A Case Study in Holding Excess Liquidity

Bill Nelson | August 4, 2021

We unexpectedly unearthed a nugget of insight into current bank regulation and supervision in a 50-year-old report on the discount window. In 1965, the Federal Reserve launched a major review of the discount window. In 1971, the Federal Reserve Board published the result of the review: “Reappraisal of the Federal Reserve Discount Mechanisms.” The volume includes a chapter on “Discount Policy and Bank Supervision.” The entire chapter (really the entire book) is fascinating (for example, the chapter includes several numerical measures of liquidity adequacy used by examiners 50 years before the LCR purportedly became the first numerical measure of liquidity adequacy), but one small section especially caught our eye. Appendices to the chapter provide four examiner comments on big and small banks with too much or too little liquidity. The examiner comment about a community bank with excessive liquidity is enlightening.

> The bank, not having borrowed for several years, maintains at all times an apparently excessive amount of liquid assets. This excessively liquid position is not the result of board policy, but stems rather from an apparent total absence of effort on the part of management to employ profitably all available funds. In 1965, the reserve account balance was in excess of that required by a daily average of approximately $125,000. Because of the pressing demands of daily activities, the management admittedly maintains a “safe cushion” in the reserve account so that it will not be forced to make a daily calculation of the requirement. The regular offers of a correspondent bank to purchase excess Federal funds are always refused because the reserve position is unknown. In addition, the bank sold to a correspondent bank mortgage participations aggregating about $300,000 on June 1, 1965. As of examination date, about $100,000 of the proceeds of this transaction had not been reinvested and remained with the correspondent bank. The elimination of these excess balances would leave the bank still in a highly liquid position, with about 20 percent of the investment account in Treasury bills. As a standby liquidity protection, management has an open commitment from the correspondent bank to purchase an unlimited amount of the bank’s mortgage portfolio. The loss of potential earnings inherent in a situation such as this was discussed with management.

In addition to the wonderfully disdainful “pressing demands of daily activity,” the comment makes several observations that remain valuable today. First, excessive liquidity is unproductive. Second, lines of credit from other banks are valuable sources of liquidity. Third, earnings are a source of strength. Lastly, it is hard also not to conclude that even though there were 13,544 banks in the United States in 1965, the competitive pressures on a community bank were not especially intense.

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