HORSING AROUND BUT NOT EATING HAY

by Steve Brown

We found it interesting that horses will eat for 24 hours per day if they are left alone. Since bankers are never left alone by the regulators, we thought you might like to know some of the crackdown points coming your way in 2009 so you can better prepare. We pulled this information together following presentations by the regulators, recent guidance updates, conversations with bankers and discussions we have had with examiners. Given all that is going on, four areas that certainly won't be missed in the next exam will be earnings/capital, asset quality, liquidity and risk management.

We begin with mortgages, since that is what seems to have caused many of these problems. Regulators will be closely examining borrower credit history (FICO), loan characteristics (LTV, structure, payment to income), documentation standards (no docs, misrepresentations, occupancy/appraisal fraud) and simultaneous seconds. Any loans that trigger warning flags will require more documentation, risk analysis and loan reserves. As long as home prices remain in free fall, expect additional scrutiny on these sectors within the overall loan portfolio, particularly in geographic areas that have been the hardest hit (AZ, CA, FL, MI, NV, etc.). To avoid problems at the next exam, make sure you have proper documentation in the files and have stressed the overall portfolio under varying scenarios (rising LTV, rising debt to income, falling property value, etc.).

Next, we highlight leverage. There can be no doubt that the industry is undergoing a period of deleveraging, as banks move to reduce loan-to-deposit ratios, unwind overextended wholesale funding and generally evaluate risks within the portfolio. Bank management and boards alike are re-evaluating risk appetite, as the industry prepares for a wave of increased regulation that will certainly reshape the landscape.

Earnings are also getting worse, as banks pour money into loan loss reserves and asset growth slows overall. Banks are focusing efforts on their best customers, trying to meet their needs but requiring more collateral and protection. Clearly, banks everywhere are tightening up lending parameters in an effort to protect against future losses. While the greatest area of concern remains consumers, CRE has begun to weaken, so look for scrutiny in this sector to increase as well.

Liquidity has also become an issue bankers will have to beef up. No longer are static risk measures going to cut it. Examiners these days want to see dynamic changes modeled along with robust contingency planning that has actually been tested. Simply saying your bank would participate loans if stresses occurred isn't good enough anymore, you must have documentation to show this or it won't count. Non-core funding, brokered deposits and heavy FHLB borrowing are all areas regulators will be closely examining. Documentation that includes a strategy for each one is critical to avoid regulatory problems.

Capital adequacy is also going to be closely scrutinized in coming quarters. As loan losses mount, banks need to be sure they have planned for the worst. Building capital to super-capitalized position (of 12%) for banks with concentrations in CRE or construction is critical these days. Capital contingency plans should be developed and banks that are at risk of falling below well capitalized should act sooner rather than later to suspend dividends, improve liquidity and try to raise more capital from whatever sources may be available.

To avoid getting thrown off the horse at your next examination, follow these suggestions, be proactive in addressing risk, enhance your liquidity contingency planning, immediately address asset quality issues, raise capital as a buffer wherever possible and remain flexible to address unforeseen issues. This is certainly going to be a tough year, but hopefully our discussion points this morning will help you along the way.

BANK NEWS

Sub S TARP Begins Tomorrow

The head of the financial stability office of the Treasury, Neel Kaskari, said the TARP program will open to Subchapter S Corps tomorrow.

Small Business Risk

Revenues have declined at 50% of small businesses, forcing owners to cut back on capital spending, lay off employees and restructure loan terms.

ID Theft

A new report finds a 50% increase in the number of reported data breaches in 2008, compared to 2007. Overall, 37% of breaches occurred at businesses, while schools accounted for 20% and employee theft rose to 16%.

Competition

Wells Fargo sells 5.7 products per retail customer and about 6 products to each commercial customer.

Slow Rebound

Equity analyst Meredith Whitney expects banks will be on "life support" for the next 18 to 36 months.

Hotel Risk

Experts predict hotels will suffer an 8% drop in revenue per room in 2009, the 5th largest drop since 1930.

Fed Speak

A top FRB official said in a speech given last week that the recession will be "longer and more severe than originally forecast."

CRE Sector

The Urban Land Institute predicts this year will be the worst one for commercial real estate since 1991, as vacancy rates and job cuts rise. The ULI calculates property values nationwide have fallen 20% and landlords will have to reduce rents by 30% in 2009 to fill vacant office space.