RESERVE AND EARNINGS SENSITIVITY

by Steve Brown

When we first got into banking during the early 1980's, reserves were considered a sacred part of the balance sheet to be used only in case of emergencies. Soon, with the advent of FAS 159, reserves will go away entirely, as all loans will be marked to market.

Unfortunately, for 2008, the nature of reserves lies on a middle ground - delivering the worst of all worlds. In the last couple of years, the SEC and FASB have started to better enforce FAS 5 and 114 in an attempt to eliminate "excess" reserves (theoretically to stop earnings manipulation). As a result, recent historical loan performance is often used as a basis for reserve calculation, instead of a more forward-looking measure.

If there were no business cycles, this methodology would be exemplary. However, as we are finding out (yet again) over the past 6 months, the business cycle is alive and well and loan losses are as correlated to economic performance as ever. Back in the early 1980's and 1990's, it took exactly 7 months for a construction loan to a small residential developer to show material signs of impairment and 20 months for a typical CRE loan. In 2008, loans appear to be following a similar path.

We are indifferent between capital and reserves, so while banks are under-reserved, they are overcapitalized (on a risk-adjusted basis). Therefore, from a risk standpoint, we are in a much better position today than at any time in the past. However, changes in the industry have also brought new characteristics to reserves and earnings volatility. Because of the current accounting treatment of reserves, loan loss allowances have gone from dampening cyclicality to exacerbating it. This is to say, instead of building reserves in economically robust times and using them to address problems during an economic downturn, the opposite is now occurring. Back in the 80's, the average bank had reserves of 2.70%. Now, that figure is barely above 1.13%.

We wholeheartedly agree that banks today have better underwriting, diversification, monitoring systems, liquidity and management than back in the 80's, so reserves/capital should be lower. However, from our ALLL Quantifier model, our data indicates that reserve levels should average between 1.2% and 1.9% for community banks. This means for 2008, banks will need to increase reserves at a time when earnings are already compromised. The average bank with over 300% CRE / 100% construction exposure to risk based capital is estimated to have to increase reserves by 40%. As mentioned before, we expect performance in all lending segments to deteriorate with the exception of multifamily (excluding condos). Given current credit stress sensitivities, this is projected to decrease bank earnings by 32% on average.

This just tells the reserve story. In our analysis, we also expect charge offs to rise by a factor of 4.5 to a 1.3% to 1.5% gross level by the end of the year. Add in the increased reserve levels mentioned above, hold overhead constant, take into account today's lower margins, assume flat loan growth and a lower level of earning assets and our 2008 scenario shows most banks will eat into almost 2Ys worth of earnings.

This information is just for an "average" community bank. If you have not run your own customized scenarios, you should call us immediately to see how our outsourced ALLL Quantifier and Credit

Stress Analyzer can uncover hidden risk in the loan portfolio. If nothing else, join us for a free educational overview of these products by clicking on the link in the related links section at the bottom of the page. By having a feel for what your bank could be facing; capital, reserves, liquidity and performance expectations can be better managed.

Related Links:
ALL Quantifier/Credit Stress Analyzer Overview

BANK NEWS

Risky Business

France's 2nd largest bank, Societe Generale, announced a whopping $7.2B in losses related to trading fraud it has uncovered and another $3B in writedowns related to failed CDO investments. The fraud is one of the largest ever in Europe and far larger than the $1.6B lost by Nick Leeson (a trader for Baring's Bank in the 1990's).

Housing Sector

National homebuilder Lennar reported a $1.25B 4Q loss, as it wrote down land value and it was forced to lower sales prices to reduce housing inventory. The builder also reported home deliveries slid 50%, new orders dropped 50% and cancellations climbed to 33%. Meanwhile, Beazer Homes 4Q home closings slipped 24%, net new home orders dropped 29% and the cancellation rate climbed to 46%.

Restructuring

Bank of America said it would lay off 650 more people in its corporate and investment-banking unit, following 3,650 layoffs announced since October.

Housing Pain

A FL housing industry official called the State's current housing situation the "worst housing downturn in our lifetime." Local economists put the odds that FL will fall into a recession in 2008 at more than 70%.

Stock Buybacks

A total of 424 banks and thrifts announced share repurchases in 2007, with the vast majority buying back 5% of outstanding shares, followed by 2.5%, 10% and 7.5%.