

The Learning Curve

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WHAT IS LIQUIDITY WORTH?

I was not alone when I wondered out loud over the past few years about whether bankers were fools to manage liquidity so closely. Regulators require it, and all bankers know, for example, that funding illiquid assets (loans) with hot money is a recipe for trouble. But it is an expensive pain in the neck, right? Carrying low-yielding assets and/or writing term, fixed rate CDs/FHLB advances is an expensive hit to both ROA and ROE.

On the other hand, examples such as the Bear Stearns debacle or the Jefferson County, Alabama, sewer bond situation demonstrate that, while it may be expensive, *you are betting your bank if you don't manage liquidity effectively*. We all know about the demise of Bear Stearns. Jefferson County, Alabama, however, was largely overlooked. The city of Birmingham needed to issue some \$5 billion in sewer bonds. Fixed-rate funding could have been arranged in at least two ways: 1) issuing fixed rate debt—a garden variety municipal bond; or 2) issuing “puttable” floating rate bonds and executing interest rate swaps “to fix” the floating rate on the borrowing. At first glance, option # 2 could be worth as much as 50 basis points in savings or \$25 million per year. That's a lot of savings, but there's a problem with the put on these bonds. What if the puts are exercised and the investor, in effect, says “give me my money back”? No problem, thought the management; we will simply insure the bond with private insurance. With insurance, there would be no reason to “put” the bond. Therein was the rub - if the insurance company's own credit was at issue, the bonds might be and were “put” in massive amounts. On top of that, with falling rates, the “pay fixed” swaps were under water and the authorities were obligated to collateralize the swap liability. In the popular press, the swaps have been blamed for the mess; the true source of the mess is the “put” in the bond—a problem of liquidity—funding long-term projects with what became short-term money.

The lesson is an old one well known to bankers: liquidity matters when you need it the most, usually in bad economic times, and it costs money. How much? It is easy to access on the asset side: liquidity is worth the difference between the liquid bond, usually short-term, and the alternative asset, either a longer-term bond or term loan. The liability side is much tougher to assess, but it can be done. Consider the following funding alternatives: 1) borrowing FHLB fixed-rate term advances for 5 years; 2) paying-fixed on a swap vs. 3-month LIBOR for 5 years and financing with 3 month rolling FHLB advances for 5 years. The rate paid on the 3-month advance will correlate closely with the 3-month LIBOR received, thus one canceling the other. As such, the liability cost is thus “fixed” for

5 years because all that is remaining is the fixed-rate payment from the swap. Currently, the 5-year swap rate is about 3.50% and the 5-year FHLB advance is 4.00%, suggesting alternative #2 is about 50 basis points cheaper.

That 50 basis point difference is the price of liquidity—in this case, 3-month money vs. 5-year money. FHLB advances may be subject to somewhat different terms, but any other capital market transaction for 5-year money vs. 3-month money would show the difference, in this case, 50 basis points.

We have often talked about our business becoming more competitive—that the name of the game is to find and “pick-up nickels”. The 50 basis points is the equivalent of 10 nickels. The 50 basis points may be the difference between gaining a new loan customer or losing out to a competitor. In the long-run, the ability to pick-up nickels will determine the difference between mediocre and excellent performance.

In the example above, using the swap sacrifices liquidity for a liability-pricing advantage. This has nothing to do with the swap *per se*. Swaps can be used to *enhance* liquidity. At our bank, for example, we are in the process of issuing 3-year CDs and swapping them back to a fixed-rate. If these were 5-year CDs, what would it take to pick-up the nickels? As seen above, anything under 50 basis points would be a savings. So pricing the CD at something under LIBOR plus 50 basis points is the goal. This would represent a funding advantage and would take into account the cost of liquidity.

Sometimes it is advantageous to sacrifice liquidity for pricing advantage, sometimes not. That is a management question, but these questions will become more crucial as the banking business becomes ever more competitive with ever more secular pressure on margins.

It is also important to note that *core* demand deposits are a very large wild card regarding liquidity questions. To the extent that a bank has core deposits, they are really long-term, not short-term, and are thus *extremely valuable* when we consider their price and “maturity” versus the term fixed-rate advance vs. swap-and-roll described herein.

You should have an asset/liability management system that does this for you. Ours does. As we say, in order to pick-up the nickels, you need to identify them first. All of these strategies and the metrics will become routine in community banking over the next few years. In a period of secularly decreasing margins, it will determine winners and losers.

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