WARNING ALARM

by Steve Brown

If you are a community banker that has just been visited by the regulators, you know things have become less warm and fuzzy as of late. That isn't surprising, given the substantial drop in credit availability and massive problems in the market.

To help, we re-read the notes we took following personal discussions we have had with Ben Bernanke after each and every FOMC meeting this past year (where we discussed the action he took and why). While this may have been a dream, there is no denying that we have been awakened from our slumber by a loud regulatory alarm bell.

From all of our contact points among community bankers and regulators we talk to all over the country, here are some of the hottest areas we believe examiners will focus on when they next show up at your bank:

Liquidity Risk Management: Bankers should have a funding strategy that makes sense given the changing times. Using simplistic and static ratios (such as a current ratio) is not enough. Bankers should also incorporate forward-looking measurements into their analysis and identify a variety of sources where liquidity can be obtained. In short, bankers should measure liquidity in both the asset and liability side of the balance sheet. Scenario analysis and contingency plans are critical to have in place and examiners will closely evaluate situations of extreme liquidity strain. Regulators want banks to "expect the unexpected,", so steps should be taken to ensure capacity is available from Federal Funds lines, FHLB advances, repurchase agreements, brokered deposits, subordinated debt, holding company lines, traditional deposit sources, internet deposits, public deposits, cashflows from assets and securities price risk (i.e. bid-offer spread of securities held as an indicator of liquidity).

CRE Loan Concentrations: Given the shift in credit conditions and the level of community bank exposures to acquisition, development and construction lending in particular, look for regulatory scrutiny in this area. Bankers should move to enhance monitoring, analysis, underwriting, administration, portfolio risk management, credit risk ratings, review and stress testing. Diversification by sector, geography, underwriting standards and other factors will be closely reviewed. Bankers should ensure they have adequate board and management reporting capabilities. On the construction side in particular, independent property inspections, documented loan disbursement practices, developer experience, updated appraisals, debt coverage analysis and guarantor financial statements are all encouraged.

Leverage Transactions. If there is one thing we know for sure, when times are tough and fixed income sales are off, brokers paid on a commission basis have no problem thinking up leverage strategies and pitching them to community banks. Loan production is softer, so it is prime time for these pitches. Examiners will likely take a hard look at situations where wholesale funding is used to purchase securities assets in bulk. Lower interest rate and highly volatile times are rarely the environment to execute a leverage strategy. This is a departure from core business activities and regulators also see it as risk to capital ratios, available liquidity and usually low return transactions. Bankers receiving these pitches should think long and hard before proceeding and make sure they have analyzed the risks through static and scenario testing. Documentation before trading of the interest rate, option, basis, yield curve, liquidity, market and operational risks are all critical.

As the alarm bell continues to sound, bankers that prepare, forward test, document and have contingency plans will find themselves with enough ear plugs to help muffle the noise.

BANK NEWS

M&A

Community Bankers Acquisition Corp will acquire BOE Financial Services ($294mm, VA), the HC for Bank of Essex, for $52mm, or about 1.6x book.

FED TAF

The 1st of 4 FRB auctions was completed for $20B and the results were just released. Banks participating in this new liquidity program were able to borrow for 28-days at rates averaging 4.65%. More than $61B in funding was requested, resulting in a coverage ratio of 3.1. The higher than Fed Funds level indicates that demand for liquidity (even collateralized) remains strong. The next auction will take place tomorrow morning and will be for 35 days.

Mortgage Applications

Despite lower rates, the Mortgage Bankers Associated reports a 20% decrease to the lowest levels of applications since 2004.

Deposit Accounts

Studies find roughly 30% of those who open new checking accounts will leave in their first year, about 300% higher than more established customers.

Quality Employees

A study of 4,000 branches finds top performing branch manages deliver 3x the growth of average managers. Interestingly, only 10% of branch managers can consistently deliver outstanding performance.

Growing

Comerica Bank ($60B, MI) will continue its aggressive growth in the West by opening 6 new banking centers in AZ and CA by year end.