LIQUIDITY: THE NEGLECTED COMPONENT OF CREDIT ANALYSIS

Liquidity is a basic that will bite you in the butt when you ignore it

* * *

Commercial lenders are not the most modest of bank employees.

After all, we lend lots of money, manage important customer relationships, and contribute significantly to the revenues of the bank. We consider ourselves well-trained, experienced, professional, and indispensable.

Then our industry experienced 2008.

And as our numbers fell, so too, many of our number were not left standing by the end of that year.

There are many reasons for what happened. Yet, we are constantly putting the blame on others-the culture, the boss, the economy, the customer, the politicians, Wall Street.

This could be a very long list.

Personally, I think we lost sight of some basics in credit analysis. One of the biggest items (but not the only one) was liquidity. Sauce for the goose is sauce for the gander. Here's what I mean.

A basic concept that drives so much

Liquidity means the ability to pay one's obligations in a timely fashion, without undue strain or significant loss of principal. That's true for both borrowers and lenders. But we lenders should spend more time thinking about it.

Banks have to be able to meet the withdrawal of deposits. It's like gravity.

Although few of the industry's liabilities are actually on demand, for many years we've behaved as if our depositors could withdraw time money as if it were demand money. Much of our deposit base behaves as if it were contractually in demand deposits.

Our retail customers have largely come to expect it.

Our loan portfolios are seldom on demand, by contrast.

When was the last time you drew up a pure demand note? (Younger lenders: Have you ever?)

Instead, we make loans with contractual maturities ranging from 30 days to five years. In fact, think about your note case and the number of notes that have contractual maturities of less than one year.

Are the credits necessarily structured to perform (fully pay out) at the note's maturity?

Or is this a convenient way of maintaining control over the interest rate you can charge and avoid being locked into a fixed-rate term for too long a period of time given your expectation of the direction of interest rates?

Relate the basics to your borrower mix

Banks have had to be nimble and quick in managing their liquidity. That's been so for many years now, but it doesn't change the fact that banks intermediate between savers and users along the time line. We borrow short and lend for longer periods of time. At least we substantially lend long by purpose, including the true source of repayment.

Experienced lenders know these things. But they leave the details to the ALCO process.

We are seldom very involved in the details of the overall portfolio as much as we're involved with our own book of loans.

I think that's the reason that we tend to gloss over the true state of liquidity of our borrowing customers. We just don't think about it in concrete terms.

We measure liquidity by the "current ratio," which is the ratio of short-term assets divided by short-term liabilities.

Having done that, then we turn our attention to other important balance-sheet items and relationships. What we're not really looking at as carefully as we might is the composition of the short-term assets and liabilities.

Some questions to ask

1. Do we inspect an aging of the borrower's receivables?

2. Do we look for concentrations of credit?

3. Are we aware of the level of returns or disputes?

4. Are "reps and warranties" issues buried but discoverable in these numbers?

5. If you or I have taken security interests in the receivables, we're likely to demand and inspect agings. What credit problems are lurking in the numbers?

6. Do we perform due diligence on them if they are not primary collateral?

Inventory comes in a variety of types as well as goods-whatever the company sells and in whatever form it initially arrives before the fabrication or manufacturing process begins. Inventory can include goods in the finished, semi-finished, or raw material states.

They are not of equal collateral value to us as lenders.

Sure, if it's finished goods we can sell it off. The same with raw materials-send them back. But semi-finished goods will require the application of money and labor to finish them before they can be sold.

That's why the "quick ratio" is so important. It addresses the composition of the inventory that comprises the short term assets.

I know we all know these things-or at least learned them at one time. But what I'm asking is why we seemed to forget the basics as we loaned our way through the second half of the most recent lending cycle?

Liquidity-forget it, but it won't forget you

Borrowers who in normal times are healthy, prosperous businesses occasionally hit a "slick spot" due to the economy or some set of circumstances not easily anticipated. Liquidity can be perishable and fragile. It's most abundant when needed least. When markets or fortunes turn, its absence can be fatal for the business.

Many lenders did not anticipate the liquidity strains of either their customers or their own banks. When the environment turned sour, liquidity was gone and gone with it were the opportunities to survive to another day including our own ability to help the customer through the liquidity drought.

This is one of the reasons that loan structure is so crucial.

Lenders should try to structure loans and relationships to encourage the borrowers to maintain reasonable liquidity, while at the same time assuring that the bank through lending covenants is adequately protected.

It's also a matter of a disciplined approach to due diligence.

If you never set foot in the customer's place of business, how can you know that something may be amiss?

If you don't ask the right questions or insist on the proper information, how can you stay on top of a customer's liquidity?

Liquidity is fragile-hard to maintain, sometimes hard to measure or calibrate during good times, and very hard to retrieve when lost.

We can do better.

And for the good of our banks and our customers, we need to be better the next time around.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

Order Ed O'Leary's two-hour "Improving Your Bank's Workout Function" CD