

## UNDERSTANDING MODERN CAMELS, PART 5: LIQUIDITY

Fifth in a series about what regulators want in a CAMELS

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Jeff Gerrish has been taking readers through a six-part look at the modern essentials of the CAMELS system. Read his takes on Capital, Assets, Management, and Earnings after you read this fifth installment on Liquidity.

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Is bank liquidity important?

Only if you want to keep the doors of the bank open.

Defining the term

Liquidity is basically the ability to meet the demands of your bank's depositors and others with a claim on the institution.

At the beginning of the financial crisis, before the regulators and Congress acted to shore up liquidity, e.g. increasing the deposit insurance limits, etc., there were a number of bank failures that were due solely to the inability of the bank to meet the demands of depositors or other creditors.

Either the bank could not raise funds in any acceptable way, i.e. no brokered deposits or its lines of credit with institutional lenders, even the Federal Home Loan Bank and the Federal Reserve, dried up.

Indeed, several banks have failed in the recent crisis with Tier 1 capital in the 3% to 4% range, due to liquidity issues.

### Building a liquidity plan

The critical role of liquidity makes it clear why regulators expect your bank to have a Liquidity Contingency Plan.

Keep in mind, such a plan is something your bank could draw on if the bank ever gets in trouble and needs it. Unfortunately, if the bank ever gets in trouble and needs it, all the sources of liquidity identified in the Liquidity Contingency Plan will probably be unavailable.

Nevertheless, the bank needs to have a Liquidity Contingency Plan because the regulators say so.

Also, as part of the examination process, the examiners will review the bank's liquidity for CAMELS rating purposes. The examiners will view the current level and prospective sources of liquidity compared to funding needs. They will also

review the "funds management practices" relative to your institution's size, complexity, and risk profile.

What the examiners would really like to see is a bank with the ability to meet its liquidity needs in a timely manner. Also, they do not like liquidity being maintained with brokered funds.

Today banks face unusual circumstances. Many banks are maintaining significant amounts of on-balance sheet liquidity. In part, this is to meet the needs of their depositors and other creditors, and in part, because there is really no place to put the money, certainly for the long term.

#### Factors for evaluating liquidity

As with the other component ratings, Liquidity for examination purposes is rated from 1 (the best) to 5 (the worst). If Liquidity is rated a 1, it means that the bank has "strong liquidity levels and well-developed funds management practices." If the bank is rated a 5, it indicates "liquidity levels or funds management practices are so critically deficient that the continued viability of the institution is threatened."

Generally, when the regulators assess liquidity, they look at the following factors:

- • Adequacy of sources compared to current and future needs and the ability of the bank to meet liquidity needs without adversely affecting its operation or condition.

- &bull; Availability of assets that can be converted to cash without undue loss, such as a securities portfolio or government-guaranteed loans.

- &bull; Access to money markets and other sources of funding.

- &bull; Diversification of funding sources.

- &bull; Assessment of the degree to which the bank relies on short-term volatile sources of funds, such as brokered deposits (infamous and uniformly despised, at least among the regulators).

- &bull; Trend and stability of deposits.

- &bull; Ability to securitize and sell certain pools of assets.

- &bull; The ever-present capability of management to properly identify, measure, monitor, and control the institution's liquidity position.

As noted, Liquidity will be graded 1 through 5 and be a part of the CAMELS rating system. But it's not necessarily that simple.

Oddly, I have seen some banks that were rated CAMELS 4 due to the asset quality snowball addressed in previous blogs, where Liquidity normally would have been a 1. However, the examiners refused to give that rating to the bank and instead graded it a 2 or a 3 because the bank's composite, they had determined, was going to be a 4.

How fair is that?

A critical component

Remember, going forward, my comment at the outset about keeping your doors open. As I have told the boards of seriously troubled banks in the last three years, when asked, "Are the regulators going to close my bank this Friday?":

"No, not this Friday--unless the bank has a liquidity crisis."

Next week we'll look at the final factor in CAMELS, sensitivity to risk.

#### About the Author

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Gerrish formerly served as Regional Counsel for the Memphis Regional Office of the FDIC, with responsibility for all legal matters, including cease-and-desist and other enforcement actions. Before coming to Memphis, Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks.

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