WHAT MATTERS IN SURVIVAL BANKING

by Steve Brown

Because of our position in the industry, a large part of our time these days have been bird-dogging rumors of potential community bank failures. We can tell you that after a recently completed review of the 85+ banks that are in some version of trouble, the old saying we learned 20Ys ago seems truer than ever - "Performance depends on deposits, failure on credit quality."

It doesn't matter if a bank did interest only loans or provided 40Y amortization to the market. While these items are usually symptoms of aggressive lending, as we look over the data, there is almost no correlation to explain defaults. For that matter, despite what many bankers are led to believe, the quality of the collateral of a loan rarely makes a difference. Whether you have loans with an 80% LTV or 65% LTV, receivables, inventory or stocks as collateral; it matters little when it comes to survival. We have seen banks with an 80% weighted average LTV in their portfolio perform just fine, while banks with a 65% LTV have experienced larger writedowns. In fact, while our information is inconclusive at this point, some of the data indicates banks with higher LTVs may actually perform better (as they paid more attention to underwriting to start). Regardless, when a portfolio goes bad, poor collateral is usually a symptom and not a cause.

Until this current downturn provides enough data to re-write the rules, the definitive guide to the causation of bank failures still rests with an FDIC study published several years ago. The FDIC reviewed 1,996 banks that had been on its troubled list (i.e. CAMELS rating of 4 or 5) between 1990 and 2002 and updated a similar study done over a decade ago by the OCC. The updated findings are not only interesting, but also shed light on why examiners do what they do.

To begin with, the FDIC found 96% of all banks that failed started off as troubled banks. While perhaps not surprising to many bankers, those who do loan participations may want to examine basic credit underwriting of counterparties, in order to better measure total exposure. In general, the FDIC found that banks that fail generally have similar characteristics. This group of banks had lower underwriting standards/processes, resulting in poor asset quality (i.e. higher past due loans, non-accruing loans and OREO). The banks also had higher expenses (i.e. interest expense, loss provisions, loan charge-offs, salaries, premises expenses, and other non-interest expenses) and had more volatile funding (i.e. Federal Funds purchased, time deposits over $100k and other borrowed money). Interestingly, this seems to run counter to analysis done by the OCC following the thrift debacle of the 1990's. In the FDIC's analysis, asset quality provides the best precursor indicator to failure, rather than a long held belief that capital levels provided the best early clue.

The FDIC study is interesting not only for what it found as the precursor to failure, but what it found as a precursor to survival. For banks that recovered: 52% experienced an increase in non-interest income; 72% increased capital; and 59% experienced an increase in their efficiency ratio. For banks that failed: 72% had an increase in loan-loss reserves; 56% had more loans past due; 46% increased provisions for loan losses; 76% had higher OREO; and 40% increased loans and securities with maturities longer than 5Y. Finally, and counter-intuitively perhaps, the data found banks that recovered were about 1.5x more likely to increase their volatile liabilities as those that failed (28% and 19% respectively). Boil it all down and what do you have? Banks with riskier assets have a higher incidence of failure; non accrual loans are a better predictor of failure than past-due loans and the sooner loan losses are recognized, the more likely it is the bank will survive.

Of course, if you ask us, the best predictor of survival is the quality of management. Show us a CEO that pays attention to the data, that sits in loan/deposit committee meetings, that takes the time to talk to customers, that thinks strategically and has superior hiring practices; and we will most likely show you an institution that will thrive in any environment. Until we figure out how to better quantify management, however, we will focus on loans and deposits to figure out what banks have the genetic composition to survive.

BANK NEWS

M&A

Valley National Bank ($12.7B, NJ) was purchased by Greater Community Bancorp ($974mm, NJ) for $167.3mm, or about 1.8x book.

M&A

FSB Bancshares, the parent of Farmers State Bank of Indiana ($62.4mm, IN) was purchased by First Financial Services Corp ($870mm, KY) for $14mm, or about 1.4x book.

Goldman Sachs

Announced that it will cut staff by 15% due to slowing demand for equities, fixed income and M&A.

OCC

Dubbed the "Bear Stearns Rule," The regulator announced an interim directive that would grant national banks a temporary increase in their lending limit to be used in emergency situations.

Credit Union?

The National Association of Realtors applied for a federal credit union charter in order to offer a full range of financial services over the internet.

CIT

The finance company announced that it would consider selling $7B in assets to raise funds and bring capital in-line.