

## Know your partner (July 2009)

When you call for backup, it's good to know your liquidity source will be there. Will yours?

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Don't just assume that contingency funding will be there when you need it

In these extraordinary times, there is a heightened scrutiny and awareness of the risk of bank failures and their impact on consumers and businesses. What has been less discussed publicly, however, is the interrelationships banks maintain with other banks that may be at risk.

These relationships include correspondent banks and bankers' banks. The risk is not just in terms of selling fed funds on an overnight basis. It also includes the risk to contingency funding.

The failure this spring of Atlanta's Silverton Bank exemplifies the need to develop a higher level of due diligence and risk analysis when dealing with other banks. Another glaring example is the failure last September of Lehman Brothers. In that case, banks that had derivative exposure, such as interest rate swaps, found that the failure of the counterparty caused great distress. Both examples were unusual situations, to be sure, and do not suggest that similar problems exist generally among upstream correspondents or bankers banks, but today it's important to view these two broad areas with the same diligence as counterparty risk. Will your partners be able meet contractual agreements as expected?

Banks can no longer rely on the rating agencies to fully alert them to counterparty risk. Lehman Brothers, AIG, and WorldCom were all investment-grade securities that slipped dramatically and rapidly into questionable future value.

For larger correspondent banks, we would recommend using other research to monitor the creditworthiness of the counterparty, in addition to rating agency information. Other research would include Value Line. Though a stock analysis provides financial strength rankings, Value Line, in our experience, analyzes companies in traditional ways that have served them well over the years.

For smaller correspondent and bankers' banks it is essential to perform a more customized analysis. For instance, a benchmark and peer analysis takes into account capital, credit, liquidity, and interest-rate risk. The current economic environment has proven the point that more in-depth analysis needs to be performed. According to SNL, four banks have disclosed taking losses from Silverton's failure.

Prior to engaging in any relationship with a correspondent bank or bankers' bank, it's important to gauge and be comfortable with the level of risk you are taking. Four interrelated questions should be considered:

1. Have you quantified the risk inherent in the relationship?
2. Do you understand the impact to your balance sheet?
3. Have you modeled the impact the potential loss could have on your balance sheet and income statement?
4. Are you comfortable with the likelihood of that loss and the potential likelihood of the impact on your balance sheet?

How real is your liquidity backup?

The biggest concern that we see with reliance on contingency liquidity policies is whether or not the funding will be there if your bank has a liquidity problem—that is, when it actually needs it. We advise that contingency liquidity plans should not be created in a vacuum, but should be based on real-life occurrences.

We have seen instances where banks had serious liquidity issues and found that their correspondent turned from them even in fully collateralized situations.

Another concern is a liquidity event that affects whole regions. Will your correspondent have enough money to provide funds to all banks it has agreements with? For this reason, we would not suggest integrating correspondent borrowings or Federal Home Loan Bank borrowings into emergency liquidity needs. Further, we recommend that all banks, as part of their contingency liquidity events, sign up for various liquidity programs that the Federal Reserve may offer.

Another concern is that many correspondents and bankers banks are loan participants. We believe that the credit trends at these banks must be watched very carefully. Silverton, for instance, made loans all over the country. But according to SNL, a large portion of the loans were made in Florida and metro-Atlanta. This created a significant loss for Silverton—11% of nonperforming loans within the entire portfolio. With all of this information at your fingertips, you should do the following:

- Watch trends in noncurrent loans, which includes nonperforming loans and loans over 90 days.

- Monitor the bank's trend in "Credit Canaries" as seen in the Credit Risk section of the OCC-produced Canary Report, which identifies high-risk banks. Although the Canary Report is not indicative of all risk, we find it an excellent advance indicator of shifts in escalating credit risk.

- Look at the mix of the bank's loan portfolio to see how closely it matches the risk profile of your own portfolio mix, and your own risk tolerance. But don't stop there; watch how the mix may shift over time.

Again, this is not to say all correspondent and bankers bank relationships are at risk—the strong ones have nothing to worry about from increased scrutiny. But the times dictate due diligence and prudence with your shareholders equity and your financial security depends on thorough analysis of every relationship and every interaction. BJ

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