SHOT ACROSS THE BOW

by Steve Brown

Captains of naval destroyers will often fire a warning shot across the bow of a submarine when they find it has strayed into a sensitive area. The shot serves as a warning to the sub commander and tells them to take immediate action or face further consequences. In banking, regulators can be like destroyer captains. They will sometimes fire shots across the bow of banks, in an effort to warn them of activities deemed sensitive, risky or of increasing concern.

That is exactly what happened on March 17 of this year when the FDIC came out and reiterated AGAIN that banks with CRE concentrations (particularly those with construction and development loan concentrations) had better follow prudent risk management lending practices. As we read the missive, it wasn't lost on us that regulators had decided to use the terminology construction and development (i.e. C&D) rather than acquisition and development all over their warning letter. It seems clear that as examinations have rolled out across the country this year; banks seeking to avoid a C&D (i.e. Cease & Desist) would be well served to better manage their C&D.

The shell that landed in the sea just beyond the edge of community banking carried wording painted on it that reminded banks with concentrations in C&D (and CRE for that matter) to make sure and have a strong capital position, strong loan loss allowance levels and vigorous credit management practices in place to manage the risk. In addition, a clear warning bell was sounded telling banks to maintain updated financial information on borrowers, conduct frequent financial analysis on projects and strengthen loan workout infrastructure as needed. As this shell exploded in the sea and ocean sprayed everywhere, regulators outright told banks to increase capital levels to ensure ample protection was available against unexpected.

To be sure, regulatory shells are whizzing by frequently in this part of the ocean, so community bank submarine captains should be wary. Regulators are worried about ongoing weakness in construction lending and recent examination results that have uncovered underwriting weakness. Specifically, regulators are extremely concerned about construction loans where banks have added extra interest reserves but the underlying real estate project is not performing as expected. Regulators consider this practice to be right on the edge, saying banks that do this are eroding collateral protection and concealing loans that would otherwise be reported as delinquent.

In an interesting twist to this story, the FDIC even reminded banks that when they released CRE Guidance on December 6, 2006, there was lots of liquidity available and the economy was stronger than it is now. They also reminded banks that when they released the ALLL Policy Statement (on December 13, 2006), that banks should have incorporated a more robust ALLL process. In other words, they gave banks ample time to correct deficiencies and are now firing two additional warning shots.

Given that the regulators have filled the sky with projectiles, the time to wait has ended. Community banks should take immediate action to revamp their ALLL; assess changes in economic conditions/collateral values; increase capital; manage portfolio concentrations; improve management information systems (increase board reporting); enhance the risk rating system to better detect deteriorating credit trends; maintain updated borrower financial information; update property cash flow statements and tax returns; evaluate the overall financial condition of borrowers including concentrations of builders within the portfolio; update appraisals as conditions warrant and improve the workout process.

Construction and CRE lending is clearly a restricted area these days and warning shots have been fired. It is time bank captains take evasive action to avoid additional problems.

BANK NEWS

M&A

Nova Financial ($500mm, PA) will acquire Pennsylvania Business Bank ($121mm, PA) for $11mm or about 1.37x book.

Trust Preferred

We estimate regulators will require some 15+ banks to stop making or "defer" payments on their trust preferred debt (at the holding company level) in an effort to preserve capital at the bank. If this occurs, the move will permanently alter pricing and structure of the trust preferred market for banks.

Worried

A recent Grant Thornton survey reveals that 49% of bankers believe that the recent downturn will affect the earnings performance of their bank (what are the other 51% thinking?). Additionally, 46% say they have confidence in the appraised values of their own underwritten properties, but only 22% of bankers say they have confidence in appraisals other banks ordered for participations.

Financial Layoffs

Wall Street firms have now fired 49k employees over the past 10 months and expectations remain the eventual total could rise to 100k. The biggest include Citigroup (15,200), Merrill Lynch (5,220) and Lehman (4,990).

New Study

56% of online-adverse customers say "loss of control" is the reason they don't use online banking.