CLEAR THE DECKS AND PREPARE FOR BATTLE

by Steve Brown

Back in the day, sailors would hear their captain shout "clear the decks," as a way to alert everyone on the ship to stow gear and prepare for battle. Given that so much action long ago used to happen on the deck of the ship (loading cannons, shooting guns, etc.) that made sense. Today, for banking in particular, we think this term should be dusted off and used in a similar fashion. Perhaps the CEO should get on the roof of the bank and shout "clear the decks" to alert management teams to take the time in these last 10 working days of the year to maintain a laser focus as you try to finish off key items that could be impactful on generating profitability next year, but that have been languishing on your desk. We know that sitting in your office and preparing for battle in 2011 takes extra effort this time of year. After all, you would probably rather be sipping eggnog (yuck) or chatting about holiday plans with coworkers. However, if you can do it, taking these last 10 days to stay focused as you clear the decks, can be a great way to get you prepared for what is to come next year.

One area you may want to focus energies on is contingency planning around credit quality. One quick way to begin is as easy as having a better understanding of your classified asset ratio. Open up a spreadsheet and in the first cell add together the total of your substandard loans and any OREO. That is the numerator to our calculation. Then, in the next cell, add together your Tier 1 capital and ALLL to get the denominator. Then, in the third cell, simply divide the numerator by the denominator and you have the classified asset percentage. This is a critical number from a regulator's standpoint and while many other factors come into play when assigning the C in the CAMELS ratings, banking folklore indicates ranges of roughly 0% to 25% to be a "1"; 26% to 40% is roughly a "2"; 41% to 80% is roughly a "3"; 81% to 100% is a "4" and above that is a "5". While knowing rough levels where regulatory pain increases is important, it is also critical to understand the dollars this represents. To do that, simply play with the numerator in the calculation above to see exactly how much in dollars terms would need to go to substandard to push your ratio into the danger zone. Then, take a look at the largest loan on the books and see exactly how many loans would have to be downgraded to push your bank into the next worst rating category. While that could absolutely happen, it is more important once the number is known that you have a plan in place to deal with this. After all, it takes roughly a year to work through issues on the largest loans in the portfolio (of course this varies as well), so having a contingency plan thought out well in advance is important. Then, when certain triggers are hit, the bank can take such action as raising capital, increasing the loan loss reserve, shrinking the loan portfolio in relation to the capital outstanding, etc. There are many actions that can be taken to improve this ratio, but each one has its issues, so breaking out the compass now to make sure you are heading in the right direction will ensure you don't get lost at sea in 2011.

Another area to zero in on is around interest rate risk. Given the tax cut extension deal, QE2 and decent retail spending over the holidays, having a good handle on what happens to your bank when rates rise 200, 300 and 400bp are critically important. While few expect a major jump in short-term rates in 2011, it is not out of the question. Once the Fed's liquidity programs are stopped and reversed, no one is too sure what will happen (since we have never been here before). Our advice here is to dump the Call Report driven ALM model quickly and get something more robust. Then, model different scenarios; discuss the impact with management and make sure everyone understands the risks already resident in the balance sheet. Rates will eventually rise, it may negatively impact credit quality this time around and it will squeeze bank margins more than many expect (it is already starting to as of this week). Getting a better understanding of the dynamics now in both credit and interest rate risk will give your bank maneuvering room when the cannons begin to fire.

BANK NEWS

Loan OT

A number of banks and trade associations are challenging the recent Henry v. Quicken Loans case which concluded that loan officer's duties, in themselves; do not qualify them as "administrative" employees. As a result, non-managing loan officers may be eligible for overtime pay.

DIF Ratio

As expected, the FDIC this week adopted the final rule that sets the DIF's long-term designated reserve ratio at 2% of estimated insured deposits. Prior to Dodd-Frank the minimum ratio was 1.15%. We have argued that higher capital standards and better risk management should make 2% too much, but it is better than the 2.5% the FDIC did consider.

BofA

Their CEO said they would entertain talks with large mortgage investors to possibly settle claims. This is a huge shift for the bank that contended that it didn't have any liability.

Worst Overall

The BLS indicates the 10 worst metropolitan areas in the country for unemployment right now are El Centro, CA (29.3%); Yuma, AZ 26.7%); Yuba City, CA (17.8%); Stockton, CA (16.3%); Merced, CA (16.3%); Modesto, CA (16.2%); Visalia-Porterville, CA (15.9%); Fresno, CA (15.7%); Palm Coast, FL (15.5%) and Hanford-Corcoran, CA (15.0%).