CONNECTING THE DOTS

by Steve Brown

Sometimes you forget the simple things in life. For instance, when we were much younger, we used to enjoy finding the hidden picture in the connect-the-dots puzzle. By drawing a line and going from numbered dot to numbered dot, the outline of an object would be revealed, as a sense of accomplishment and wonder washed over us. The same holds true in

banking today, particularly when it comes to managing risk and more specifically, loan stress testing. Since we help legions of banks in this area, we think we have a decent view into what is going on as well in this area. That is why we wanted to connect some dots for your reading pleasure, to get you thinking about different aspects of such analysis.

The beginning dot in the process is to start by trying to answer the question of what stress testing is and what you are actually testing. Many community banks take a stab at this by focusing in on the underlying collateral, by using various techniques, analysis or models that focus on loan to value (LTV). The problem with using this approach is that it misgauges risk not only because there is a large chunk of the overall loan portfolio that is ignored (basically anything non-CRE related), but also it ignores cashflow, the primary driver of credit risk.

Collateral-focused analysis also misses the default potential that arises out of the interest rate risk of the borrower. Put another way, by measuring cashflow, you can layer in the risk of the loan borrower's payment increasing as interest rates increase. In so doing, you quickly are reminded that a prime flat loan in an environment where rates rise 300bp (interest only for simplicity) will see its DCR double. So, if the DCR is 1.50% and rates rise by that amount, the debt service goes below 1 to 1 and losses in the loan portfolio increase. Given how low rates have been for so long, this is a key reason regulators are focusing in on interest rate risk as well.

Yet another dot to connect is the fact that the only way to get a true picture of risk is to integrate interest rate and credit risk analysis. A good stress test model will also take into account the historical lag of rising rents, increasing expenses and greater occupancy in a higher rate environment. Understanding this interrelationship between the general economy, rates and debt service coverage is central to a robust stress test.

Another thing we see quite often is that even when banks try to be conscientious and diligent in following the rules by stress testing, they rarely take it to the next level. What we mean by this is that stress testing is merely one step in a series that should also include quantifying loss potential on capital and capital adequacy (which is what regulatory agencies want bankers to do, in order to set up better contingency plans). While many banks use varied methods to stress test the loan portfolio, many are not yet translating the impact to capital or capital planning.

Finally, there is the regulatory focus in all of this. It should be noted that regulatory guidance (related to loan workouts for example) indicates the three primary drivers of credit are cashflow, collateral and guarantor support. Of those, guarantor support and collateral are secondary sources and not the primary source. Any analysis or modeling that is collateral based will understate the risk associated with cashflows on the performance of the entire portfolio. For example, higher levels of non-accrual loans reduces interest income and misses the impact of the combination those events may have on capital, that can in turn add pressure to liquidity.

Stress testing a loan portfolio and understanding its impact is a complex subject, so don't lose heart if you miss connecting a dot or two. For banks seeking help, we have a seasoned team backed by a model that has helped many, many banks over the years. In the alternative, for those bankers intent on stress testing the loan portfolio themselves, connecting the dots between rate risk, loan defaults, capital and earnings is a step to include.

BANK NEWS

Negative Rates

In today's WSJ, former Fed Vice Chair Blinder opined that the Fed is running out of "ammo" and that a negative reserve rate for banks and looser examination standards remain viable options to stimulate the economy.

Weaker Growth

JPMorgan has cut their Q3 GDP forecast to 1.5%. Goldman Sachs is now forecasting 3Q economic growth of 2.3%, while Wells Fargo sits at 2.4% and BNP & UCLA both stand at 2.5%.

Proxy Access

As allowed by Frank-Dodd, the SEC approved a final rule that lets any shareholder or group that holds at least 3% of the stock (for at least 3Ys) of a public company, with over $75mm in float, to place a board nominee on an annual ballot. The irony here is that while the Frank-Dodd law was intended to reduce risk, this provision, we predict, will increase management's focus on short-term earnings in order to prevent giving activist shareholders an easy path to get on the board.

Muni Underwriting

A new rule that is being proposed by the MSRB and SEC would band banks from acting as both a financial advisor and underwriter to municipalities. At present, banks can do both roles as long as they resign from underwriting just prior to placing the bonds in the market (but after they have earned partial fees).