

CONTINGENCY PLANNING --
A GUIDE TO LIABILITY MANAGEMENT?

Remarks by

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at the

Iowa Bankers Association's
89th Annual Convention

Hilton Inn

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On Friday, May 10, 1974, the Franklin National Bank canceled its second-quarter dividend, the first such omission by a major bank since the 1930s. That weekend, it issued a statement saying that its foreign exchange department had incurred losses of about \$2 million and had potential losses of approximately \$25 million. Uninsured depositors and creditors, alerted by earlier market speculation on the soundness of Franklin, reacted promptly and began to withdraw substantial amounts of funds. The Federal Reserve, on the assurance from the Comptroller of the Currency that Franklin, a member bank, was solvent, extended emergency credit through the discount window to help offset these losses. This assistance (ultimately amounting to \$1.7 billion) continued till early October when Franklin was absorbed by the European-American Bank and Trust Company.

The May 10 announcement came at a time when markets were under substantial pressure. Firms were attempting to finance a rising volume

of inventories with bank credit, banks were trying to satisfy these demands with funds from the CD, Eurodollar, commercial paper, and federal funds markets; and the Federal Reserve was endeavoring to keep the growth of the money supply within desired bounds. Further, a number of banks were suspected or known to be holding real estate loans that were nonearning and might involve loss write-offs. News of Franklin aggravated a difficult situation. In these circumstances, it's not difficult to understand why creditors and large, uninsured depositors switched their funds to federal government obligations or to the largest banks in the country, feeling that size and the concern of the authorities would protect such banks. In the process, smaller banks that had been tapping the national money market were adversely affected: some had to pay substantial premiums for their CD's, others could not borrow all they wanted, and perhaps a few found it difficult to obtain funds at all.

The possibility of further liquidity problems raised questions within the Federal Reserve concerning the Fed's information about such situations. What banks were likely to experience a problem? If cash

outflows developed, how much assistance would be required, for what length of time, and with what types of collateral?

The information available at the time, it seemed to me, was not sufficiently precise. As a result, I asked the larger banks in the Ninth District to share with me their own contingency plans for meeting unanticipated withdrawals of interest sensitive funds. The responses, as you might expect, ranged from well-developed plans in a few cases, to rather informal statements of how such a problem might be dealt with.

With the easing in credit conditions over the past year and a half, and the conscious rebuilding of liquidity in the banks and the economy in general, the risk of loss of interest sensitive funds has become much less of a concern for the time being. (One might add that other concerns, mainly about asset quality, have taken over the limelight.) Nevertheless, I believe there is still some point in following up the notion of contingency planning, since 1) I have little doubt that we will face another turn of the credit cycle sooner or later, and 2) well-thought-out contingency plans can serve a number of purposes even though they are never put to test of actual use.

I am well aware that bank supervisory authorities are after you for more information in any case. So-called "universal" call and income reports applicable to all insured banks have been published for comment, with the expectation that a revised format will be available for end-1975 statements. For large banks [i.e., those with total assets over \$300 million -- \$100 million for nonmember state chartered institutions] supplemental information will be required on loan maturities, loan commitments, maturity schedules of large time deposits, maturity distribution and geographical composition of foreign assets and liabilities, etc. Although I had no part in formulating this request for additional data, I think it's pretty clear that one of the purposes for the request was to provide the authorities with more complete and up-to-date information on potential liquidity problems.

My own thought -- and it has no official standing within the Federal Reserve, much less among the other bank supervisors -- is that this concept could usefully be taken a step further in the form of a contingency plan, specifically matching up liquid liabilities against

liquid assets. Now this kind of exercise may not sound very novel in the banking business. After all, matching maturities on the balance sheet has been an implicit, if not explicit, part of the game since banking began. Nevertheless, I'm convinced that traditional modes of balance sheet analysis have not kept pace with burgeoning liability management, so reinventing the wheel may not be a waste of time in this case.

Why should the Fed be particularly concerned with this kind of contingency planning? In the first place, of course, because we, like other supervisory agencies, are charged with maintaining a "sound" banking system (i.e., one that can survive "contingencies"). More specifically, however, the Fed, as lender of last resort, has a unique role to play if liquidity contingencies become realities. And frankly we're better off knowing ahead of time something about the extent of our exposure. Let me take a few minutes to explore this latter point with you.

As has been demonstrated on several occasions, the Fed stands ready to lend to solvent banks that are experiencing serious liquidity problems. This emergency lending program of the Federal Reserve can be

viewed as a means for providing time for an evaluation of the problem, time for recovery, if that seems justified, and time, if recovery is not possible, for seeking other banking organizations that may be willing and able to take over a failing bank.

I think it's important to note that the role of the discount window in providing emergency lending would be considerably reduced if all depositors and creditors were insured. But as you know the present system of insurance provides only partial coverage for deposits, and none for other creditors. The principal argument for this partial coverage is that creditors and large depositors have an incentive to carefully evaluate a banking institution's safety. Institutions, it is argued, are thus forced to follow safer practices in order to hold and obtain uninsured funds. However, the strength of this incentive is open to question. Indeed, it can be argued that this "market test" has been greatly weakened by the efforts of regulators and supervisors themselves, in their zeal to detect problem banks, obtain remedial action, and, in the event of failure, prevent losses to all depositors.

In effect, then, the Fed, as lender of last resort, can be viewed as providing insurance on otherwise uninsured liabilities of banks. Unlike FDIC insurance, however, there is no explicit premium paid by banks for this coverage. The Fed, and ultimately the taxpayer if there are losses, stands behind the banks' creditors in the name of financial stability, but without any direct control over the degree of exposure assumed by individual bank managements in their balance sheet liquidity. In crass terms, one might argue that go-go managements are encouraged by a free public backstop. Under these circumstances, the least that might be expected by the "insurer" (i.e., the Fed) is a discussion with the "insured" bank as to the extent of its potential reliance on back-up financing through the discount window should its interest sensitive liabilities (i.e., the short-term liabilities not insured by the FDIC) one day disappear.

As a basis for such a discussion, I'd like to suggest a particular form of contingency plan. Let me say at the outset, however, that I hold no brief for the specific details. The reasonableness of the

exercise will be a matter of judgment, as is, ultimately, all bank supervision. The items to be included might well vary from bank to bank. Moreover, the concept will certainly have greater applicability to some banks than to others. For example, smaller banks without substantial uninsured interest sensitive liabilities would probably find the exercise unnecessary. By the same token, the largest money center banks might find the assumed circumstances unrealistic. At the moment, then, the suggestion is untried -- it may turn out to have little value, and even if it has promise, it may have to be modified substantially to achieve its potential.

The purposes of the contingency plan exercise are simple enough:

- 1) to gauge the extent of possible reliance on the Fed's discount window by a given bank under the assumption that certain of its interest-sensitive liabilities could not be renewed at maturity, and that the run-off had to be financed through asset liquidation and borrowing from the Fed;
- 2) to inquire whether the bank has adequate collateral in appropriate form on which to borrow at the Fed for the amounts contemplated;

- 3) to gauge the possible losses that might be incurred in the liquidation of assets under such circumstances, and relate those losses to capital (and possibly to income);
- 4) to reach a judgment on the reasonableness of the bank's liquidity position (and possibly its capital) based on this analysis.

Now contingency plans are a dime a dozen, if you don't count the costs of putting them together. The number of possible situations that might be studied are limited only by the imagination of those asking the questions. Obviously, therefore, the reasonableness of the assumptions that go into the hypothetical contingency have a bearing not only on the particular results, but on the usefulness of the whole exercise. Just as a banker can't operate on the assumption that all his depositors will come in one day and demand their money, neither can he operate necessarily on a perfect balance between the maturities of his short-term assets and liabilities. Intermediation, in other words, implies not only standing between depositors and borrowers with equal maturity preferences, but also between short-term creditors and longer-term borrowers. It's a matter of

degree and judgment.

What kind of assumptions might be reasonable?

- 1) Although it is assumed that the ability of the bank in question to renew its borrowings is impaired, one also has to assume that national money markets are functioning, so that good assets can be sold.
- 2) As a "worst case", one might assume that uninsured interest-sensitive liabilities (i.e., Fed funds purchased, securities sold under repurchase agreement, large time deposits, due from foreign branches, assets sold to holding company against commercial paper) simply cannot be renewed at maturity. In this extreme case, for example, Fed funds borrowing would disappear overnight.
- 3) A "less bad" case, involving a partial run-off of the same liabilities, would provide perspective, and perhaps greater reality.
- 4) Short-term investments could be liquidated at par at maturity, or at market prior to maturity. "Market" in this case, however, would assume high interest rate levels, and hence in most cases, losses from book values.

- 5) Good loans could be sold at varying discounts, but loan maturities might be assumed to match required roll-overs and take-downs under existing lines of credit; in other words, no cash would be generated by loan maturities themselves.
- 6) Cash balances could be reduced, but not eliminated, on the assumption that the bank remains in business and requires clearing balances, etc.

By spreading the assumed liability run-off and asset liquidation over periods out to, say, six months, one can determine for each set of assumptions the amount of required borrowing from the Fed on the first day, the first week, the first month, and so on. One can then relate these borrowing requirements to the bank's capital as one test of the reasonableness of its position, as well as check on available collateral.

Even with fairly specific assumptions of the kind just indicated, there will still be substantial areas of discretion and judgment in what might otherwise look like a precise arithmetical calculation. Just how many assets could be sold in a given time period, for example, is never

going to be beyond dispute.

But this lack of precision need not frustrate the value of the exercise. The contingency plan is not designed to provide self-evident answers, but simply an analytical framework for discussing the reasonableness of balance sheet liquidity. Nor need such discussions be confined to dialogues between bank managements and the Fed. Indeed one might hope that the framework would prove most useful to banks in setting their own internal management policies. Many banks operate with self-imposed limits on the Fed funds they borrow, or the CD's they will sell, usually related to some balance sheet ratio. But more often than not, these ratios are simply historical wisdom, handed down from manager to manager. The contingency plan framework provides a rationale for this type of internal guideline. Indeed, I think it's interesting, if not significant, that the type of analysis I'm suggesting was a key factor in causing one bank to shift its acquisition of funds away from reliance of Fed funds and toward CD's in order to spread its potential borrowing at the discount window more evenly over time.

One theoretical point in closing. If the Fed took seriously its emergency lending role as in fact an insurance function, a good case could be made for varying the premium (reserves?) with risk exposure. The FDIC does not do this, but the law establishing SIPC specifically contemplated varying premiums with risk. For the time being, however, perhaps it's sufficient that we see what if anything can be learned from contingency plan analysis, and leave the question of premiums to some later date.