UNLOCKING CREDIT RISK

by Steve Brown

Unlocking the door to the next regulatory exam may not be as difficult as some bankers think. While exam topics and focus will vary from bank to bank and regulator to regulator, we thought readers might appreciate getting a copy of a key to the door marked credit risk. These items were identified as key credit risks facing banks in the coming year. First, bankers will have to get a better handle on the adequacy of their ALLL. Regulators are concerned that ALLL is weakening and banks are reporting decreasing reserve coverage. In support of this concern, we have reviewed more than 20+ budgets for banks this week and in a quarter of the cases, banks continue to lower their reserve levels relative to loan growth despite an increase in loans on nonaccural. Better documentation and analysis of the loan loss reserve is now expected. In short, bankers will need to ensure ALLL levels reflect expected credit losses, capital levels are sufficient and that documentation is robust enough to support conclusions. There is a new policy statement on ALLL which revises and replaces the 1993 policy. Basically, the new policy emphasizes banks are responsible for developing, maintaining and documenting a comprehensive, systematic and consistently applied process for determining ALLL. Bottom line: The days of "big thumb" calculations are out, replaced by analytical and statistical ones. Next (and going hand-in-hand with the ALLL changes), regulators are focused on CRE concentrations. This topic has been well-covered, so we won't go into detail, but this will continue to be an issue through 2007. Last month, regulators issued new regulatory guidance on this issue. Bottom line: Banks with concentrations will need to enhance risk management practices, analytics, procedures and policies. Finally, a third big concern emanates from current weakness in particular sectors such as housing and the automotive industry. Examiners have learned their lessons from the 80's and 90's and understand severe problems usually surface within particular regions and sectors often leading to a more macro downturn. Regulators expect banks to not only have a handle on the potential "ripple" effect of a large employer going out of business, but consider potential direct and indirect exposure to adverse regional economic scenarios. Bankers will need to ensure they have appropriate risk management processes and testing in place to mitigate these risks. Bottom line: Risk management practices, analytics, procedures and policies should be enhanced such as the greater use of credit shocks. So in closing, our suggestion for banks is straightforward and revolves around some key infrastructure components of an effective risk management program. Make sure to have active board and senior management oversight. Ensure adequate policies, procedures and limits are in place. Double check internal controls to make sure they are comprehensive. Make certain the bank has adequate risk-measurement, monitoring and information systems to handle the upgraded aspects of risk management. This looks like it will be the year of risk management for regulators, so open the door and walk through. Banks that do so can feel confident as they lock the door behind them.

BANK NEWS

M&A

Umpqua ($7B, CA) will acquire North Bay Bancorp (648mm, CA) for $142.9mm in stock. The price is a 26% premium to market or approx. 2.38x book price.

M&A Update

A slew of investment banking equity reports indicate activity should continue to be strong in 2007, especially in high growth areas such as CA, FL and TX. A difficult environment, flat yield curve, heavy competition for customers, aging boards and increased regulatory pressure are all expected to push more banks to sell. Banks discussed as possible acquisition candidates included City National ($14B, CA), Colonial ($22B, AL), Compass ($34B, AL), Fifth Third ($109B, OH), Greater Bay ($6.9B, CA), Huntington ($35B, OH), Key ($92B, OH) National City ($136B, OH), New York Community ($30B, NY), Sovereign ($90B, PA), Suntrust ($183B, GA) and Washington Mutual ($380B, WA). Also making the list was Countrywide, the country's largest home lender and a $93B bank.

Interesting

A credit union in FL is offering savings accounts to children in foster care that waives the requirement of an adult co-signer. Children aged 13 through 18 can open accounts under the program.