SPECIAL ASSESSMENT IMPACT

by Steve Brown

Last Friday was one of those days that changed the future in a subtle way. The FDIC released their final rule - imposing a 5bp special assessment on each bank's assets, less Tier 1 capital, as of June 30, 2009. The amount of the special assessment for any institution cannot exceed 10bp of a bank's deposit base for 2Q, thus making the final rule less than or equal to the interim rule of 10bp based on deposits.

The news that the special assessment will be based on assets signals a shift in risk analysis for banks. The reality is that neither asset volume nor deposit volume has any correlation to bank failure or potential FDIC fund impact. However, the only thing the switch accomplishes is that it better spreads the premium across all banks, which is an improvement from past practices.

Some banks have traditionally "gamed the system" by increasing their use of wholesale funds like using FHLB advances. This increases risk to the deposit fund without a corresponding in premiums. While leverage in and of itself is not a precursor to risk, leverage in the wrong hands does correlate to higher losses. Use of wholesale funding has occurred at larger banks more than community banks, so community banks are relatively better off versus the interim rule. This "freeloading" problem is now rectified in a blunt force way. However, the other impact of the special assessment is that it hits banks that utilize investment leverage. Here, banks increase assets and fund themselves through wholesale sources. This tactic will now serve to increase non-interest expense on a relative basis, when compared to banks without leverage programs, thus making leverage programs less attractive.

While the special assessment helps the banking system, it has increases the short-term risk for all. While it is true that examiners will adjust earnings for the one-time charge when assessing CAMELS ratings, the assessment nonetheless hurts profitability by levying an additional fee at the end of 3Q which is basically "front loaded" (a ramp up would have been much better). The net result is higher community bank risk for at least another year, as profits will likely drop by 30% to 40% for 2009. Finally, we hasten to add, the current assessment raises just shy of $6B, which is short of what we expect the FDIC DIF fund needs to handle just existing bank closures. The current final rule also gives the FDIC the authority to impose up to 2 more assessments of up to 5bp each (1 of which Bair called "probable," while the other was seen as "unlikely.")

Ironically, it was the OCC's Comptroller, John Dugan (or his staffer), that wrote in opposition to the special assessment and rubbed salt in the wounds. In a release the Comptroller wrote, "Large banks have certainly had their own problems, but they did not force smaller banks to load up with commercial real estate funded by brokered deposits, which is the combination that has been at the heart of so many community bank failures."

This is a snarky comment for a regulator to make, especially since it is in opposition to the facts. To date, construction and single family mortgage lending have resulted in most of the problems, not commercial real estate. While CRE is a problem, it is only a problem in so far as banks have been concentrated in this area. Probabilities of default in CRE are less than or similar to most other lines of bank business and their correlation to the economy is about average. Going after brokered deposits also isn't really fair, since funding is fungible and failed banks also loaded up on high-priced local deposits, FHLB advances and public funds. There is only an extremely small correlation of brokered deposits to bank failures (less than 1 half of 1%).

Those comments aside, community banks must now go to work and plan for the additional impact of the special assessment and adjust both strategy and tactics accordingly. Alerting the board, recasting budgets and planning for lower earnings are all obvious first steps. After that, it is back to finding ways to increase profitability, so we can help pay for mistakes of the past.

BANK NEWS

Closures #35 & #36

Regulators closed Strategic Capital Bank ($537mm, IL) and sold it to Midland States Bank of Effingham ($438mm, IL). Midland agreed to assume all the deposits and most of the assets of Strategic under a loss-share agreement Regulators also closed Citizens National Bank ($437mm, IL) and sold it to Morton Community Bank ($1.8B, IL). Morton agreed to assume all deposits, except about $200mm in brokered deposits and almost half of the assets of Citizens under a loss-share transaction.

FDIC $250k Extension

On May 20, President Obama signed a law that extends the temporary increase in the standard maximum deposit insurance amount (SMDIA) to $250k per depositor through 12/31/2013 effective immediately. The SMDIA will return to $100k on 1/1/2014.

Capital

The Fed adopted a rule allowing bank holding companies to include perpetual preferred stock issued in connection with TARP into Tier 1 capital calculations.

Gross Negligence

The FDIC is positioning to file a series of lawsuits against management and directors of failed banks alleging gross negligence. The move is an attempt to collect on Directors & Officer insurance.