FOREST FIRES IN BANKING

by Steve Brown

Fighting forest fires is easy, as long as you catch the fire when it is small and before it has a chance to grow into a full blown inferno. Banking is easy too, as long as all you have to do is take a deposit, make a loan, set aside a little bit of reserve for a rainy day and book a profit. Unfortunately, most forest fires are not caught at the lone ember stage and most banks are not immune to the effects of the largest recession since the Great Depression. Customers and the economy are severely strained, so bankers can expect asset quality to remain a hot topic.

To address the biggest risk in banking, credit, banks start with a sound risk management process. Strong credit risk management begins with a comprehensive loan policy, a robust credit grading system, sound underwriting processes and a thorough internal/external review program. While most banks take steps to separate the loan origination function from the loan review function, this deserves more elaboration.

To stay ahead of credit problems, banks should consider having external loan review teams rotate through about every 6 months. While most banks do this about every year to 18 months, market conditions warrant a more frequent cycle. These reviews do not have to be a complete analysis of the portfolio (if they are done more frequently), instead, banks can focus efforts on targeted portfolio subsectors, the 10 largest exposures or areas identified by regulatory updates as critically stressed (construction, land, etc.). Sure, loan reviews cost money, but they can also alert management and the board to possible trouble areas while the fire is still small, so it can be quickly put out.

Banks are notorious for putting together a loan policy when they launch and then modifying it over time without a broader view. While this is not unexpected, it may make some sense to step back and reexamine the entire document every so often. Asking such questions as whether the policy addresses the types of loans the bank still wants to originate, which ones it won't, lending territories, diversification standards, loan documentation requirements and other factors is important. While annual policy reviews by the board of directors are nice and should be part of any standard approach, banks should consider what lessons have been learned during this once-in-a-lifetime crisis and determine if changes may be needed going forward.

Underwriting is another critical component. It is typical for a bank to base credit decisions on management's previous experience with a borrower and collateral value, but more robust financial analysis is required. Validating cash flow and keeping up with training as the bank grows are critical to ensuring underwriting consistency is maintained. Take a moment to consider how well your bank does this and perhaps build modifications into upcoming tactical planning sessions.

Credit grading is important. Banks that are proactive in assigning accurate risk grades stand a much better chance of addressing problems before they become too large to handle. Loan grading is a critical functionality of proper credit management and credit migration should also be incorporated to show movement over time.

As with management, directors also play a role, beginning with protecting the long-term success of the bank. Active oversight, ensuring the bank has an effective risk management program, developing long-range objectives, setting rick appetite, establishing policies and generally ensuring management is performing as expected are all critical.

In a bank, everyone plays a role in fighting credit fires, but catching them early is one key step in making the process easier.

BANK NEWS

Branch M&A

Bank of the West has entered a deal to purchase 2 Wachovia branches in northern CA for an undisclosed sum. Loans will not be included in the deal.

Online vs. Branch

According to an ABA survey, 25% of consumers prefer online banking, ranking this method of conducting bank business as #1 for the first time in history. This is true for all age groups under 55Y; however, 26% of those over 55Ystill opt for visiting local branches 1st. For all customers, 21% prefer visiting branches and 17% ATMs. Mobile banking came in at 1%.

FRB

The Agency will gradually pull back on the Term Auction Facility and Term Securities Lending Facility citing improved financial conditions. Schedules are available through Jan, after which the Fed will decide whether or not to make these facilities permanent.

CU Assessment

The NCUA will levy a 15bp special assessment on all federally insured credit unions to replenish both the deposit insurance fund and the Stabilization Fund.

Home Sales

Existing home sales fell 2.7% in Aug, breaking a 4 month streak of gains.

Housing Slump

The current housing slump has pushed home prices lower for 27 months in a row in some stressed states, compared to 17 months during the recession of 1989 to 1992.

Housing Rebound Nuances

Home sales jumped last month, but it should be noted that FRB data finds the percentage of sales from bank foreclosures in July for hard hit states was 70% in NV, 61% in AZ and 46% in CA.