LEARNING TO MAKE MISTAKES AND PLANNING FOR 2010

by Steve Brown

Speaking of mistakes, much has been made off Thomas Edison's 2,998 mistakes where he tried to heat various items before coming up with the carbonized cotton filament. Edison recorded and published his failures, as well as his successes, knowing that one led to the other. Instead of covering up failures, Edison held them up as a success in trying to figure out what not to do.

In banking, we are in an unprecedented time where we have seen how mistakes can turn into terminal failure. When banks run into problems, it is rarely a result of a single error in judgment. The last year in banking has provided 10Ys worth of education. We can now better understand why diversification is important, how some loans carry more risk than previously believed, how risk-adjusted loan pricing matters over time and how regulatory risk must be better appreciated. In addition, for 2010, banks must use this knowledge in an effort to better align profitability, risk, capital, reserves and liquidity.

In the coming months, we will be providing banks with more information on how to better tie interest rate, credit, liquidity and capital into the planning effort. The days of running just a baseline scenario for a strategic plan are over. For 2009, banks are running an average of 5 different views of their bank under various economic, regulatory and liquidity conditions. Looking at what happens if the FDIC $250k limit gets reduced is just one scenario that needs to be run by all banks.

In 2009, because of so many banking mistakes, we now have a more quantitative understanding of what risks are present and what their impact is. However, the key point that we want to drive home today, is that those banks that have learned from past mistakes see a future that looks less risky. For example, back in 2007, banks loved credit risk and booked loans at a double digit pace. If banks liked credit then, in 2010, pricing is much better, collateral asset prices are lower and liquidity is more fairly priced. Logic would dictate that 2010 may be the time to take on more risk, since it comes at a better return and will most likely be less volatile in its performance. Growth comes at a lower risk than almost any time than in the past.

Opportunities abound and the ability to take advantage of them rests on management's ability to ascertain the bank's capacity to take on more risk. To do this successfully, management must do 2 things. First, incorporate past mistakes into future planning and second, have confidence in those future plans. Because we are facing so many different outcomes, bankers need to be brutally honest of their past performance and disciplined in their planning methodology. Running multiple planning scenarios will force management to think through how variables such as volume, price, risk and return will affect the bottom line. Output from these "stress tests" will hopefully give managers and their boards the confidence needed to embark on even greater performance in 2010. Like Thomas Edison, mistakes may provide the best catalyst for future success.

BANK NEWS

M&A

Bank of New York Mellon will sell Mellon United National Bank ($2.37B, FL) to Spain-based Banco Sabadell for $142mm. Banco Sabadell also owns TransAtlantic Bank ($526mm, FL) and will merge this existing subsidiary with Mellon United. In the 1Q, Mellon united posted a $9.4mm loss as loans past due rose to 8.17%.

Offshoot

Capital Bancorp ($5.7B, MI) will split from Michigan Commerce Bancorp ($1.3B, MI) in continuing efforts to increase capital levels and shed struggling banks. The move will shrink the amount of nonperforming loans by over 67%.

Earnings

PNC: Earnings dropped to $207mm from a year prior, driven by rising loan losses, declining revenues and the FDIC special assessment. Nonperforming loans rose by $1B in the 2Q compared to the 1Q. Fifth Third: The bank reported an $882mm profit, despite the fact that nonperforming assets rose 28bp to 3.48%. The bank also booked a $1.06B profit from the sale of its payment process business, revenue doubled to $3.42B and NIM increased to 3.26% from 3.06%.

New Regulation

The Obama Administration has sent proposed legislation to Congress that would create a Financial Services Oversight Council (FSOC) to coordinate regulations and identify risks. FSOC would be structured as a council chaired by the Treasury and include the FDIC, FRB, CFTC, SEC, FHFA and two new agencies (the Consumer Financial Protection Agency and the National Bank Supervisor). The bill also gives the FRB authority to designate companies as Tier 1, subjecting those companies to increased scrutiny and higher capital standards. According to Treasury officials, Tier 1 is defined as any financial firm that could pose a threat to the economy's financial stability, based on their size, leverage or interconnectedness.

Muni Pressure

State tax revenues have fallen 11.7% in the first 3 months of the year, the steepest decline on record.