EATING M&M's TO REDUCE REGULATORY PAIN

by Steve Brown

Researchers say the food dye that gives blue M&M's their color may also help mend spinal injuries. Apparently, the dye blocks a chemical that kills healthy spinal cord cells around the damaged area. We don't know if eating M&M's will help bankers get through their next regulatory examination, but it certainly can't hurt. Along those same lines, following the outcome of regulatory orders for other banks can help protect you. Those reports show regulators are cracking down hard and changing the industry. Here are some significant changes you should be aware of:

Capital ratios have been increased. While the "official" capital ratios required to be considered "Well Capitalized" still remain 10% for Total Risk-Based, 8% for Tier 1 Risk-Based and 5% for Tier 1 Leverage, the "unofficial" capital ratio requirements (based on C&Ds and regulatory discussions) have become 12% for Total Risk-Based and 8% to 9% for Tier 1 Leverage.

Wholesale reliance is not allowed. While there are no "official" statements on the absolute level of wholesale funding a bank can utilize, recent orders appear to place the number somewhere around 5% to 20%, depending on overall liability structure. Banks in excess of those levels should not be surprised to see greater scrutiny from regulators and increased pressure to "raise funding locally" (regardless of pricing disparity to possibly less expensive wholesale options).

Earnings still matter. When calculating appropriateness of loan loss reserve levels and earnings, regulators will often look at the budget forecast through the remaining portion of the year. If there are enough projected earnings to support ongoing loan loss reserve increases through year-end, then things are good. If not and the bank is below peers (with ALLL) on a relative basis, expect pressure to be applied aggressively.

Troubled-debt can be trouble. Trouble debt restructurings (TDRs) are inherently complex beasts, given all the moving parts. That said, we were shocked to hear from bankers that they were getting pressure from regulators to place all TDRs in nonaccrual status. We find this amazing when you consider the Obama administration's request that banks work with troubled borrowers instead of foreclosing. If TDRs are all going to be nonaccrual anyway, you may as well consider foreclosing and removing the problem from your balance sheet once and for all. We'll keep asking around on this one, but be very careful and tread lightly with any potential TDRs.

Strategic planning is important. Regulators expect banks to have a 3Y strategic plan that includes specific goals for the dollar volume of total loans, total investment securities and total deposits. In addition, plans are expected to specify the anticipated average maturity and average yield on loans and securities; the average maturity and average cost of deposits; the level of earning assets as a percentage of total assets; and the ratio of net interest income to average earning assets. Be prepared, be thorough and avoid future problems.

Detailed contingency funding plans (CFPs) are mandatory. Given all the stress in the industry, regulators are requiring banks to prepare a CFP. At a minimum, the CFP should includes an analysis of additional liquidity sources; adverse scenario analyses (to assess possible liquidity events that may be encountered); identification of responses as a result of the potential impact of such events; as well as short, intermediate and long-term liquidity analysis.

Tighter board oversight is required. It is clear regulatory agencies feel the industry would not be in all this mess if boards had maintained proper oversight. Regulators want boards to regularly review reports on adversely classified assets, ALLL, capital, liquidity and earnings at a minimum.

Whether you like to eat green, red or blue M&M's, having protection of any kind in this environment is welcome.

BANK NEWS

2 Bank Closures (94 YTD)

On Friday, the FDIC closed two subsidiaries of Irwin Financial ($3.2B, IN). Both Irwin Union B&T ($2.7B, IN) and Irwin Union Bank ($493mm, KY) were bought by First Financial Bank ($3.8B, OH). First Financial will assume all deposits of the two banks (at a premium of 1% for B&T and 0% for Irwin Union), 27 branches & 78% of assets.

Special Assessment

FDIC Chair Sheila Bair said that while it appears that a 4Q special assessment is probable, her agency is looking into different methods including issuing debt to banks, diverting other special program fees and borrowing from the Treasury. Look for more news in the next 2 weeks.

FRB Speak

The FRB indicates it expects the pace of economic recovery to "pick up" in 2010 and that there are now "smaller downside risks" to the projections. Unfortunately, FRB speakers are "unsure when credit conditions will normalize."

Employment

42 states lost jobs in Aug, up from 29 in Jul. The biggest cuts were seen in TX, MI, GA and OH. In all, 14 states plus DC reported unemployment rates of 10% or more. MI reported the highest rate at 15.2%, followed by NV, RI, OR and CA at 13.2%, 12.8%, 12.2% and 12.2%, respectively.

Term Unemployment

The BLS reports people who have been unemployed for 27 weeks or longer reached its highest level since 1948 (as far back as the data goes).

IPOs

There are 8 IPO's this week, the most since late 2007. Three of these will be REITs seeking to buy distressed real estate (mostly from banks).