MONSTER REGULATIONS BUT TIME TO ACT

by Steve Brown

Facts show that someone within 200 miles of your own home has claimed to have been in direct contact with a monster or other unexplainable being. While some bankers say they have recently seen monster regulators, we are here to tell you that examinations have been telegraphed well in advance.

Whether you believe you have heard noises in the attic or not, there is no mistaking the fact that regulatory rumblings are getting louder. The good news for community bankers is that despite all the hype to the contrary, regulators largely do not try to surprise anyone. In fact, most regulatory growling surfaces months or even years in print before examination teams ever show up at bankers' doors.

In an effort to outline where the pressure points are and where they may be coming next, we dug into our notes from recent conversations and meetings. Our goal is to highlight upcoming issues bubbling to the surface, so community bankers have time to react and prepare.

The regulatory message - tighten up your lending risk management practices because risk in CRE is rising quickly. By now, everyone knows that the regulators in December 2006 told bankers they were very worried and very serious about risk in CRE lending activities. They even went so far as to define CRE concentrated banks as those with total construction, land development and other land loan levels of 100% or more of total capital. They further refined the measure by including banks that had total CRE loans of 300% or more of total capital. They then closed the definition off by zeroing in primarily on new banks by flagging those whose CRE exposures had grown 50% or more over the prior 3Y period. All told, this guidance applied to nearly 3,000 community banks across the country and its message was clear. This year, banks are reporting heightened regulatory scrutiny of their CRE loans, with a special emphasis on the risk inherent in construction, land development and other land loans.

The regulatory message - have enough ALLL to handle writedowns because the market is deteriorating. In December 2006 regulators told banks that the allowance for loan losses would come under scrutiny. They added a Q&A section to the updated guidance and told bankers that they must maintain an ALLL at a level appropriate to cover estimated losses on individually evaluated loans, as well as within the overall portfolio. Bankers need to quantify and refine this measure to make sure it takes into account recent market deterioration, while providing enough cushion for expected loan writedowns.

The regulatory message - protect consumers from ID theft. In November 2007, regulators reminded banks that they must have a written identity theft prevention program. They also provided a list of 26 "red flags" that banks consider incorporating into their identity theft prevention programs. Bankers looking for the list are directed to FDIC FIL-100-2007.

The regulatory message - Hurricane Katrina caught banks off guard, so make sure flood insurance is updated. In December 2007, regulators reminded banks that flood insurance is required for the life of a loan secured by improved real estate. Borrowers forget to renew their policies, so banks need to monitor and control this to make sure they have enough flood insurance.

The regulatory message - bank failures will probably begin to occur and regulators are going to ensure liquidity by allowing lenders to liquidate collateral faster. In April 2008, the regulators told everyone how they would treat "covered bonds" in the event of a bank receivership. They said they would allow lenders to have expedited access and liquidate such collateral within 10 days of receivership. Covered bond collateral was defined as obligations of banks secured directly or indirectly by a pool of mortgage loans or AAA- rated mortgage bonds.

Seeing monsters can be scary, but know that regulators aren't monsters and bankers that are prepared stand a much better chance of passing their next examination without incident.

BANK NEWS

M&A

Empire Bank ($727mm, MO) an operating company of Central Bancompany of Jefferson City ($8.4mm, MO) will buy Greene County Bank ($40mm, MO) for an undisclosed sum.

Interest On Reserves

In an effort to add another liquidity tool to his toolbox, Ben Bernanke has asked Congress for the authority to pay interest on commercial bank reserves.

BOLI

Wachovia took $315mm in losses tied to its bank owned insurance contract. This is in addition to losses taken at 5th 3rd, and BB&T for similar deficiencies. Many community banks have similar liability, as 3rd-party guarantors of stable value contracts can no longer honor their obligations due to the deterioration in MBS spreads and failed leverage programs which supported such contracts.

UBS

If losses weren't enough, the world's largest money manager is being investigated by the Dept. of Justice for its role in potentially helping clients evade U.S. taxes.

Lending Volume

The SBA reported loan volume is down 15% for the first 6 months of fiscal 2008.