RESEARCHERS WITH WHITE COATS & BANKING

by Steve Brown

Research shows people need to hear new information between 4 to 10 times before they understand it. Research also finds that people can only handle so much variety before our decision making skills begin to fall apart. We like choices, but too many options - more than 15 and out brain circuits begin to misfire. Cleary the data shows that despite being able to walk upright, we still can be dense at times and can't do too much at once either. Since the banking industry is changing so fast and we need to learn even faster, let's take a quick look at how rating agencies are viewing banks these days. Things used to be simple when banks could just get a credit rating, but these days it is more about economic and industry risk, as well as bank specific factors such as capital levels, risk position and the management team. To get to the root of the matter and still stay below 15 things to process, we will focus on just a few of the major factors that such analysts are using to determine bank strength. There is now a greater emphasis on the value of economic and industry risk. Given the crisis, analysts now look more broadly at national and local economic conditions. Those conditions are then rated (say on a scale of 1 for very low to 10 for very high), based on the stability and structure of the economy, potential imbalances and credit risk of consumers and businesses. When it comes to the industry, analysts focus efforts on how banks are doing that focus most of their efforts on deposit taking and lending. That view is then adjusted further based on how well regulatory agencies do in managing financial turmoil, the competitive landscape, financial products and the role of nonbanks. Banks that operate with higher leverage ratios (i.e. higher loan to deposit ratios, lower capital ratios, etc.) are penalized when leverage gets out of whack with peer groups. The next level of analysis comes in the form of the business position of the bank. Here, analysts monitor loan to deposit ratios, reliance on wholesale funding and the overall funding mix. In addition, revenue stability, market share and the customer base is analyzed. Finally, contributions of different business lines and geographies are analyzed to determine strength of the overall revenue stream. Banks are then compared to peers and slotted by business activities that are less risky, more risky or average in comparison. When the bank is reviewed for funding, analysts are looking for more detail on sources and concentrations. They seek out and review the loan to deposit ratio, long term funding percentage, amount of stable core deposits, amount of insured deposits and other funding alternatives in particular. Here again, these levels are compared to peers to determine whether the bank is being more or less aggressive in its funding and whether it is more or less dependent on wholesale sources for example. Business concentration is also an area of focus. Analysts review the bank and asses its concentrations, geographic area, customer focus, product set and other factors against peers. Banks with below average diversification are seen to have a weaker model than one with a diversified funding / lending mix. The final piece analyzed is capital and earnings. Analysts compare the bank's capital ratios to industry averages; look at the mix of capital and measure earnings strength (to determine how quickly capital can be rebuilt). Earnings ratios that are higher, such as NII to total revenue; fees to total revenue; and net operating income before loan loss provisions to assets tend to increase the stability of the bank and are viewed positively.

Research can come from many different sources and it can be overwhelming, so we suggest focusing on the first 5 to 7 you come across, as that is probably enough for anyone to handle.

BANK NEWS

FOMC Minutes

The Fed released last month's minutes and there was little new insight other than further declaration that the Fed will end QE2 on time and implied that QE3 is not likely unless there was a "significant change in the economic outlook." The release was only significant for what it did not say - no mention of an exit strategy for monetary easing.

New Mortgage Disclosures

Per Dodd-Frank, the CFPB proposed 2 alternatives for a single mortgage disclosure form that combines both the Truth in Lending and RESPA notifications. The CFBP will now conduct surveys and evaluations of hopes of producing a single, usable form before the July 2012 deadline.

Durbin Support

The National Retail Federation started its 2- month focused lobbying and marketing effort to support the proposed debit card interchange rules.

US Debt

The debt ceiling is not causing markets to roil as some might think. Already a factor, it has barely moved Treasury yields.

Euro Debt

Credit spreads all widened out yesterday on concern over another bailout. Greece moved the most at 25bp.

Unemployment

A WSJ survey of economists finds the unemployment rate will slowly recover, falling from 9% in Apr to 8.4% by the end of 2011 and 7.7% by the end of 2012.