CAMELS – Liquidity

Liquidity measures a bank´s ability to pay for current obligations. Or, how efficiently present and future cash flow needs can be met without adversely affecting daily operations.

Sound banking operations and monitoring systems are a precondition to ensure sufficient solvency on an ongoing basis. – Even a mid-size financial institution unable to meet its short-term obligations and going out of business within days, perhaps even hours, could endanger an entire regional banking system. Therefore, liquidity planning and monitoring is an essential element of any banking operation, but also an essential tool of supervision.

Next to cash, a financial institution holds a wide range of investments, exposing it to more or less liquid or efficient markets. Adequate liquidity means that an institution either has sufficient funds available or can obtain them easily and swiftly: This can be done by either raising funds or monetizing assets at reasonable cost.

Current and future liquidity requirements have to be monitored on an ongoing basis, among others by using sophisticated planning and simulation tools. Such requirements may stem from cash flow needs for the funding of loan demand, share withdrawals, or the payment of liabilities (e.g. deposit withdrawals) and expenses (e.g. interest payments, salaries, else). – However, merely hoarding excess liquidity for this purpose may be unreasonable and rather point towards an uneconomic, inefficient liquidity management, as yields earned will likely be meagre.

A bank´s business model foremost generates income by mobilizing short-term deposits at relatively lower interest rates and lending or investing these funds long-term at relatively higher rates. Inherently, this makes banks vulnerable in managing and / or matching all of the following: Lending as well as borrowing interest rates, but even more so deposits and other liabilities with loans and securities held.

As far as funding is concerned, despite deposits only having short maturities, history and empirical research suggests that this source of funding is actually rather sticky, providing a stable source of funding. On the other hand, interbank funding and other short- to medium-term funding tools (e.g. repos), have proven much more fickle, especially during market turbulences.

Therefore, a bank´s funding sources should be widely diversified not only across investor clusters but also in regards to instruments as well as their respective terms, such as maturities. And, contingency planning to meet unanticipated events or handle periods of excess liquidity, is important. Whereby such planning also has to include off-balance sheet obligations, such as guarantees or stand-by commitments.

To ensure banks having sufficient liquidity, especially in the course of market instabilities, the Basel III framework introduced a set of minimum requirements: Among others, nowadays banks have to permanently hold highly liquid assets of an amount equivalent to the expected net cash requirements over a period of 30 days. Assets qualifying for this purpose are only cash and a set of selected frequently traded and highly rated government bonds.

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Liquidity

TOTAL CUSTOMER DEPOSITS | TOTAL ASSETS

TOTAL LOANS | TOTAL CUSTOMER DEPOSITS

LIQUIDITY | TOTAL ASSETS

GOVERNMENT SECURITIES | TOTAL ASSETS

LIQUIDITY | DEMAND DEPOSITS

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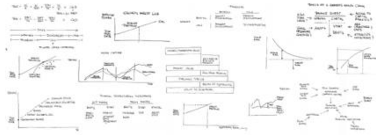

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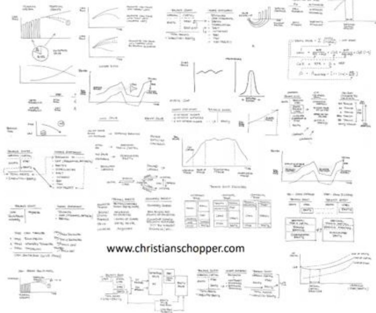

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