while utilizing multiple scenarios to analyze their IRR position, still use a single scenario to analyze their liquidity position. The irony of this frequently observed situation is that reasonable cash flow projections are the foundation of any meaningful IRR analysis.

Given that many banks are already producing reasonable multiple interest rate scenario cash flow projections for their JRR planning, what is our simple suggestion? Perhaps it is time to revisit an ancient A/L tool, the GAP report. GAP analysis is, and has always been, more appropriate for liquidity analysis than for IRR analysis. Liquidity GAP analysis focuses on projected cashflows, disregarding the repricing component of most GAP reports. It is also the simplest of the three methods allowed for the Securities and Exchange Commission's Market Risk disclosure.

One suggestion is to produce an easy to read, graphically based, liquidity GAP report for each rate scenario used in IRR reporting. Management time and A/L management committee (ALCO) attention spans are limited commodities, so it is constructive to focus on three rate scenarios:

- 1) A base case scenario (using implied forward rates)
- 2) A +200 basis point (bp) scenario
- 3) A -200 bp scenario

Periodic review of the impact of non-parallel yield curve and basis shifts on projected liquidity is also worthwhile. Historical scenario analysis can be illuminating (e.g., a capital markets disruption resulting in a liquidity crunch (circa 1998), or a bank specific funding crisis such as occurred in the last credit cycle (circa 1989-1991)). And remember, the Federal Financial Institutions Examination Council's policy statements on Interest Rate Risk and Investment Securities advise that it is sound Practice to analyze the impact on liquidity and IRR of material transactions, product introductions, and business plans.

It is prudent to monitor your liquidity position, but it is more profitable to manage it. For in the New Economy, as in the Old, you must have sufficient capital and liquidity to live long and prosper.