NOSTALGIC POLICIES

by Steve Brown

Anybody with an ounce of nostalgia has to appreciate the Cutler Mail Chute. The brass, copper and glass chute that runs from the top floor to the basement, used to be a staple in buildings throughout North America. We love ours so much that we have developed a tradition - you have to go out and rub the 1936 date whenever you are in need of good luck.

Similarly quaint are the policies of many banks. Unfortunately, many weren't any good to begin with, as they were given to the bank by a local consultant when the bank was formed. Many are as bland and generic as they come and do not provide much use. Other policies have been long outgrown as they applied to a bank that was 10Ys younger and $1B smaller. Still others were written with good intentions, but were never really thought through - so they act as more of a hindrance than a risk management tool.

Take deposits for example. Many banks have a hard limit on the amount of brokered CDs that can be used as a percentage of deposits. Brokered deposits shouldn't be any different than repo, Fed Funds or FHLB advances, in that they are all wholesale funds and subject to established lines of credit. Bankers should have unlimited flexibility to move between different wholesale sources, in order to take advantage of the lowest rate.

Setting limits on brokered CDs or wholesale funding as a percentage of total deposits makes little sense, but a majority of banks have limits written just that way. A better approach is to set a limit as a percentage of total assets, since that is what is being funded. The percentage of a particular type of deposits to total deposits is really irrelevant. For example, when you buy a house, you are not worried about your percentage of mortgage debt to other debt? No, since you are funding the house, financial institutions care about the percentage of debt to the total value of the house, since that is what is being funded. For that matter, loan-to-deposits is another worthless measure, and loan-to-assets is much better. You never really know how much capital is in play if you focus on the former.

Finally, for policy constraints, make sure you have targets and then limits to provide flexibility. Ratios depend on the market, composition of the bank and access to liquidity and are different for every bank. However, in our example above, a good wholesale funds-to-asset target might be 25% with a hard limit of 40%.

When it comes to setting policy targets or limits, make sure they are not self-limiting and self-defeating. For every ratio, whether it is capital, loans, liquidity or deposits; ask yourself why the ratio is there. What does it really tell me and am I going to manage off of it? If you don't have good answers for each question, go find your own mail chute to rub and then come back and revise your polices.

BANK NEWS

Earnings - US Bancorp

: The 6th largest bank said its 1Q profit fell about 3.5%, as the bank was hurt by higher credit losses. The bank booked a $492mm gain related to Visa's IPO, took $253mm of writedowns on money market funds, set aside $485mm in reserves for credit losses (up from $177mm last year), charged off

$293mm and saw its nonperforming assets rise 45% to $845mm. The bank said "continuing stress in the residential real estate markets, including homebuilding and related supplier industries" was the primary driver for the weakness.

Earnings - M&I

The Midwest bank said its 1Q profit fell 33%, as charge-offs increased in its construction and development portfolio. Net charge-offs climbed to $131mm or 1.08% of total loans, while its loan loss provision jumped more than 800% to $146mm. The increase in reserves was driven primarily by weakness in estimated collateral values and repayment abilities of midsize local developers.

Housing Softness

Foreclosure filings jumped 57% in March, compared with the same month last year and 5% compared to February, as the housing market continued to deteriorate. On a year over year basis, the number of homes repossessed by banks is up 129%. Nevada once again had the highest foreclosure rate of any state (the 15th consecutive time), as 1 in 139 households received a foreclosure filing last month. That is nearly 4x the national average and an increase of 62% compared to the same month last year.

Data Breach Cost

According to the Ponemon Institute, the average cost at banks to handle a breach in security that exposes customer data is $297 per compromised record.