TESTING TO BE MORE PREPARED

by Steve Brown

As we were driving into work this morning, CNBC broke a story that the Fed has asked all of the major banks to provide information on how they would raise additional capital if they were confronted with a similar environment as 2008. While it isn't earth shattering that regulators might ask banks to stress test their contingency plans, it is interesting that as the story went, the Fed may have offered the scenario it wanted to see. After all, who is in a better position to know what scenario might come true than the Fed with all of their resources? To be fair, we did some quick checking around the wires this morning and so far haven't seen anything else on this, so we aren't exactly sure what the Fed may or may not have asked for. Nonetheless, the topic is an interesting one to think about as you begin your day and consider contingency planning at your own community bank.

Contingency planning is really all about thinking and testing the potential impact on your bank, if a given scenario were to play out. When done correctly, contingency planning gives your bank a blueprint of sorts that offers up a response plan in the event the bank has to deal with major crises. Such planning can include a detailed analysis or can be more of the quick and dirty table top variety (sit around a table and walk through what you would do if so-and-so were to occur, as you think about the impact along the way and develop a plan). The key is to be more prepared when the crisis surfaces, since they tend to arrive rapidly and can last for an extended period of time.

For instance, think about the impact of a potential recession on your loan (and deposit) portfolio. Before we drill down, we start at a high level and assume a recession would freeze consumer and business spending, push GDP into a contraction, push oil prices lower and increase unemployment from an already high 9.1%. While this is a scenario no one really wants to see, running it and being prepared to take action to survive, is prudent - particularly when you consider the odds of such a scenario have increased in recent months, so we will proceed. The good news for banks is that they already have lots of liquidity, so that isn't likely to be an issue. Loans on the other hand could see increased payoffs (as businesses hoard even more cash and pay down debt) or higher defaults (some borrowers that have been hanging on for the past 2Ys will simply run out of time). Earnings will be very difficult to find, so layoffs are likely to increase in the industry and unprofitable locations, products, etc. will be exited as fees are increased wherever and whenever possible.

Next, layer in the impact of a recession event when the 2Y Treasury yield is already sitting at only 0.20%, the 10Y is at 2.00%, 3M Libor is 0.33% and Prime is at 3.25. Mortgage rates are already at historic lows as well, but large banks that control this sector seem to have pretty tight standards and borrowers who could have refinanced may have already done so, so lower long-term yields may not do much. Yields have never been here in history, so no one really knows, but further downward drift on longer term yields at least in theory should lead to increased refinancing of home and business loans (assuming the borrower can qualify). Given already low levels, however, look for banks to try and hold the line on loan rates with floors, but for cracks to appear as competition becomes extreme and the best credits refinance away. This could drive more M&A activity (as director exhaustion sets in), but the problem here is trying to figure out what will someone pay for a loan portfolio that is barely yielding anything and that could contain ticking bombs. Borrower demand for longer term fixed rate loans will reach a crescendo and the competitive environment will intensify even more than it is today.

As can be seen, contingency planning can provide valuable insight, as it gets the management team thinking about what they would do if a given scenario were to occur. Whether you are thinking about the impact on your bank of a European default, layoffs in your market by a large national bank, no organic loan growth for 2Ys, or a host of other scenarios; the key to understanding is to take it out for a test drive and do some careful thinking. Only then will you know whether scenario #1 will require you to raise more capital, close branches, buy loans, reduce expenses, raise fees, or a combination of any and all.

BANK NEWS

Guilty

Gary Foster, a former VP at Citigroup, entered a guilty plea after being caught embezzling $22mm over the past 10Ys. Foster transferred money from various Citigroup corporate accounts and then wired the money to his personal account at another bank. He concealed his thefts by, among other methods, making false accounting entries to create the appearance that the bank's cash account was in balance.

No Fees

A survey by Ipsos Public Affairs finds 71% of bank customers say they do not pay any monthly fees, 11% pay $3 or less, 6% pay $4 to $6 in monthly fees and 4% pay $7 to $9.

Not Good

Modeling by Bank of America Merrill Lynch indicates the probability of a double-dip recession is above 80%, driven by the impact of the US debt downgrade, problems in Europe and ongoing market volatility. Meanwhile, Bill Gross of PIMCO fame said in a speech that the global economic crisis is leading to a possible "developed economy" recession in the US and Europe.