MATERIAL LOSS REVIEW

by Steve Brown

You may not have known it, but even examiners get examined. One of the ways this occurs is through a material loss review ("MLR"). Simply put, when the Deposit Insurance Fund incurs a material loss with respect to an insured depository institution, the inspector general of the appropriate Federal banking agency is required to make a written report that ascertains how it happened. The goal is to highlight key issues that led to the loss and make recommendations for preventing any such loss in the future. For regulatory purposes, a loss is considered material if it exceeds the greater of $25mm or 2% of total assets at the time the FDIC is appointed receiver.

We have read many MLRs in our time as we find them a good way to gain insight into what may lie ahead on examinations. For example, community bankers would be interested to know that some points of focus in the current examination cycle may even stem from the 83 page MLR on IndyMac. While a thrift, certain aspects of the MLR apply to all bankers.

The IndyMac autopsy around this large bank failure immediately highlights some key points: 1) the bank executed a high risk business strategy (originating and securitized subprime single family mortgage loans on a large scale); 2) that strategy resulting in a high concentration of risky assets (offered an extensive array of nontraditional mortgage loan products that came with an increased risk of borrower default); 3) problems were compounded by aggressive growth; 4) the growth was funded by non-core deposits (relied heavily on FHLB advances that represented 34% of total assets and brokered deposits); 5) the bank held inadequate loss reserves (different business units were inconsistently calculating their own ALLL and senior management did not provide detailed guidance) and 6) the bank engaged in unsound underwriting practices (encouraged the use of nontraditional loans and guidelines provided flexibility in determining whether, or how, loan applicants' employment, income, and assets were documented or verified). There are more aspects to this analysis too numerous to mention here and while IndyMac may not completely relate to community banking, it is clear the impact of this event probably was a catalyst to increase scrutiny on funding sources, loan diversification, capitalization and other factors.

Some of the regulatory components of the MLR are equally brutal, as presented in the report. The MLR indicates examiners conducted regular and timely examinations, but did not always address key areas (aggressive growth without sufficient controls, poor loan underwriting and reliance on volatile funding sources); they did not address concerns about non-traditional loans (such as a narrow definition of subprime loans, the impact of negative amortization and the thrift's failure to monitor its option ARM portfolio); they did not require correction of poor underwriting (thrift used mortgage brokers, internal audit required improvement that did not happen, found problems with appraisals) and they did not issue an enforcement action soon enough (financial condition was rapidly deteriorating and management was not moving fast enough to correct the issues).

Based on this analysis, the report highlights the following areas as lessons learned: scrutinize underwriting practices when banks have concentrations; traditional liquidity can be severely curtailed so contingency plans are needed; concentration risk mitigation practices are needed; enforcement action should be documented, timely and communicated to the board; guidance for liquidity monitoring should be expanded; banks should have liquidity contingency plans; and procedures documenting follow-up to examination findings should be enhanced.

As can be seen from this single MLR, no matter whether you are regulator or banker, there is always room for improvement. For the curious among our readers, MLRs on individual banks can be found under the FDIC Office of Inspector General at http://www.fdicoig.gov/mlR.shtml

BANK NEWS

BofA

The Bank names their chief of consumer banking, Brian Moynihan as CEO. Moynihan will take over at the end of the year for the outgoing Ken Lewis.

Public Co Rules

The SEC approved final rules that will go into effect 2/28/10 and cover: compensation policies (stock & option grants); fees to consultants with a potential conflict of interest; risk management board oversight; background and qualifications of directors and nominees; legal actions involving officers and directors; diversity directors and board structure

CU M&A

Two credit unions with great names combine. Self-Help Federal CU ($360mm, NC) has entered a deal to purchase El Futuro CU ($7.5mm, CA) for an undisclosed sum.

Higher Foreclosures

RealtyTrac reports foreclosure filings in Nov climbed 18% over the same period last year, but were down 8% compared to Oct. The good news - Nov. marked the 4th straight month of decline.

Corporate Risk

Analysts say volatility in corporate profits (range between highest and lowest) has reached an all-time high, compared to a period of time going back to the 1930s.