TAKING A BITE OUT OF C&I FRAUD

by Steve Brown

While many banks feel more comfortable with real estate lending, it is really C&I that has less risk on average. Total non-accruing CRE loans (excluding construction) are running about 3.6% of total loans, versus 1.5% for C&I. Thirty day plus delinquencies and probabilities of default are also about double for CRE compared to C&I. Unlike an office building, a going concern business can adapt and change in a downturn making it more flexible. However, when working with C&I borrowers, note that the presence of fraud is greater. Unfortunately, in a downturn, the probability of fraud increases. According to a 2011 study by Kroll, fraud is up 20% year over year. In addition to various forms of embezzlement and outright theft, information theft, fraud in the business model (conducting businesses that customers are not authorized or licensed for) and business process fraud (cutting corners to save money such as the illegal dumping of toxic waste) are on the sharp rise.

Luckily, bank best practices when it comes to fraud mitigation for C&I lending can dramatically reduce the probability of fraud. Over the last 5Ys, we have interviewed hundreds of banks with below average C&I defaults and have boiled down some key process improvements that your bank may want to consider if you don't have them already. While these tips won't eliminate fraud, anecdotally, they seem to reduce both the incidences and the dollar loss by 30% to 50%. At a high level, the ability to limit fraud is a direct result of how much respect the borrower's management and board has towards prevention. Here are some of the most important attributes for borrowers to have in order of impact on fraud mitigation:

1) Does the company have a risk and/or compliance officer? Usually, if the borrower takes compliance this seriously, then the borrower is on the right track. This one marker seems to make a huge difference in the frequency of fraud. 2) Are background checks conducted on all new hires? 3) Does the company have a whistle-blower protection policy? 4) Do they have an anonymous fraud tip hotline? 5) Are surprise audits conducted? Of all the items on this list, audit committees that conduct surprise audits recorded the lowest frequency of fraud (however it didn't limit losses, hence this doesn't occupy the #1 position). As an interesting side note, as the Kroll study found, fraud was later detected in 76% of companies that had external audits, showing that the traditional #1 way to limit fraud has limited value. 6) Is there fraud training for employees and executives? 7) Is there a written code of conduct that addresses ethics, fraud prevention and conflict of interest? 8) Is a mandatory job rotation or forced vacation required? 9) Is there an external audit reporting directly to an independent audit committee? And, 10) Does the company maintain a data breach plan.

If your borrower answers no to all the above, then it is important to understand that default risk is greater, due to fraud and that should be taken into account with pricing. Conversely, top performing banks in this category often insist that some or all of the above be put in place before a loan is made. This is one reason why the larger national C&I loans that we sell have performed better than the average community bank C&I portfolio. The covenants on these large loans are comparatively stricter and fraud due diligence tends to be greater (along the lines of what we have outlined).

At a minimum, this is a great topic where banks can take a leadership role in helping educate borrowers on the importance and steps towards fraud prevention. Not only might you garner a new customer, but the probability of having one pay as agreed also rises.

BANK NEWS

M&A

Berkshire Hills Bancorp ($4B, MA) has agreed to acquire The Connecticut Bank and Trust Company ($283mm, CT) for approximately $30mm in cash and stock. The merger is valued at 138% of Connecticut Bank's tangible book.

Branch Sale

Seeking to boost capital, Waccamaw Bankshares ($588mm, NC) will sell 11 branches to First Bancorp ($3.3B, NC) for a 1.5% premium. The sale includes about $180mm in deposits and $98mm of performing loans.

Insurance Bank

The Fed rejected MetLife's dividend increase request and plans for a shareholder repurchase, pending a new round of stress tests that will assume more adverse macroeconomic scenarios. Analysts predict the largest US life insurer will move to exit from banking more rapidly. Higher capital standards and regulatory oversight have already pushed the company toward a strategy of divesting depository and mortgage origination businesses.

Student Loan Risk

Experts say the student lending sector could soon have issues, causing a $1T problem. College tuition has jumped over the years, pushing student loan debt to soar 400% over the past 10Ys. Graduating students are having a hard time finding a job and a report by the Institute for Higher Education Policy finds only 37% of borrowers are able to pay them back fully on time. The White House is releasing a plan today to support restructuring large classes of student loans.

Products Per Customer

A closer review of Wells Fargo's 3Q earnings report finds sales of a checking account and three other products increased 18% over the prior year and were purchased by 86% of new checking account customers. In addition, the retail bank household cross-sell ratio in the West was 6.28, while the business household cross-sell in the West reached 4.21 products per household.