THE LIQUIDITY PARTY WILL EVENTUALLY END

by Steve Brown

The next time you find yourself grasping for something to say to get a conversation going with a potential client, let them know a recent study (by HSBC) found people who planned for retirement had 5x the assets of those who did not. They will at least find you somewhat interesting and perhaps they will even view you as a fountain of critical and interesting information. Either way you win, so what the heck - try it out and see what happens. Speaking of things to know and to try out at some level, we focus in on recent analysis around the banking industry related to liquidity. While banks are currently awash in liquidity, things change rapidly, so understanding and evaluating differences can help you better prepare for a time when funding is more difficult to find. Before that discussion can begin, however, we need to know what liquidity is. From a regulatory perspective, liquidity represents the ability to fund assets and meet obligations as they become due. From an asset perspective, liquidity attempts to define how easy an asset on the balance sheet of the bank can be turned into cash and includes the pile of cash already sitting around and available for immediate use. The key to liquidity comes in measuring how fast assets can be converted to cash and in turn, how much the price of that asset must be reduced in order to do so. Once you know that, you are well down the road toward measuring and managing liquidity. Banking examiners take a close look at liquidity because it can mean the difference between banks that make it and those that do not. Liquidity comes at a cost, so needs that are not met through holdings of high quality short term assets could force a bank into the markets to raise additional funding under adverse market conditions (and potentially at an undesirable cost). To avoid a crisis, history shows banks that perform the best have some common characteristics. These include avoiding funding concentrations, having a stable asset and liability structure, growing at a modest pace and having a strong, flexible and tested contingency plan in place to deal with any potential crisis. Red flags examiners will more closely review can be many and change as conditions change, but some of those that seem to surface frequently include: trends that show a sharp reduction in large balance liabilities; substantial deposits that are short term in nature and tied to municipal special assessment accounts; a loan portfolio that consists of a large percentage of problem credits; a loan portfolio that contains loans with features of low marketability; large amounts of unused lines of credit; concentrations of credits to an industry with present or anticipated financial problems; a significant portion of assets pledged to support wholesale borrowings; impaired access to the capital markets; a competitive environment that supports customer investment into alternative instruments; and a close relationship between deposit accounts and principal employers in the area who are having financial problems. Examiners will also take a close look at large deposit concentrations, which are defined as funds concentrated or payable to one entity that aggregate 2% or more of the bank's total deposits. Finally, the market has its own view on liquidity. Banks that have strong characteristics that include good liquidity ratios; short term sources of liquidity that cover short term uses by at least 120% (even under adverse scenarios); enough liquidity to survive with no access to market funding in the next 12 months; no large liquidity needs in the next 24 months; immaterial contingent liabilities and a contingency plan that does not rely on large amounts of wholesale borrowing.

Tracking and testing the bank's liquidity with a few key ratios and then reporting trends and issues in the board package also make sense. Some ratios you might want to trend for reporting purposes include: liquid assets to short term liabilities; liquid assets to total deposits; liquid assets to short term wholesale funding; and liquid assets to core deposits.

The good news is that there is still plenty of time to prepare for an eventual Fed drawdown in liquidity, so make sure you have made arrangements for a ride home before the party officially ends and you will be glad you did.

BANK NEWS

Business Loans

According to the Equipment Leasing and Finance Association (ELFA), loans, leases and lines of credit to businesses in July were down 22% from June, but still up 2% from July 2010.

Mortgage Performance

The MBA published its Q2 report which details SFR mortgage delinquencies rose 8.44%, an increase of 12bp vs. Q1. In short, after improvement over 2010, delinquencies are starting to increase. Foreclosures have improved to their lowest levels in a year and after looking at the details, while some movement is attributable to slower action by banks, it appears that there is some fundamental improvement (although it may be temporary).

CRE Lending

Moody's reported its commercial property index climbed for the 2nd straight month, as investors bought properties and the market continued to firm up. In June, prices climbed 0.9%, but overall they are down 6.6% from the same period last year and down 45% from the high reached in Oct 2007. Low yields and few other alternatives have boosted investor interest in the commercial real estate sector.

Spooky Signs

The 3rd biggest increase on record in the past 30Ys in the benchmark M2 gauge of money supply (cash in circulation plus bank deposits and retail money-market funds) last week has spooked some investors. The top two weeks prior to this one were following 9/11 and the Lehman collapse. It has also been pointed out that the surge in supply is due to deposits fleeing European banks for safer US ones.