BANK STOCK LIQUDITY

by Steve Brown

In the United States, bank stocks enjoy two completely different markets when it comes to liquidity. Some large community banks trade in very liquid fashion while others have little float and little activity. The question is, should you be worried about stock liquidity?

Given the need to raise capital and the state of bank equity, the question is much more than academic, as banks may want to devote more or less resources into developing equity liquidity in their stock depending on their goals. Some investors are attracted to banks with large equity liquidity and some shy away. Depending on this philosophy, most private equity groups are attracted to banks with large liquidity, as they want to make sure they can have an easy exit. However, there are a small percentage of equity firms that take the view that they want to be the only large player in a bank's stock as when they want to exit they are not competing for liquidity. More importantly, there are many bank CEOs that believe that not having an easy exit makes investors and potential investors understand that the investment is a long term, "buy and hold" opportunity.

For the most part, equity funds are more likely to acquire a bank's stock if there is evidence of liquid trading. That being said, one important thing to understand is the greater liquidity the more these institutional buyers are going to be attracted to your bank stock and the higher probability is that you have more "active" ownership. At times, funds have used the implied threat to sell their shares, a move that would likely negatively impact stock price, as a means to affect change at the bank. Should this occur, the threat of an exit may or may not serve to improve corporate governance.

By way of background, institutional investors, like bank private equity funds, are required to file public disclosures with the SEC should the fund acquire or control 5% or more of a bank's stock. These forms come in two flavors: 1) a Schedule 13D which means the investor plans on taking an active interest (such as a proxy fight wanting a new board), and, 2) the cheaper and less hostile, 13G Schedule that discloses a passive investment. These schedules give us an easy way to look back and track major institutional investments in banks.

By looking back on investor equity activity and using the difference between the bid and ask as a measure of liquidity for a bank's stock, a couple preliminary conclusions can be had. First, and no surprise, the more liquid a bank's stock is the higher participation there is from institutional investors. However, contrary to what some CEOs believe the more liquidity, the more likely an institutional investor will file a 13G instead of a 13D. In other words, more liquidity does not necessarily mean more active investment. The other interesting aspect of liquidity is that if you look at the stock price movement for the next 3 days after the filing of a 13G or 13D, the stock price normally goes up indicating that institutional ownership is usually a boost to stock price and a signal to the market that there is greater confidence, the stock is undervalued and/or maybe stronger corporate governance is on the horizon.

While it is hard to opine on if material institutional ownership in bank stock is beneficial, preliminary evidence suggest that it does help boost or support the price of a bank's equity. The conclusion today is that if you are looking to attract greater institutional ownership, creating more liquidity in your stock may be a first step.

BANK NEWS

SBLF

141 community banks received a total of $1.6B in what is likely to be the final round of funding in the SBLF Program. This brings the total to 332 banks out of 900 (37%) that have been approved for a total of $4B of $30B (13%).

Basel

In a meeting yesterday, the Committee finalized its proposal that places a capital surcharge on systemically important banks. The charge is between 1% and 3.5% based on performance criteria that are now being finalized. In addition, no information was released on the potential revision to the controversial minimum liquidity rule, but we expect that to be forthcoming next month.

Discover

The credit card bank said that it expects to receive enforcement action by the FDIC today over allegations of deceptive marketing practices related to the sales of ancillary fee-based products, particularly payment protection plans that, for a monthly fee, allow borrowers to get a break on their card payments if they lose their jobs or other problems that put pressure on their incomes.

Housing

The news just isn't getting better yet, as the latest Fed report finds bank mortgage lending fell 12% in 2010 vs. 2009. Total mortgage origination was 7.9mm, one of the worst years of the past decade. Weak demand, tight credit standards and an inability by underwater homeowners to refinance were all contributing factors.

Mortgage Fraud SARs

Financial institutions filed 29,558 Suspicious Activity Reports (SARs) on mortgage loan fraud in 2Q, a 88% increase. The increase is a result of a stepped up review of mortgages originated during 2004 through 2008. The most frequent types of issues were the misrepresenting income, occupancy, debts and assets. In addition, debt-elimination scams and scams involving the fraudulent use of Social Security numbers were also common.