BETTER PLANNING FOR BAD NEWS RUN-OFF

by Steve Brown

The saga of David Letterman's workplace infidelity is instructive for banks on several counts, especially for those that are working on contingency funding plans (CFP). To be clear, we are not condoning anything that Mr. Letterman did in any way shape or form, so please don't send an angry e-mail. We simply point out that one of the most compelling aspects of this event is that Letterman took very negative news and turned it into a ratings boost - simply by telling the truth.

Compare Letterman's tactics to President Bill Clinton, Sen. John Edwards, Sen. Larry Craig, Gov. Mark Sanford and Gov. Eliot Spitzer. Letterman didn't issue a flat out denial, didn't put up a faÃƒÂ§ade of resentment, didn't feign faux humility and didn't try to misdirect. He confessed to his philandering in a self-humiliating and human way that the public clearly related to. His proactive straight talk should be considered a road map for banks that run into trouble - tell your problems quickly and tell them straight.

If you do, what will it gain you? The quantitative record is out on this point, but we can tell you from interviews and evidence that there are some scenarios that each bank should have within their CFP. As we have written about extensively before, the purpose of the CFP is to lay out a road map to detail funding tactics should sources begin to dry up. The question is - what scenarios should you run and what has been the experience of other banks that have had to disclose bad news (such as negative earnings, weak capital position or regulatory order)?

Stressed scenarios should be specific to each bank depending on the branch network, deposit structure, pricing, brand and management. Here again, price sensitivity works against banks. As we have seen over the past year, banks that have a lower cost of funds and less interest rate sensitivity, are also those that exhibit less run off in times of a negative shock. The more time spent building a bank's brand and loyalty, the more willing the customer is to "stick it out."

To give banks a framework, consider that the average "bad news" release, such as a regulatory action disclosure causes an anecdotal 7% run-off in the 3-months after the disclosure. This number varies from 0% to 40%, but the most common outcome (mode) we have heard is a 3% run-off. This sort of analysis should be standard in any CFP. In fact, most banks have taken their stressed base case to a different level and included an "extreme stressed case." Here, banks we have spoken to seem to be coalescing around the outcome that a negative event brings a 10% run-off immediately and then a 25% run-off in core deposits within the following 3 months.

Selling securities, borrowing from the FHLB, the discount window, seeking public funds or other tactics would all be included to replace the potential run-off in deposits. In addition to funding options, many banks detail what ratios and thresholds will act as triggers and at what point will the board be notified.

Another best practice attribute of quality CFPs is the inclusion of a set of marketing options. While marketing will not replace lost deposits, it may help dampen run off A CFP would include a set of pre-approved tactics and materials that will greatly decrease a troubled bank's reaction time. Banks that have done this have countered bad news in hours as opposed to days. As Letterman highlighted, it is important to get your story out quickly, truthfully and with your spin. This includes a plan to purchase advertising space for a letter to the community, a prepared press release and some counter testimonials.

Letterman has a history of straight talk. He opened up about his heart surgery, speeding tickets, having a child later in life and a variety of other items. If banks construct their liquidity plan to handle the worst and then offer rapid and full disclosure, hopefully their customer base will be as accepting as Letterman's has been.

BANK NEWS

JPMorgan

The Bank reported higher than expected 3Q earnings, but also reported NPAs more than doubled in the quarter, compared to the same period last year. Fixed income securities sales in its investment banking business (accounted for 67% of the investment bank's revenue) more than offset rising loan losses, pushing bank earnings to a $3.59B profit.

Loan Pricing

In a test of the Legacy Loan Program last week, the FDIC garnered at 71 cents on the dollar sale price for Alt A and selected subprime collateral.

Housing Bottom

The Mortgage Bankers Association estimates foreclosures to continue rising through most of 2010, topping off only after unemployment hits 10.2% in the 2Q.

Payments

In 2009, the number of checks, debit cards, credit card and auto payment transactions will top 100B, according to research by Moeb Services. Debit cards will account for 33% of all payment transactions, paper checks at 24% (from over 85% in 1979), credit cards at 23% and ACH payments at 20%.

Consumer Complaints

Discontent with credit card practices came in as the 4th, as the most common complaints received by state attorney offices. Predatory lending and mortgage practices were 6th.