

Bank Asset/Liability Management



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After the Current Financial Crisis: Why Community Banks and Credit Unions Will Have a Winning Hand

Every financial crisis is unique. The calamity currently besetting the financial sector¹ is so because to date it has been primarily a big banking problem rather than one directly affecting all institutions. No question that some community banks and credit unions that made poor asset quality decisions or are at ground zero in imploding real estate markets have suffered, and failed in some cases. But losses and failures are not as widespread among this group as they were in the thrift industry, for example, during the last banking crisis. It is the largest of banking sector entities most hurt so far, changing the financial landscape in some very important ways for community banks and credit unions.

While community financial institutions appear to be mostly taking a wait-and-see attitude (or maybe just keeping their heads down!) it is worth considering what is ahead. To this reviewer, the future is going to see a power shift back to real banks — those that possess solid local lending and deposit franchises. The winning business model will have high underwriting standards and strong attention to both deposit pricing and deposit non-rate value propositions. Living off of (supposedly) easy yields and fees is over.

That conclusion is based on an early read of the tea leaves for the current financial crisis, which makes two things very clear. These are as follows:

¹ This article was written in late September 2008, as the “bailout bill” was first evolving.

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- ***The destructive power of credit and liquidity risk.*** Nothing kills a financial institution faster than lack of liquidity or credit losses, and the two become impenetrably intertwined when the going gets tough. Interest rate risk, by comparison, is a slow bleed.

Liquidity risk victims to date have passed away friendless. Reliant on wholesale funding or high rate hot money deposits, there were few core depositors around to mourn. The sophisticated and ever more cautious providers of wholesale funding rather monitored every move or announcement and responded negatively in particular or in general during the several waves of liquidity contagion experienced since August 2007. The moral: Live by just wholesale funding markets, perish by those markets.

Credit risk casualties are more complex. Some institutions (and this accounts for many of the smaller failed banks and credit unions) simply had the bad luck to be at one of the several ground zeros in the real estate crisis. Sector concentration is usually a bad idea and we see here how badly it can play out. Others made (in hindsight) bad investment decisions, for example to buy Collateralized Debt Obligations (CDOs). The moral: Watch what you invest in, and where and what you lend on, and read all of the fine print.

Larger banks, and investment banks in particular, fell prey to a vicious internal cycle supported by silo thinking. Fees on derivative products or collateralized debt issuances became so large and important to earnings (and bonuses) that the products were pushed into the investment portfolios of the parent, where the enhanced yields were greatly appreciated, which engendered more fees (and bonuses) as the next round of issuances took place, were added to the portfolio, and so on. When the full scope of the toxic holdings was discovered, its notice was usually due to cascading losses — too late. With losses came a liquidity squeeze, and then a quick death rattle. The moral: Fees linking with easy yields held internally do not describe a successful banking entity.

- ***A banking franchise can stand the test of the times but a lending franchise cannot.*** There is a huge difference between a *lending institution* and a *banking institution*. The former, for example Indy Mac or any of a large number of mortgage banking operations, were volume loan machines funded by fickle wholesale funds or high rate hot money deposits. Without low cost core deposits, the pace of loan production had to be higher and investment and loan portfolios riskier to gain yield, with all of it exposed to institution specific and event driven liquidity risk.

Community banks and credit unions, on the other hand, were able to generate reasonable returns without the razzle-dazzle because their funding costs were lower and liquidity needs less. This, for most institutions, kept the worst of poor quality investments and loans out of their balance sheets by reducing yield reaching and its associated greater risks. It also lessened their reliance on wholesale funds.

Not that community financial institutions have escaped unscathed. Once gilt GSE paper unexpectedly became permanently impaired and other surprises happened. But in most cases, these were in small doses. The main tax on performance has been the effect of the *mortgage zombies* on high-rate MMDA and CD rates paid. These mortgage lending-oriented institutions, who once relied on wholesale funds for liquidity, but are now desperate for any funding, have kept deposit pricing well above historic spreads to Treasuries. The moral: A strong core deposit franchise is what separates the banks from the bust, but it cannot offset all the bad.

Practitioners of old school banking are riding out the storm successfully. Not unbattered, for sure, but not, for the most part, in jeopardy of failure.

The franchise argument applies to lending also. Lost in all of the credit-loss hype (and reality) is the simple fact that most loans on the books of banks and credit unions have not gone bad and likely will not. It is only where underwriting standards gave way to greed that credit losses became extraordinary. Where a true lending franchise existed, with good underwriting, there are still solid returns and ongoing business. Moral: No doc and low doc are dead; long live the steely eye of loan underwriting standards.

See a pattern in all of this? Practitioners of *old school banking* are riding out the storm successfully. Not unbattered, for sure, but not, for the most part, in jeopardy of failure. The institutions in this set, holders of positive brands and strong local loan and deposit franchises, can also expect to inherit a new world when the dust settles. Larger banks will be saddled for a long time with organizational turmoil, lingering losses, tight capital, and close regulatory scrutiny, opening up local markets significantly.

Given experience to date and expectations for tomorrow's markets, the future is going to reward a fundamentals-oriented lending and deposit-taking management style. But this is the solution now in place in most community banks and credit unions — the future can be their oyster if the new financial order is acted on.

What needs to happen? Community financial institution managers need to solidify their institution's brand, invest in their lending and deposit franchises, and make the most of the earnings potential in the balance sheet. Any short list of action items for the near future would include the following:

- *Solidify your brand.* Convince your market that you are not just a place to bank; you are their bank (or credit union). Smaller and more individualized looks positive right now, in the midst of the falling giants, so make the most of home field advantage.

Community financial institution managers need to solidify their institution's brand, invest in their lending and deposit franchises, and make the most of the earnings potential in the balance sheet.

- *Invest in your local deposit franchise.* Local deposits are the answer to just about any question in banking right now, and core deposits (traditional checking, savings, and money market categories) are the preferred solution. But these balances are primarily driven by the non-rate elements of an institution's overall deposit value proposition, such as service, convenience, product, and barriers to exit (such as ACH transfers, free bill paying, etc.). The non-rate deposit value proposition does not just happen — it needs to be nurtured and continuously developed. So make it happen, and grow core deposits.
- *Develop your local lending franchise.* Good loans are not going to get any easier to make, but there will be more opportunities to make them as larger financial institutions retrench. This opens up areas that once looked poor, such as auto lending, and takes competitors out of other areas, such as mortgage loans. This is not the time to move boldly into areas you know little about, which is a sure fire way to credit risk,

but opportunity is knocking in areas where you have current expertise.

- *Consider buying, instead of growing, deposits.* There are going to be a lot of deck chairs moving in the near future as the large banks sort out their footprints. This means branches will be available for sale, and with them deposit (and sometimes) loan books. If the price is right, and strategic needs or regulatory pressure on larger banks will create this in many cases, a great way to grow deposits is to simply buy them.

In a changing financial sector, there is ample opportunity for community banks and credit unions to prosper.

- *Make the most of the earnings potential in the balance sheet.* There are not likely many easy ways to rearrange current assets and liabilities to enhance earnings without adding risk. Asset/liability management has come a long way, and most financial institutions are good at it. But almost all balance sheets will yield higher earnings if two key underlying behaviors are better quantified: loan prepayments and core deposit effective duration (which rests on average lives and repricing). By moving from approximation-level ALM model inputs to institution-specific, fully quantified inputs, forecasts of expected earnings outcomes become more accurate. This allows financial managers to make precise changes in asset and liability mix that add up to higher earnings. Quantified balance sheet behavior information also enhances liquidity model accuracy, which may lead to further gains.

In a changing financial sector, there is ample opportunity for community banks and credit unions to prosper. None of the long term issues are gone — loans will continue their grind into commodities and competition will keep ratcheting up — and expect high-rate MMDA and CD pricing to stay high for a while as big banks struggle to fund themselves. But current events define a bold new world for community financial institutions; all it is going to take to succeed is a good plan and decisive action. So let's go!

— William McGuire
McGuire Performance Solutions