INTERESTING INFORMATION AND LOAN GRADING

by Steve Brown

We enjoy finding interesting information to share with you. On that front, we were recently reminded that studies find the average company saves over $7,000 for each employee suggestion it enacts. It is good to know the goofy suggestion box with the old pirate lock on it really does add value. The building in the picture is also quite interesting and it caught our eye, so we threw that in for good measure as well. Speaking of interesting things, consider the human dynamics that invariably find their way into the loan grading process of bankers. Many bankers seem to like to use a 10 level loan grading system that essentially breaks down as: exceptional (1); excellent (2); strong (3); good (4); satisfactory (5); adequate (6); watch (7); weak (8); substandard (9); and doubtful (10) - with loss completely written off. While variations exist (typically with a lesser number of "pass" buckets), people seem to like the number 10 (maybe because we grew up counting our fingers and toes), so that is the prevalent one.

The problem with this approach is that "pass" or "good" credits often get lumped into just one or two "super grades." Not as obvious perhaps, this is typically done because single grade scales comingle two separate key concepts - probability of default (PD) and loss given default (LGD). When these concepts are separated into their respective components, additional gradation can more logically occur (such as along discrete bands of cash coverage ratios for PD's or along discrete bands of LTV for collateralized credits). We have talked about this before, but another easy thing you can do to get more granular is to add a "+" or a "-" to each grade, similar to the way credit rating agencies handle things. A "+" means the credit is at the top-end of a given grade number; while a "-" indicates it is at the bottom. Using neither qualifier means the loan is right in the middle of that grade and of average quality for that grading level. We suggest this as an option for those banks seeking to increase granularity; because doing so is relatively easy and it is already well understood by directors, officers and regulators. Leveraging older research that is still the most comprehensive we have found out there, the data shows the average community bank uses 3 to 5 "pass" grades, while larger banks use 20 or more grades. For comparison; Nationally Recognized Statistical Rating Organizations (NRSRO's) such as Moody's or S&P, typically use 26 individual grading buckets from "AAA" to "D." All of the hubbub over banks striving for more granularity in risk grades comes from a desire to more effectively and efficiently price risk. Additionally, further gradation, coupled with migration, can assist with loan loss reserve calculations. When further coupled with regression analysis against changing economic metrics, granularity also allows banks to configure stress models. Over time, by monitoring how well loans perform against discreet ranges in key metrics (such as cash coverage ratios), added granularity and logic can be built into internal grade scales. Then, with a bit more analysis, banks can ultimately refine the process to also incorporate ratings for both the borrower and the facility. This is not just a "Holy Grail" objective; it is the preferred method of measuring and managing credit from both a capital markets and regulatory perspective, so bankers should take note. You certainly don't have to do all of this right now, but it is an important concept to digest as you work toward better managing loan portfolio risk over the longer-term. The key immediate objective community banks must address today is the need to keep updated information on credit metrics, such as cash coverage ratios and LTVs in order to have a basis to build such methodologies. Furthermore, regulators increasingly want banks to use their own default experience to establish and value risk estimates wherever possible. Only you know whether or not your grading system is detailed and objective enough to give you quality information you can use and leverage. Over time, we expect more pressure to come from investors, capital markets and regulators to move the banking industry toward this approach. In the meantime, we leave you with the interesting fact that more steel in the US is used to make bottle caps than to manufacture automobile bodies.

BANK NEWS

Rejected Dividend

Underscoring the importance of credit stress test performance, It appears that Capital One also had its dividend plan rejected by the Fed along with BofA.

Fed

In a talk to the ICBA convention, Chair Bernanke said the Fed has 50 employees devoted to analyzing the impact of interchange restructuring and overseeing the transition of the OTS to the OCC. In addition, Big Ben also reassured bankers that they are vigilant in trying to do the right thing under Dodd- Frank and the implementation of the new Basel III capital rules.

Housing Sector

A CoreLogic study of short sales finds the number tripled from 2008 to 2010 and that approximately 1.9% of short sales warrant further investigation for fraud.