OF SPECIAL MENTION

by Steve Brown

Depending on the contents inside, sometimes when you knock over a bucket it can create quite a spill. Consider the comments we have been hearing from community bankers around the country, related to loans classified as "Special Mention." Bankers say examiners seem to have a renewed interest in loans sitting in that bucket and in some cases are pouring the contents into a "Substandard ("SS")" bucket, as a result of more aggressive downgrades. As usual, that got us thinking.

About 18Ys ago, the regulatory agencies cleaned up their definition of Special Mention ("SM") through an interagency statement. That statement said loans classified as such are those that have potential weaknesses deserving management's close attention and that if left uncorrected, could result in deterioration of the repayment prospects for the asset (or in the institution's credit position) at some future date. The statement then went further to indicate SM assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Loans can be classified SM, but the category should not be used to identify an asset which has as its sole weakness credit data exceptions or collateral documentation exceptions that are not material to the repayment of the asset.

That is interesting, but to fully understand the scope of such assets you have to dig in even deeper. To do that, we focus on SS loans, which are defined as assets that are inadequately protected by repayment capacity, equity and/or collateral pledged. These assets have a well-defined weakness or weaknesses that could hinder normal collection of the debt and are characterized by the distinct possibility that the lender will sustain some loss if the deficiencies are not corrected.

In summary, from a regulatory viewpoint, adversely rated (criticized) credits are the total of loans classified special mention, substandard, doubtful and loss. Classified credits are those rated substandard, doubtful and loss. Classified loans have well-defined weaknesses, while special mention loans exhibit potential weaknesses that could result in further deterioration if left uncorrected. Exam teams expect banks to carefully monitor the condition of their borrowers, to ensure that they promptly identify and address any emerging weaknesses and adjust loan loss allowance levels and report classifications appropriately.

Now that the definitions are clear, we jump back to the regulatory handbook used by examiners themselves. It indicates that when it comes to SM assets, low credit risk banks have a low percentage of loans categorized this way and ratings changes within criticized and classified are evenly distributed between upgrades and downgrades. High risk banks by comparison are identified as those where SM loans represent a high percentage of loans and capital and the majority of criticized and classified changes are downgrades. When assessing the quality of credit risk management, examiners are also instructed that higher SM levels indicate management may not be properly administering the loan portfolio. The SM category is specifically not to be used as a compromise between pass and substandard.

When it comes to troubled debt restructurings ("TDRs") and the SM category, it is more about the borrower's ability to repay in accordance with modified terms. According to exam manuals, SM could be used when potential weaknesses remain for a formally restructured credit if there is risk to orderly repayment under modified terms.

Given the stress on the industry, consider SM to be a bucket that should be quickly emptied. You are much better off to move these loans yourself before examiners appear at the door. Either take the pain by downgrading them to SS or move them to Pass if possible. Cleaning up a spilled bucket is never fun, but if you knock it over yourself, at least you will already have towels ready.

BANK NEWS

M&A

First Financial Bancorp ($6.3B, OH) will acquire 16 branches and $143mm in loans from Liberty Savings Bank ($979mm, OH) for about $22.2mm (a 6.41% net premium on branch deposits).

Warning

Moody's said it may put the US debt rating on review for a downgrade if efforts aren't made to reduce the deficit and raise the debt ceiling.

Stock Sales

Reuters reports how the "Smart 30," a group of some of the market's largest hedge funds, are liquidating their holdings of US banks, as the sector suffered the largest decrease of composition in hedge fundÃ¢Â€Â™s portfolios.

Dependent

A study by American Express finds 57% of people in their twenties are still financially dependent on their parents.

Customer Program

ou might want to consider offering a program for your customers to help them create a will, given a survey by Lawyers.com finds 67% of people do not have one.

Disability

A study by industry association LIMRA finds in 2009 only 48% of companies paid for long term disability insurance for their employees, down from 59% in 2002.