CREDIT STRESS TESTING FREQUENCY

by Steve Brown

Once upon a time, in the land of Fair, lived a king who was about to give away his beautiful daughter's hand in marriage. The problem was that while he wanted her to marry the important, but arrogant knight, she was in love with the good-hearted peasant boy. The King was vexed with this problem and, wanting to seem fair, devised a game where he wrote "Banishment" and "Marriage" on two pieces of paper and was going to let the knight and peasant boy pick in order to leave love to fate. When the morning came to choose the slip of paper, the knight slyly slipped a similar slip with "Banishment" in the royal sack and removed "Marriage," so that both slips would say "Banishment." The knight, who had first pick because of his status, deferred to the peasant boy to pick first. Thinking this was odd that the Type A personality knight would let him go first, he thought - and then figured it out what the knight was up to. The brilliant peasant boy went first and before revealing his slip, he made a big show saying that he will now reveal the knight's slip of paper in the sack for all to see. He did, the knight was banished and the peasant boy and his princess lived happily ever after. The moral to the story is - to protect your downside, you need to be smart about it.

In the same vein, banks faced with a seemingly no win solution of deteriorating credit quality need to consider their choices wisely. Today, we want to raise an interesting phenomenon on the heels of the European stress test results (due out at 12pm ET after European market close). We find it odd that in this environment of personal liability, why community bank managers and boards run their stress test once per year, but their interest rate risk shocks quarterly. While a rise in interest rates can cause pain and present sizable risk, it rarely kills. Credit risk, on the other hand, can result in instant banishment (or worse), all within months. In fact, from when the Treasury first announced their version of the stress test in early 09, to the time they put forward the details, the economy had moved from the "bad base case" to the "adverse case" in less than 3 months. Credit risk dwarfs all other risks at the bank and thus a stress test should be run at least as frequently as interest rate shocks and liquidity stress testing. This should be quarterly at a minimum and maybe monthly in a rapidly declining geography or a drastically changing balance sheet.

Running a credit stress test more frequently not only monitors the largest risk at the bank in a more timely fashion, but also serves to limit directors' and managers' potential civil liability should anything happen to the bank. For banks that run their stress test every year, trends in capital adequacy cannot be deciphered until it is often too late. Running the stress test quarterly not only uncovers changes, but can be acted upon in a timely manner. If something does go wrong with credit, managers can be comforted to know that they employed the best practice when it came to credit risk monitoring.

A sign of a prudent executive is that he relies on prudent experts that have experience in determining a bank's capital adequacy given the composition of a loan portfolio. Concentrations, non-performing loans and low capital levels continue to be the most dominate risk in our industry. Running a stress test at least quarterly and seeing how a variety of factors could potentially impact capital is just what the smart peasant boy would do to become a future King.

BANK NEWS

Pay Czar

An updated report is due out today that will cite 17 financial firms (we believe the names will not be disclosed) for making more than $1B in "ill-advised" compensation payments during the peak of the crisis in '08.

Ratings Problem

The stoppage of rating issuance by the credit agencies arrived at a temporary solution when the SEC ruled that bond sales can occur without a stated rating for the next 6 months. Over the past week, asset backed securities new issues have stalled because of a lack of ratings.

Small Biz Bill

The Senate ended debate and agreed to restore the $10B bank capital fund portion (of the $30B total package) of the old bill back to the total legislation that will now move to the House. The complex legal maneuvering was required to garner the needed votes. Also of note in this bill is an increase in the minimum SBA 7(a) guarantee from $2mm to $5mm. and 7(a) Express Loans from $300k to $1mm. In addition, 504 loan guarantees would go from $1.5mm to $5.5mm. These increases would increase the profitability for SBA banks.

Basel

In a departure from past practices, the international banking supervision committee is analyzing a proposal that would support banks in building extra capital buffers in good times in order to offset downturns. The proposal will be brought public at the next G20 summit in Nov.

Deposit Signage

The FDIC updated its official sign for deposit insurance now that coverage is permanently at $250k. Banks need to order the sign immediately from the FDIC (it's free) at https://vcart.velocitypayment.com/fdic/.