LIQUIDITY & SENSITIVITY IN CAMELS

by Steve Brown

It is our last part of a 5 part series on CAMELS ratings nuances, details and regulatory focus and as with you; we are also getting pretty tired of seeing pictures of camels. We close off today with a discussion on liquidity and sensitivity.

Examiners review liquidity risk based in part on a bank's ability to generate funds at a reasonable cost to fund loan growth and deposit runoff. To get started, examiners will often review metrics such as the net noncore funding dependence ratio (the degree to which a bank is funding longer-term assets with non-core funding). The thought is that noncore funding is sensitive to changes in interest rates, which is why regulators focus in on FHLB Advances, brokered deposits, borrowed money and CDs > $100k. The higher the ratio, the more examiners feel the bank is relying on funding sources that may not be available in times of financial stress. Other metrics examiners will review include liquid assets (fed funds sold, AFS securities); core deposit growth (do core deposits support anticipated asset growth); diversification of funding sources (does the bank have a strong core deposit base, established borrowings lines and procedures in place for acquiring internet-based or other forms of emergency borrowing); and whether external forces (economic conditions, competition, marketing efforts, etc.) are having a material impact on liquidity.

The liquidity rating is based upon many factors, but frequently examiners will assess: the adequacy of liquidity sources; present/future liquidity needs; percentage of assets that can be easily converted to cash; access to other sources of funding (i.e. discount window, FHLB, etc.); diversification of funding sources; reliance on short-term, volatile funds; trend/stability of deposits; and management's ability to identify, measure, monitor and control the bank's liquidity position. Policies, strategic planning, IT, reporting & contingency funding are also critical.

Given all the talk about when and how much the regulators will eventually increase interest rates, banks need to be monitoring sensitivity to market risk. These exposures include interest rates, foreign exchange rates, commodity prices and equity prices, but for most community banks sensitivity is all about interest rates.

As all bankers know, measuring interest rate risk (IRR) can be more art than science at times, but if we have learned one thing over the years - assumptions matter. We know many banks that don't modify assumptions feeding the model even when interest rates have moved significantly, loan portfolios have changed or the economy has shifted. Both the Board and management need to decide whether or not the assumptions are applicable to the bank to ensure risk tolerances are actively managed.

Examiners will review sensitivity and assign a risk rating based on an assessment that includes: sensitivity of earnings due to changes in interest rates; sensitivity of capital due to changes in interest rates; ability of management to identify, measure, monitor and control exposures given bank size, complexity and risk profile; nature/complexity of interest rate risk exposure and if appropriate, the nature and complexity of market risk exposure due to trading/foreign exchange operations.

Component ratings roll up to a single composite rating. Since few banks seem to be a "1" anymore given the industry situation, we will focus on "2's" and "3's".

A composite "2" means the bank is fundamentally sound and generally no component rating is more severe than "3". The bank has only moderate weaknesses that are well within the Board's and management's capabilities and willingness to correct. These banks are considered to be stable and capable of withstanding business fluctuations and there no material concerns.

A composite "3" means the bank exhibits some degree of supervisory concern in one or more component areas. These banks may exhibit a weaknesses that range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than "4". In this situation, management may lack ability/willingness to address weaknesses; these banks are generally are less capable of withstanding business fluctuations; they may be in significant noncompliance with laws/regulations; risk management practices may be less than satisfactory and while failure appears unlikely, these banks require more than normal supervision (may include formal or informal enforcement actions).

We have finally crossed the desert of CAMELS ratings this week, so drink deeply as you enjoy your own banking oasis.

BANK NEWS

Assets For Sale

Attempting to spark interest, the FDIC plans to split up loans from failed banks into good and bad and sell them off in pieces.

CU Edging In

A bill is now before congress calling to raise the 12.25% cap on business loans for credit unions. The bill also proposes excluding loans below $250k from the cap count.