THE BLOWING SANDS OF EARNINGS IN CAMELS

by Steve Brown

Now that most of the credit crisis has passed, we know bankers are again focusing more intently on generating earnings. Despite the fact that Dodd Frank just celebrated its 1Y anniversary, regulation remains in flux. That is why we know any camel worth its weight in water will be seeking to separate mirages from reality, despite the continued blowing sands around banking. The good news is that camels have 2 sets of eyelashes to help protect against the sand, so bankers in short supply can perhaps pluck a few if needed to keep going. Earnings are also much more interesting to shareholders, bankers and directors as they are critically important to fund dividends, remain competitive, maintain capital levels, grow and engage in new activities.

When assessing earnings under CAMELS, regulators look at several factors that include: level, trend and stability. They ask why earnings are fluctuating, what is the cause of the fluctuation, what is the impact on future earnings; the quality/sources of earnings and whether sources can be relied upon or are nonrecurring. They also focus on capital augmentation and seek to see whether earnings are boosting capital or coming from risky ventures, exposure to market risk or fluctuating significantly due to changing interest rates. Finally regulators want to know whether earnings are enough to support ALLL and how much earnings are impacted by the allowance for loan losses.

Some key data points we have found examiners will take into account when looking at earnings include: net income, net interest income, earnings before provisions and extraordinary items (core earnings), noninterest income, overhead expenses and ALLL. In this environment, even banks with strong historical earnings performance have been impacted by deterioration in the loan portfolio, rising overhead expenses, greater provisioning and other factors. Earnings are in short supply for most banks in the country, so examiners are taking a closer look at the root causes and how well the bank has done its contingency planning.

Regulators assign a CAMELS rating to earnings based not only on the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. Inadequate risk management, high levels of market risk, loan losses, low levels of ALLL, and other factors all come into play during this evaluation process. Bankers should also understand that examiners will heavily discount extraordinary gains, nonrecurring events and favorable tax effects for the same reasons.

When assessing earnings, regulators will evaluate factors that include: level of earnings; trends and stability; ability to provide for adequate capital through retained earnings; quality/sources of earnings; level of expenses in relation to operations; adequacy of budgeting systems and forecasting processes; robustness of management information systems in general; adequacy of ALLL and exposure to market risks.

A CAMELS rating of "2" indicates the bank has earnings that are satisfactory and sufficient to support operations, while maintaining adequate capital and allowance levels (after consideration is given to asset quality, growth and other factors). A rating of "3" reflects a bank that needs to improve earnings, as they may not fully support operations or provide for the accretion of capital and ALLL (in relation to the institution's overall condition, growth and other factors affecting the quality, quantity, and trend of earnings).

As with banking, camels lost in a sandstorm will just sit down and wait for it to pass. A robust plan that protects earnings will get your bank moving again as soon as the dust settles and help you pass examinations with flying colors. Earnings are still tough to find these days, but this sandstorm is almost over so keep moving forward.

BANK NEWS

Closure (58)

Bank of Choice (1.1B, CO) was shuttered with branches, deposits and most assets assumed by Bank Midwest ($2.9B, MO) without a premium. Southshore Community Bank ($46mm, FL) and LandMark Bank of Florida ($275mm,FL) were shut and acquired by American Momentum Bank ($664mm, FL) without deposit premium.

Citi Cards

Citibank launched its "Simplicity Card" that has no fees, no penalties for late payment and 1 interest rate for purchases and cash advances. Of course, the card doesn't come with rewards and the rate is a simple, but high 17%.

Proxy Access

A Federal Appeals court overturned a SEC rule that allows shareholders to use a proxy ballot to place a nominee to the board with as little as 3% share control (as long as the same shareholders have held it for a minimum of 3Ys). The courts ruled that the SEC did not meet a procedural requirement that mandates a cost-benefit analysis and that the lower court failed to take into account the rule's impact on competition and capital.

More Stress

A survey by the NFIB finds 40% of small business owners say receivables are coming in at a slower pace and manufacturers with less than $10mm in annual revenue received payments 48 days late in 2011 (a 6 day increase over 2010 and a 10 day increase in the past 5Ys).