THE ASSET QUALITY IN CAMELS

by Steve Brown

Significant industry and economic pressure is leading to worries about future loan losses that are keeping both bankers and regulators up nearly every night. As is seeing an oasis in the desert, loan performance can appear to be a mirage at times. That is one reason why asset quality is closely monitored and why we continue our discussion of examiner hot buttons as we review the "A" in CAMELS.

Loans typically represent a majority of assets, so examiners spend most of their time during on-site visits reviewing loan files and performance. Given the risk, regulators also expect bank boards and management teams to spend significant time evaluating lending risks, putting together loan policies, participating in loan committee meetings, closely reviewing credit write ups and staying on top of reports that show credit migration and the condition of the loan portfolio. From the examiner point of view, when assigning the rating, a great deal of emphasis is placed on management's ability to recognize and control portfolio risk. Even banks with low levels of adversely classified assets can receive a less than satisfactory rating because management is not adequately controlling potential credit risks.

Areas in particular that will be closely monitored by regulators include: Policy Effectiveness - do policies convey BOD risk tolerance, is it revised at least annually, is it a guide toward achieving the strategic plan, has it been customized to fit the institution? Policy Enforcement - do policies require a comprehensive credit write-up, does it easily identify exceptions to policy, has it gone to loan committee, have exceptions been addressed (why necessary and how mitigated), are exceptions being tracked and reported to the board? Portfolio Management - are loans being administered properly, what is condition of the portfolio, are there monthly reports on potential and existing problem credits, delinquencies, new/renewed loans, concentrations, downgrades/upgrades and a robust rating system? Adequate ALLL - Regulators require banks to ensure the reserve is evaluated at least quarterly (more banks are now doing it monthly to stay on top of fast-moving trends), it should include a comprehensive analysis of the portfolio, segmentation by characteristics (grade, loan type, etc.) and consider such factors as changes in lending procedures and/or staff, changes in the nature/volume of loans, trends in past due/adversely classified credits, existence of credit concentrations and changes in local/national economic conditions.

Regulators have certainly sent the message as well that banks need to have a handle on concentrations. Whether those concentrations are in construction, commercial real estate, borrower or industry, expect greater scrutiny and a requirement for higher capitalization. Regulators also now expect banks to consider the risks of such concentrations in the strategic plan, prudent limitations as a percentage of capital and close monitoring/reporting by management are important.

When assessing asset quality, we have found that regulators will most often look at key ratios that include: asset growth over the past 12 months; non-current loans to gross loans (percentage of loans that are 90 days or more past due/no longer accruing interest); net losses to average loans (level of annualized net losses as a percent of portfolio) and ALLL to loans (cushion available to absorb losses relative to total loans outstanding).

When assessing asset quality, regulators will delve into factors that include: adequacy of underwriting standards; credit administration/risk identification practices; level, distribution, severity and trend of problem assets; adequacy of ALLL; credit risk arising from unfunded commitments/commercial or standby letters of credit; asset concentrations; adequacy of policies, procedures and practices; ability of management to administer loans; adequacy of internal controls/management information systems; and volume/nature of credit documentation exceptions.

Maintaining asset quality in this environment can be as difficult as finding water in the Sahara desert, but prepared bankers can make this trek a successful (albeit difficult) one nonetheless.

BANK NEWS

Rising Home Prices

Today's Case/Shiller report indicated that home prices in 20 U.S. metro areas rose by 0.5% in May, marking the first increase in 3Y.

Liquidation

Following the closing of Security Bank Corp's 6 GA banks on Friday, the firm has announced plans to file for liquidation. In total the 6 banks held $2.8B in assets and $2.4B in deposits. The bank had funded itself with a large portion of brokered deposits and high interest rate investments.

Online Banking

A survey by Harris Interactive finds nearly 70mm households use online banking services, a record high. In addition, 79% said they did so because paying bills online was faster, 72% said it was more convenient and 71% said they used online banking because it gave them more control over payment timing

Wealth Services

A recent study finds 49% of community banks, 63% of regional banks and 83% of large banks provide wealth management services for clients.