NECKTIES AND ALLL IN BANKING

by Steve Brown

According to a recent Gallup Poll, the number of men who wear ties to work every day has fallen to a record low of 6% and sales have plummeted to $680mm last year (about 50% the level of a decade ago). That isn't any wonder when you consider that a study of people's spending habits this past Father's Day show only 1% bought one. In fact, tie-wearers are so hard to find, that in the middle of last year, the Men's Dress Furnishings Association (which began in 1947 as the Men's Tie Foundation) went out of business. As with the necktie, loan grading and loss reserve allocation can come in a variety of colors and styles, but here are some tips bankers should consider that we have culled from regulatory guidance, experience and from discussions with banks that have completed regulatory examinations.

More bankers are calculating the Allowance for Loan and Lease Losses (ALLL) on a monthly basis these days in order to keep pace with fast-moving market conditions. While most still do so quarterly, more frequent analysis is certainly something to consider given the environment.

Make sure your qualitative factors and reserve levels are directionally correct. Banks get into trouble when they throttle up reserves in a given sector or sub-sector and then lower them when evidence suggests market conditions have worsened. Ensuring your reserve percentages each month are moving in the right direction is critical to avoid regulatory problems.

Regulators define "substandard" assets as those with a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. These credits are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Just because a loan is graded substandard does not mean it is necessarily impaired, however, once it becomes significantly past due or is in nonaccrual status, losses are more probable and impairment is likely. Here, it is important that bankers measure both the risk of default (the loan will not perform as agreed) and the risk of loss (the loan will not be repaid in full).

Regulators indicate in guidance that when banks assess a loan under FAS 114 and determine it is impaired (but the amount of impairment is zero), the loan should not be thrown back into the FAS 5 assessment. However, regulators caution that when banks determine an impaired loan needs no associated loss allowance, that the measurement process be thoroughly documented and appropriate for each loan.

The bank's historical loss experience (should be over a long enough period of time to capture sufficient loss data and banks are expected to review the range of losses over each time period used, rather than only relying on the average historical loss rate) is also expected to be adjusted by qualitative or environmental factors. This gives banks without much loss history more flexibility in determining ALLL based on current information, events, circumstances and conditions. Documentation is required to support any adjustments and should include a description, analysis of how the factor has changed over time, which loan rates have been adjusted, the amount of the adjustment, how management estimated the impact and other available data (regulatory updates, economic reports, notes and discussions with borrowers, etc.) to support the reasonableness.

In closing, banks must review the appropriateness of the ALLL at least quarterly, however regulators expect significant loans to be monitored regularly and provisions made as events occur on a continuous basis, so this is always a work in progress.

Maybe the demise of the tie is a good thing. After all, it was never easy choosing which tie to wear and we were always spilling on them every time we ate something with sauce in it.

BANK NEWS

TAG Extension

Yesterday, the FDIC extended the Transaction Account Guarantee, the program the guarantees non-interest accounts, from the end of the year to June 30, 2010. The extension will come with higher fees (currently 10bp going to a minimum of 15bp and scaled as to risk thereafter) and current participants will be able to opt out on a 1x irrevocable basis (we predict most will stay in). Currently, 7,100 institutions participate with over $700B guaranteed. For more info, go: http://www.fdic.gov/news/board/aug26no4.pdf

PE Guidelines

The FDIC voted in favor of allowing private equity firms to buy failed banks, reducing the required Tier 1 ratio they would have to hold to 10% (down from 15% and eased mandatory capital requirements should levels fall below that) and relaxing the hold period to only 3Ys.

No Disclosure

The Fed's Board of Governors asked the US District Court to delay the enforcement of this week's decision to identify banks that borrowed from any of the 11 emergency lending programs (TAF, TALF, etc.) in order to stem depositor and investor concerns.

Thrifts 2Q

The OTS reported 2Q earnings totaled $4mm for thrifts, marking the first quarter to turn a profit in 6Q. The agency noted higher levels of loan loss provisions and the FDIC's special assessment for the depressed earnings.