BETTER MANAGING LOAN RISK

by Steve Brown

When party conversation drifts around to loans or lending, community bankers become fully engaged. After all, lending is the lifeblood of the industry and there is plenty to talk about when it comes to this subject. That is one reason we were intrigued by some recent research from the regulators on small business lending. Since banks are the largest source of small business credit, we start there with our discussion this morning. Banks Are Primary Sources: The data shows primary sources of funding for small business credit come through bank loans (43%); credit cards (39%); vendor credit (20%); private loans from a friend or family (19%); or the SBA (4%). About 20% of small businesses don't take any financing (multiple answers were permitted, so the total adds up to more than 100%). Risk Management: Banks are always seeking ways to better manage the risk in the loan portfolio. That is one reason why research on industry and location has increased and community bankers know more now about their markets than ever before. To take things one step further and move along toward best practices, consider incorporating a dual risk rating system. To do this, on a loan level basis you need to assign a probability of default rating and a loss given default rating. Then you can simply take the loan amount times probability of default times loss given default and you get the expected loss on any given loan. That expected loss can then be compared against reserves to determine adequacy and to allow for better continuity planning. Predicting Default: Banks are doing a better job of figuring out the probability of default on a given loan as well. This is simply your estimate of the probability that the borrower will default on the loan and many factors can come into play. One of the best is to use delinquency as a driver. Here, loans that are delinquent more frequently can indicate a borrower is having trouble making payments and may be overextended. You can use a variety of approaches to estimate the probability that a given borrower will default, but one available right at your fingertips comes from your credit department. In-depth credit analysis of each borrower can be augmented by risk grade, delinquency history, industry and other factors. You don't have to get too fancy, to start, but by then tracking empirical evidence on actual defaults over a long period of time you can refine the process even further. The debt coverage of the loan at the outset and how it migrates is a great way to tighten up these probabilities, as is incorporating the time to maturity. Other factors that can be incorporated can include the borrower's credit score for example. No matter how you start down this path, the examiners are going here and expectations are shifting toward more transparency and quantitative analysis. Policies and Regulation: Things have shifted here as well, as the bar has risen since the credit crisis. Regulators expect banks now to have strong policies and sufficient board reporting to keep things on track and protect the bank against credit exposures. Boards and management teams are expected not only to respond to audits, loan reviews and examinations, but put forth a plan to track and resolve outstanding items that surface.Borrowers are under pressure to perform, properties are falling in value in many areas of the country and cash flow can become spotty quickly, so stay on top of reporting and audit frequently.

Loans represent about 75% to 80% of the average community bank's assets, so staying on top of things and managing risk tightly is one of the most important things you can do.

BANK NEWS

Stress Test

The Fed is looking to continue its annual stress tests on mega banks and wants to retain veto power over any capital distribution plans. While conjecture on our part, it appears this could result in lower dividends and share repurchases going forward and a state where large banks are subject to constant credit stress tests every year.

New Metric

There has been a fair amount of attention paid to "Architects' Billings," as a very leading indicator of real estate health. While we can't attest to this new data point as a predictive indicator, we can tell you that it dropped strongly in April from 50.5 to 47.6, an indication of CRE softening as fewer designs are being ordered.

Muni Risk

While many of her predictions have not materialized yet, hot shot-bank-analyst-turned-muni-analyst Meredith Whitney points out that the rising cost of local gov't pensions could cause money to be redirected from public services and ultimately hurt the economy.

Value Traps

Mad Money and annoying (and often wrong) CNBC host Jim Cramer did a segment yesterday on how he believes banks are "value traps" in that they look like they will outperform, but in reality, bank stocks will continue to decline in market price. His money quote: "As long as unemployment and housing are both lousy, as long as regulator after regulator keep going after them, these are not stocks you want to own."

Economic Growth

A Bloomberg survey of economists finds that while 1Q GDP was only 1.8%, the group expects the economy will grow at a 3.3% rate in 2Q & reach 2.7% for 2011.