A RULE OF THUMB - TEXAS RATIO ANALYSIS

by Steve Brown

People like simple ratios and rules of thumb because they are easy to understand and remember. The problem with banking is that nothing is simple these days and as the economy has derailed, we have found out that most rules of thumb are worthless.

Sadly, we watched last Friday as another bank failed. That pushes the 2009 total to 14, which at the current pace, means the FDIC will shutter about 100 banks this year. While that is still far away from the 300 to 500 bank closures bandied about by some analysts, it remains a pretty large number nonetheless. Along with the high number of projected bank failures, the press has also picked up on the Texas Ratio. In fact, rumor has it that a major newspaper is at war with the ICBA and ABA after word leaked the paper might list the worst 50 banks in the country based on this ratio. As you can imagine, we (and we are sure all of our readers) have lots of problems with this.

The Texas Ratio was a ratio that surfaced in the 1980s that was designed to measure how bad the credit problems of a bank were becoming. It is calculated as: (non-performing loans + 90 day or greater loan delinquencies) / (tangible equity capital + loan loss reserve). When the ratio gets to 100% or >, it is a warning sign that the bank's loan portfolio has deteriorated to the point where it could wipe out all reserves plus capital. The good thing about this ratio is that it is easily understood and it is time tested. Unfortunately, the simplicity of the ratio also results in problems.

The ratio does not take into account the value of the underlying collateral. Just because a borrower gets in trouble does not necessarily mean the underlying loan has no value. Banks that seize and sell nonperforming loans that cashflow at 1.50x DCR and 65% LTV for example, are going to get much more for that loan than if it the loan were nonperforming and at a 1.00x DCR and 100% LTV.

The ratio only picks up 90 day and greater delinquencies, so it may also be understating problems. Banks that have significant 60 day delinquencies will eventually see some portion roll into 90 day, but in the meantime, they can look pretty good when compared to peers. While one can argue this is only a short term effect, depending on when the analysis is done (i.e. at the end of the quarter), it can take up to another 3 months for strained banks to show up under the calculation as having difficulty.

Finally, in utilizing the ratio, the public lacks the contextual understanding of its magnitude. This is to say that the value of the ratio increases the closer a bank gets to 100%, but that is not intuitive. For instance, a bank that sees its Texas Ratio go from 5% to 25% isn't nearly as bad off as a bank that goes from 90% to 100%, despite the fact that the latter has only move 10 points (versus 20 points).

When analyzing banks, the Texas Ratio does have a place, but as with any ratio, it must be taken in context. Ratio analysis is good when used as part of a deeper review, but simplistic analysis and rules of thumb (particularly during this period of extreme market stress) don't add much value in today's complex banking world.

BANK NEWS

Failure #14

The FDIC closed Silver Falls Bank ($131mm, OR) on Friday and sold it off to Citizens Bank ($379mm, OR). Citizens agreed to acquire all 3 branches, 100% of the deposits (for no premium) and $13mm of assets (cash, securities and deposit secured loans). As of 12/31/08, Silver Falls reported Tier 1 risk-based capital of 2.6% and Tier 1 leverage of 2.0%.

Citi's Future

A WSJ story is causing a stronger bid for financials, as there is talk that the Gov't will be converting its preferred shares into common. The conversion may also come with new money, so that the Treasury ends up with between 25% and 40% of the Company.

FDIC

This Friday we are expecting official word on the TLGP extension (look for it to hit their website this weekend), as well as announcement on 2Q deposit premiums.

Bank Marketing

An ABA survey done in 2008 found the top 3 biggest marketing challenges banks say they expected to face in the upcoming 12 month period were deposit growth (33%), competition (23%) and economy (22%).

Cross Sale

The same ABA study found the larger the bank, the more likely it was to have a formal cross sale strategy and plan. Community banks seeking to capture and retain customers may want to formalize the process through exactly such a plan if they haven't already done so.