MORE WOOD TO CHOP

by Steve Brown

Community bankers count themselves among some of the very best when it comes to understanding credit risk. Unfortunately, we all know there is still another cord of wood to chop when it comes to accurately pricing credit risk in loans. One area bankers could stand to improve in particular relates to incorporating credit risk migration into monthly modeling and reporting.

Consider what happens when interest rates rise. When that occurs, asset-sensitive banks have a greater incentive to make more loans, because their margins are widening. At the same time, one could argue that borrowers get squeezed (and their credit risk increases) as their floating rate loans reset higher. While this dynamic is intuitively understood by bankers, conventional wisdom also says that as interest rates rise, corporate earnings are also rising. Therefore, any increase in loan/borrowing costs may not impact credit quality. Unfortunately, this is not true for every borrower or every geographical location. In fact, rising rates have little or nothing to do with certain industries or borrowers that exhibit greater interest rate sensitivity than others. In these cases, history suggests that credit spreads should increase to compensate for higher default risk. The point here is that credit migrates or moves, as interest rates and other factors change around it. Therefore, bankers should also develop processes to more actively monitor, measure, and control such migration over time.

Another area community banks, in particular, should consider related to credit migration comes from a loan portfolio tied mostly to Prime. Most bankers have a bias to loans tied to the Prime rate, but in so doing, credit can also be impacted. It is no surprise that community banks want their loans to be tied to Prime (given a goal of avoiding putting undue interest rate risk on the books), but reflect on what happens when interest rates rise. At such times, these loans oftentimes increase credit stress in the portfolio. By originating a floating rate loan, banks have perhaps unknowingly shifted their interest rate risk to the borrower. Unfortunately for the borrower, most small business customers are liability sensitive. That is to say that their liabilities re-price faster than their assets. As a result, when interest rates increase, their debt burden increases, boosting credit risk for the bank and accelerating negative migration.

Interest rate sensitivity also depends on the borrower's industry sector and capital structure. For example, consider that small real estate developers that borrow from community banks do so through a Prime based loan. That is their liability structure. For that same developer, higher interest rates provide an opportunity for higher rents, but timing is lagged. As a result, when interest rates rise, the default probability rises. Additionally, credit also migrates as consumer spending slows, so taking a broader view, rising interest rates also negatively impact credit for most building-related, durable goods or manufacturing firms.

So, if banks truly believe interest rates are going to rise, they should take a more aggressive and proactive view of loan pricing. Doing so will help ensure new loan origination is structured to properly compensate for potentially increased credit risk.

Chopping and stacking a cord of wood can sound daunting, but it is also good exercise. In similar fashion, bankers that chop the wood to better understand migrating credit risk and become proactive can find benefit. Credit is not static and proactively identifying a shift in a borrower profile will give the bank better control of risk, provide more opportunities to cross-sell and improve customer retention rates.

BANK NEWS

M&A

Old Second Bancorp ($2.6B, IL) will acquire HeritageBanc Inc ($346mm, IL) for $86mm, or about 3x book.

M&A

First Keystone Corporation ($531mm, PA) will acquire Pocono Community Bank ($137mm, PA) in a deal valued at $33mm, or 2.3x book.

M&A

Willow Financial Bancorp Inc ($1.5B, PA) announced it will acquire wealth-management firm Carnegie Wealth Management for an undisclosed amount.

M&A

The NASDAQ Stock Market will acquire the Philadelphia Stock Exchange for about $652mm, as NASDAQ moves to enter the options business. This marks the 5th acquisition this year and also included the Boston Stock Exchange.

Tighter Standards

An October Fed survey showed that 41% of banks have tightened lending standards "considerably," compared to 15% of banks who said so in July.

Credit Card Troubles

Capital One Financial Corp said loan charge-offs could be several hundred million dollars more than previously expected due to persistent loan delinquencies and the deteriorating housing market.

BofA Tops Citi

BofA's market value, at $197B, topped Citigroup's $178B at the close of trading Monday, making BofA the largest bank in the country by market capitalization.

AZ Expansion

Wachovia said it plans to add 100 employees to its AZ work force by next June and open 30 branches within 4Ys in the state.