# ALCO AND CREDIT IN THE LAND OF 159

by Steve Brown

As our CFO likes to say, there are only two times when bankers really look at the credit of a loan - when they book it and when it goes bad. While an overstatement, bank underwriters review loans an ongoing basis, very few actually derive risk from those reviews. In support of this point, consider that banks change internal credit ratings on loans (credit migration) at a rate that is 75% less frequent than the public markets (bond ratings on large companies). While this may indicate that independent bank borrowers are more stable than larger companies, we believe lenders have a propensity not to move credit ratings upon review - unless a significant swing occurs. Banks are great about running analytics on their investment portfolio, but to date, little has been done with regard to loans. Yet, loan risk (interest rate, credit, liquidity, etc.) dwarfs almost all other risk in the institution. Under FAS 159 and its related 157, after January 1st, 2008, bankers will now have to take the fair value of their loans to at least footnote the fair value. In the past, bankers have done this on a discounted cash flow basis. Going forward, credit risk will also need to be included, forcing banks to develop a suitable and validated methodology. For those loans designated under 159, say goodbye to accrued interest/fees and loan loss reserves, since they will all be included in the loan's market price. ALCO will now take on a whole new meaning, as it not only assesses interest rate risk, but also credit and liquidity. Risk management has arrived and once the complete balance sheet is marked to market, bankers will look for more efficient interest rate and credit hedges, in order to stabilize quarterly earnings. Greater use of interest rate and credit swaps and more credit insurance will become the norm. Want to prevent your single family loans from adding volatility to earnings? Structure a guarantee that pays you when defaults rise, offsetting earning's risk. DDAs will become even more important, as they will provide bankers with the cheapest source of interest rate hedging. More active portfolio management will ensue and risk management will finally come into its own. Those loan managers that keep an eye on liquidity will be rewarded and the buying and selling of loans will increase. Underwriting criteria and covenants for loans will need to be changed, as more corporations adopt principles-based accounting. Compensation plans will start to shift next year so they not only take into account revenue generated, but also changes in market value. PCBB is actively exploring early adoption of FAS 159 on its entire balance sheet and we openly embrace the change. To help our banks, we will be publishing more detailed guidance later this week with detailed examples. Even if you are not going to adopt FAS 159 this month, it is not too early to start planning for the shift to a fair value world.

## SELECTED NAT'L BANK EARNINGS RECAP

Â•Citigroup profit fell 11% as the firm booked expenses related to 17k job cuts, investment banking surged 36%, NIM fell to 2.62% and the bank opened 99 branches during the quarter. Â•KeyCorp profit climbed 21% driven by a 1x gain from the sale of McDonald investments unit. In addition, loans fell 2%, securities increased 9%, personnel costs increased 7%, non interest income climbed 5% and NIM fell to 3.50%. Â•Marshall & Ilsley profit climbed 17% as CRE lending soared 34%, deposit costs increased 15% and NIM fell to 3.23%. Â•M&T Bank profit fell 13% as loans increased 6%, prepayments accelerated on CRE loans, non accrual loans soared 102%, provisions increased 50% and NIM fell to 3.64%. Â•Regions Financial profit increased 13% reflecting the AmSouth's acquisition. Meanwhile, non interest income climbed 51%, non interest expense climbed 52%, non performing assets increased 12% and NIM fell to 3.99%. Â•SunTrust profit fell 3% as mortgage lending slowed, compensation costs climbed 6%; problem loans increased, non interest income jumped 8% and NIM increased to 3.02%. Â•US Bancorp profit fell 2% as demand for loans fell, deposit costs increased and NIM fell to 3.51%. Â•Wells Fargo profit climbed 11% as small biz lending surged 11%. A $90mm write down was taken on subprime loans. Â•JPMorgan Chase profit soared 55%, driven by M&A fees and trading. I-banking jumped 81%, retail banking fell 2%, loan loss reserves tripled to address subprime exposure and the company slashed $3B in expenses. Â•Wamu profit fell 20% due to subprime writeoffs. On the positive side, Wamu's retail operation was up 15% and the bank added 325k new deposit accounts.

## BANK NEWS

**M&A**

Southern Michigan Bancorp ($329.9mm, MI) will acquire FNB Financial Corporation ($151.1mm, MI) for about $26mm or 2.1x book. The acquisition adds 8 branches.

**Foreclosure Rise**

Foreclosures increased 47% in March from the same time last year. CA, FL, TX, MI, and OH make up over half of the total foreclosures.

**Risky Business**

Washington Mutual has the highest percentage of real estate investor or second home loans in the industry. These loans are thought to be riskier than primary residence loans. Washington Mutual along with Citigroup also has the highest concentration of subprime loans.