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Bank Examiners Display New Focus On Liquidity

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In 2008, as the Great Recession was beginning, I made a career U-turn and exited the practice of law to move back home and work with my father in a small community bank. One day in my first few weeks there, my phone rang, and it was a banker with whom I had worked while at my prior law firm, calling to scold me for not telling him I was leaving. This gentleman, who had been a friend of my grandfather, was a rather gruff executive, possibly even a curmudgeon at times. I had developed somewhat of an unexpected relationship with him, though, possibly because of the memories he had of my grandfather. After delivering a rebuke for having to find out about my change from someone else, the seasoned banker slipped into mentoring mode to give me advice on how to make the most of a career that he had been so successful in. I don’t remember everything he told me, but one line in particular stood out. As we were wrapping up our conversation, my banker friend said, “Son, this business ain’t hard; you just can’t make bad loans.”

Until now, that always seemed to be the prevailing view of bank examiners as well. Loan review consumed the majority of time and resources for every risk management exam, and ALCO matters were delegated to the least experienced member of the exam team. Ironically, considering the apparent causes of the most recent bank failures, the two prevailing questions about liquidity asked by examiners during every exam were: (1) how many of your deposits are uninsured, and (2) how many deposits are concentrated in certain industries? Traditionally, if those questions were answered satisfactorily, the liquidity portion of the exam was practically complete. Now that three banks have failed after ignoring those most basic concerns, liquidity has achieved a new level of respect among examiners, and their scrutiny of liquidity is going well beyond these threshold considerations. At a time when asset quality is as good as it has ever been, bankers are being criticized and even downgraded because of liquidity concerns, a result that was nearly unthinkable until March.

We are seeing a growing obsession with on-balance sheet liquidity during risk management exams, and the shift in risk management sentiment is catching many of our clients off guard. Balance sheet ratios never before discussed during exams, such as liquid assets to total assets, are now receiving unprecedented attention, and banks are expected to maintain adequate on-balance sheet liquidity or be prepared to show how the lack of such liquidity is not a concern within the scope of their overall risk management profile.

Just within the past month, we have seen a threatened liquidity and composite rating downgrade for failing to maintain adequate on-balance sheet liquidity, even when the bank proved it could boost liquidity almost instantly by accessing secondary sources. We have also seen for the first time a nonstandard condition on a branch application that requires the bank to maintain stated capital ratios, even though the bank is easily considered well-capitalized under the current prompt corrective action framework. The stated reason for this unusual condition being imposed on a healthy bank during a normally mundane branch application process was that the bank had experienced tremendous loan growth over the past year and the limits are aimed at slowing that growth in order to protect liquidity. Finally, I spoke with an Alabama banker recently who said their examiners told them they must maintain a ratio of liquid assets to total assets of at least 5% or risk being placed under a memorandum of understanding. More shocking is that unpledged securities cannot be considered as liquid assets for the purpose of that analysis, presumably because their unrealized losses prevent them from being liquidated at this time.

All of these examples highlight the need for a funds management policy and contingent funding plan that are not only reviewed and reapproved every year but also actively managed and monitored to ensure adequate liquidity in stressed environments. In addition to knowing what secondary liquidity sources are available, bankers are also expected to develop a plan for accessing those secondary liquidity sources when on-balance sheet liquidity drops too low and show that those secondary sources are readily available. Banks can't just assume the discount window will be available when they need it; they should also make sure they are up to date on all agreements, resolutions, and other documentation required by the applicable Federal Reserve bank through which they access it, and possibly even make a periodic draw on it and other available secondary liquidity lines to prove to themselves and regulators that the secondary sources are easily accessible when a liquidity stress event occurs. Finally, banks should regularly monitor their ratio of liquid assets to total assets and possibly draw on available secondary sources to boost on-balance-sheet liquidity when that ratio falls below a certain level. We have not yet been successful in getting a clear answer on what that level should be, but anecdotally we are hearing that 10% of liquid assets to total assets is a benchmark receiving a lot of attention.

Unfortunately, your next exam may not only involve questions about why you made bad loans but also why you made loans at all without considering their impact on your bank's liquidity profile. Failing to prepare for those questions now may result in an unpleasant visit by your examiner-in-charge, who will likely also be adjusting to this new liquidity focus and possibly be less equipped to exhibit grace than he or she would be for loan classifications they are more experienced in dealing with.

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