CREDIT SCORING AND LIQUIDITY

by Steve Brown

You might want to let customers know that if they open a new credit card to get a 10% discount on a department store purchase, it can lower their credit score by 30 to 60 points. Studies also find the higher the credit score the more it will drop. Speaking of interesting things to know, we turn our focus back once again to liquidity, as we close the loop on our discussion for this week. Right now, few banks are worried about liquidity, which makes sense given the Fed has flooded the system with it. However, that can't last forever and the fact that some European banks are struggling for liquidity this morning serves as a reminder of how tough things can become. The credit rating agencies and the regulatory bodies have taken a close look at liquidity since the crisis began and they have refined some of the thinking around it we now share. Since liquidity can flow in like a drip, stream or river of water, based on how dependable and easily accessible it is, the importance of understanding the characteristics of each source and attempting to rank them (from highest to lowest) is critical for banks to do before liquidity needs to be tapped. For example, you would rank unrestricted cash as having dollar for dollar liquidity that is immediately accessible, while the other end of the spectrum might be a loan sale of a given type that could take months to transact and come at a deeper discount. Understanding this and calculating approximate liquidity available using a graduated scale that incorporates such differences can make sense (you can start with a simple spreadsheet). Sorting some common sources of liquidity out for you to help get you started in this process, you might put cash and short term deposits your bank has placed with another institution at the most liquid end of the spectrum and then scale from there. You might layer in liquidity facilities from government sources (such as the discount window) next (be sure to adjust the amount you have for haircuts and other collateral adjustments to get net down to the amount you can borrow); followed by committed credit facilities (watch out for covenants); the sale of liquid securities; cash available from maturing loans; borrowing from a correspondent bank; issuing debt or stock; and selling loans. You may have other adjustments or modifications worthy of consideration, but these should help get things going. The key to this process is to try and determine the bank's ability to generate funds at a reasonable cost and within a reasonable time frame. From a regulatory standpoint, liquidity evaluation includes such factors as the adequacy of liquidity sources vs. present and future needs of the bank; the availability of assets that can be readily convertible to cash without undue loss; other sources of funding; diversification of funding sources; degree of reliance on short term or volatile sources of funds; deposit trend and stability; other risk management factors and the strength of contingency plans. On the other side of the fence, work has been done to refine and further evaluate uses of liquidity. Here, banks might want to begin by evaluating deposit stability. Rates are low, so breaking a deposit results in a low penalty in many cases and can increase the risk of liquidity outflow as a result once rates begin to move higher. Deposit composition is another area to analyze. Factors such as the percentage of deposits that are insured deposits vs. uninsured, corporate vs. retail and those driven by rate vs. relationship are important considerations. Other factors to pull into the mix include your bank's ability to reduce or eliminate undrawn commitments; the maturity profile and structure complexity of wholesale funding; market dislocations that can result in an inability to sell securities (think 2008); higher borrowing collateral requirements; a delay in borrower payments or return of funds; regulatory issues such as required support to strained affiliate banks that can result in problems, etc. The key here is to evaluate potential uses and then take the extra step to stress test both sources and uses to make sure problems are identified and plans have been made in advance. In closing, we thought you might also find it interesting as we tie back to our opening comments that you can also see your credit score drop when you transfer credit card balances, delinquencies or bankruptcies are settled; incur library fines; having one card with a high balance vs. multiple cards with smaller balances that add up to the same amount or getting parking tickets - strange, but true.

BANK NEWS

Hybrid Cards

Fifth Third gets innovative and launched its Duo Card yesterday that allows retail customers to choose between debit and credit. By reducing the number of cards that need to be carried, the bank hopes to gain marketshare in both areas.

Cards

According to Equifax, card origination at banks hit a 3Y high during the first 5 months of 2011. Interestingly, most of the growth is coming from customers with FICO scores below 660 (up 60% YOY).

Foreclosures

RealtyTrac data indicates that sales of homes in foreclosure or bank owned accounted for 31% of all US residential sales (vs. 36% in Q1 and 24% for 2010).

S&L Hold Cos

After Dodd-Frank transferred supervision of thrift holding companies to the Fed, the Fed is now proposing a 2Y grace period for S&L holding companies to file the same financial reports that bank holding companies do.

Paid Back More

Treasury said it received a $2.15B TARP repayment from AIG, taking its outstanding investment in AIG to $51B. Overall, Treasury has received $313B in repayments and other income from all TARP investments, or about 76% of the $412B disbursed.

Housing Affordability

Analysis indicates it takes only about 16% or so of the average person's income to make payments on a 30Y mortgage for the average priced home. The last time the ratio was this good was back in the 1960's.