BASEL III LIQUIDITY IDEA

by Steve Brown

If you are looking to strengthen your liquidity reporting, one consideration is the new "Acute Stress Liquidity Coverage Ratio" recommended by the Basel Committee on Banking Supervision last week. This ratio takes "high quality liquid assets" and divides it by net cash outflows over the next 30 days that could occur in a stressed environment. To encourage banks to have sufficient liquidity in times of market liquidity dislocation, the idea is the ratio should be in excess of 100%.

In the numerator, "high quality liquid assets" are defined as cash, reserves at the Fed and 0% risk weighted securities (like Treasuries or GNMA mortgages). In addition, agency debentures and mortgages plus investment grade corporate bonds are included if they compose no more than 40% of total liquid assets, and 85% of the market price is used (as a haircut).

The denominator of the ratio, 30-day projected net cash outflows, should include the amount of funding that a bank could potentially lose within a 30 day period under stressed conditions (such as a regulatory order or loss of confidence in the banking system). This could include a portion of non-contractual deposit withdrawals and 30-day or less short term funding that either would expire or could be canceled.

The key is to determine what portion of a bank's short-term deposit structure would leave, but empirical evidence from a group of banks that have come under a public regulatory order suggest that the range may be between 0% and 60% - with somewhere around 8% being an estimated average. This percentage obviously varies widely, and is based on the severity of problems, deposit composition and age/brand of the bank. At a minimum, all deposit balances over the insured $250k limit should be included in the numerator, along with some small portion, say 5%, of insured balances. From there, banks would have to utilize a larger percentage of insurance balance run off if their average deposit size was larger than average, or their exhibited duration was shorter (or less positively convexed). Here, tracking a troubled competitor's deposit balance changes may be a good proxy for a bank trying to keep tabs and serve as a benchmark to support assumptions.

Given that liquidity is plentiful right now, most community banks are just over 100% for the ratio. However, on a 5Y and 10Y look back, we estimate that many banks will fall under 100% by a 20% to 40% margin (keep in mind, however, that this calculation includes many highly leveraged banks that have since gone away). Banks that find themselves with a ratio less than 100% can do one of two things: increase credit quality of the investment portfolio or increase the duration structure of liabilities.

Moving investments to GNMA mortgages or agencies with the express backing of the US Gov't (Farm Credit, TVAs, IRBDs, FNMA or FHLMC issues with maturities shorter than 12/2012, etc.) can be one solution to solve this liquidity conundrum, but the counter argument to consider is that it also may substantially increase interest rate risk. Another solution might be to extend liabilities through wholesale means (brokered CDs or FHLB) or through more marketing/higher rate on non-brokered CDs with longer maturities. Comparatively, moving investments into higher quality issuers', costs about 14bp of yield; while extending contractual maturities of liabilities costs around 60bp.

The cheapest and best way to solve this ratio deficit is to expand the customer base and extend duration/increase the convexity of deposits. This can be done by increasing cash management services, instituting a goal-oriented savings account, etc. to make DDA balances less interest rate sensitive.

While the Acute Stress Liquidity Coverage Ratio will most likely not go into effect for another 2Ys, it may be a good idea to get up to speed now to enhance liquidity quality and management.

BANK NEWS

Troubled Banks

Our unofficial troubled bank list (the one that we think mimic's the FDIC's official list) has been updated and now totals 808 banks. July added 11 banks (44 is the 2010 monthly average), the lowest number in more than a year.

Future Bank Growth

A study by Grant Thornton asking banks where they plan to grow finds 87% expect to do so through organic loan origination; 37% will increase mobile banking; 33% plan to open new branches; 30% will buy loan participations; 24% will do non-FDIC assisted deals and 23% plan to get involved in FDIC assisted deals.

Performance

Research by Wharton that included 400+ financial executives found most CFOs believe earnings are the greatest single metric others use to judge corporate health.

Core Replacement

A survey by Aite Group of CIOs finds the number of banks and credit unions planning to replace core systems are 420 in 2010, 510 in 2011 and 575 in 2012.

B of A

The bank becomes the first to take action as a result of the new Frank-Dodd law. BofA will spin off its middle market private equity arm and rename it Ridgemont Equity Partners.

Correction

We inadvertently misled readers when we discussed the Aug. 15th deadline for Reg E. We should have clarified that the opt-in requirement for a related charge only pertains to ATM and 1x debit transactions.