ASSET QUALITY WORK REMAINS

by Steve Brown

Did you know that from the end of 2008 thru the 1Q of 2009, the average FICO score fell 6 points to 651 (the hardest hit states saw scores drop around 10 points)? Lots of factors are used to create the FICO score, but amid such significant consumer strain, nearly all continue to blink red. Consider that in the 1Q alone, credit card delinquencies hit a record high and chargeoffs reached a near-record high. As the data shows, bankers will need to be careful with credit quality for a few more quarters at least.

While FICO is a consumer tool, bankers can be doing things to improve credit quality overall and tighten up management and risk controls of the loan portfolio. Here are 7 factors to consider:

1. Control Risk. One thing bankers can do is review policy concentration limits and lower them if the risk is rising within any sector. This is a major focal point for examiners, so bankers need to be sure asset quality is managed from the board level on down to the last employee.

2. Loss Provisions. Bankers still have work to do and earnings will be strained for at least 2 more quarters as loan loss provisions are replenished. This also assumes no new credit events surface, such as in the CRE sector. Performance remains weak in nearly every sector, so flexibility, focus and patience are critical. Consider that during the 1Q alone, nearly 65% of banks increased their loan loss reserve. Despite the increase, the ratio of reserves-to-noncurrent loans fell for the 12th consecutive quarter and hit the lowest level in 17Ys.

3. Problem Loans. Bankers will need to continue to attack problems head on and as soon as they surface. The "best customers" are those that pay their bills on time, so maintaining that mantra will help as you are forced to collect on long-time customers. Keep focused on reducing exposures and keep an eye on any area that looks as though it is beginning to show weakness to limit future risk as well. Finally, don't be shy about hiring outside expertise if needed and make sure to have a strong workout specialist at the helm. The process of working through a portfolio of problem loans is a marathon and not a sprint, so it is important to remember that loan issues are part of daily life and will be so for awhile longer. Of note, at the end of the 1Q, about 60% of banks reported rising noncurrent loans.

4. Charge Offs. As banks work through problem loans, chargeoffs are also increasing. As of the 1Q, net charge offs had their highest quarterly spike in 25Ys and nearly 60% of banks reported year-over-year increases. Unless the economy recovers miraculously, community bankers will be facing a rough period for some quarters to come and increasing chargeoffs are likely to continue. Our advice here is to take immediate steps to address uncollectible loans. Regulators will force banks to charge off non-performing collateral dependent loans (down to the appraised value) anyway, so taking action on your own reduces the likelihood of unexpected regulatory action.

5. Less Lending. From the 1Q of last year to the 1Q of this year, real estate loans at banks have fallen by 2.2%. Hamstrung by problem credits, worried about customer performance and in an effort to protect capital, banks have reduced lending exposures. Bankers should expect to remain constrained on lending opportunity at least until nonperforming loans are reduced and reserves are built back up.

In the meantime, widen out loan pricing, demand up front fees and don't be shy about adding requirements before originating that next loan. Borrowers have limited options, so make sure the loans you put on the books are priced attractively and include deposits.

6. Active Restructuring. Bankers know that overall rates are low and so do customers. One way to ensure debt coverage ratios do not fall when rates rise, is to proactively refinance loans into fixed rate structures. This will require banks to hedge the ensuing interest rate risk, but that is easy and it ensures collateral values are protected when interest rate risk rises.

7. Enhance Analysis & Reporting. Community bankers are already overwhelmed by strains on the loan portfolio, so there is precious little extra time. Carving out an extra hour to tighten up board reporting, however, can be worth its weight in gold. Simplifying a complex package, reporting credit migration and beefing up discussion of problem assets are all recommended changes. In addition, bankers should hire outside loan review teams to come in every 6 months to conduct analysis. Things change quickly, so these teams can help management identify risks, so action can be taken before things get too bad. Finally, consider tightening up policies, modifying credit reviews (if needed to capture changing sector conditions) and enhancing all methods of measurement, monitoring and reporting.

Whether a FICO score is "excellent" and above 700 or just "good," it is a compilation of many different factors. Each factor requires ongoing and focused attention to improve and as with a community bank loan portfolio, it begins with the first step.

BANK NEWS

Foreclosure Relief

CA's Foreclosure Prevention Act went into effect this week and freezes all qualified foreclosures for 90 days, under the concept that the time will give banks and homeowners a chance to modify the mortgage. Banks that do not want to participate can petition the Dept. of Corporations for a full or partial exemption to the moratorium.

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