BIZ CARDS & LOAN CORRELATIONS / CONCENTRATIONS

by Steve Brown

We were intrigued to read recently that the business card has been around since King Louis XIV and that the earliest cards were used as advertising or maps (because there was no formal street numbering at that time). These days, business cards have evolved and while designs are plentiful, they have stayed a typical 3.5 inches long by 2 inches wide. More interesting perhaps, despite all the digitization that has occurred; the paper business card survives. Even technology company employees still introduce themselves with the obligatory handshake and a paper business card. Strange, but maybe people hang onto this tradition because such cards allow you to reflect back some sort of innate desire to be different or otherwise stand out in this world. Who knows how long paper business cards will last, but at over 325 years, they have had a pretty good run. Like the differences found in business cards, the loan portfolio of a community bank is equally interesting. When regulators dig deep into a loan portfolio, they often start by reviewing concentrations (aggregate exposure exceeding 25% of bank capital) and correlations (pools of loans that may perform similarly). This gives the examiner on site a good idea of potential risk, underwriting quality and risk management processes. This makes sense, particularly when you consider that the loan portfolio is usually the largest percentage of assets, with the greatest amount of potential risk to the bank's capital. One reason concentrations are closely reviewed is because of their inherent risk profile. The very nature of concentration risk means problems that occur in such credits or groups of credits can deliver devastating consequences (particularly if borrowers or industries are also interrelated). To protect the bank and better manage concentrations, bankers should consider getting a good handle on the distribution of asset quality ratings; having a plan to diversify borrowers, geography and business types whenever possible; and spending the time necessary to better understand correlations, so action can be taken to limit the impact of any potentially bad events that may occur. On the topic of asset quality ratings, many community banks still use a "single factor" framework that assigns a number from 1 to 10, where 1 is the highest quality and 10 is the lowest. Such scales were originally set up to allow enough gradations to permit accurate characterization of the underlying risk profile of a loan, but humans are humans, so such approaches can also contain a lot of subjectivity and potential inaccuracy. That is one reason regulatory agencies are pushing banks to go to a "two factor" risk rating framework focusing on probability of default and loss given default. Doing so allows the bank to get more granular and more objective, by differentiating between the likelihood a loss will occur and the loss factor that will be applied when a loan goes into default. Sorting the loans into risk buckets can still be accomplished, but it is much more analytical and objective when you simply sort based on percentages after you apply this methodology. One key thing to note is the fact that banks need to keep a close eye on the probability of default. It is usually calculated monthly or quarterly based on the most recent data available, so as conditions change, the probability of default can rise and fall. Ensuring you have a "comfort range," utilize stress testing to see where issues may arise and having a plan or plans in place to address significant issues is a good practice to adopt. Whether you are managing concentration or correlation risk in the loan portfolio, consistency of execution and process is critical. Perhaps that is why we are not big fans of those who would flip their business card to a portrait view to stand out. We think adding colors is fine, designs are fine and print differences are fine, but once you flip the card, we say you have gone too far. That said, it doesn't really matter that much anyway, since we always put business cards into Outlook for better mobile device accessibility and file the paper card in a box in the drawer.

Related Links:
PCBB 2012 Executive Management Conference

BANK NEWS

M&A

Cadence Bancorp ($3.9B, TX) will acquire Encore Bancshares ($1.6B, TX) for $250mm in cash or 2.4x book.

Mortgages

The President released a program that will allow FHA borrowers to refi at a lower cost. In addition, the Administration plans to provide military personnel/veterans a review of their foreclosure as well as compensating payment of $100k or more if errors in the foreclosure were made. Any relief would be in addition to the $25B foreclosure settlement and this proposal does not need to be ratified by Congress.

Mortgages 2

The CFPB announced that later this year it will institute new limits on forced placed insurance and issue new disclosure requirements on ARMs.

Student Loans

The CFPB will now accept complaints on private student loans and formally review lender performance. As an aside, the average graduate owes $28,100.

Lehman Brothers

With bankruptcy proceedings complete, the firm will start paying out 18 cents on the dollar next week.

Small Business Lending Competition

Consulting firm Omega Performance conducted a survey that shows 78% of banks plan to increase resources to small business lending.

Staffing

A new study funded by the Dept. of Labor finds 40% of the workforce is made up of nonstandard workers, such as contract, temporary or part-time. This is up from 27% 6Ys ago and is notable; as this group usually receives no benefits.

Fed Survey

A new survey finds: respondents predict unemployment will average 8.3% in 2012 before falling to 7.9% in 2013 and housing prices will decline another 0.1% to 0.5% in 2012 before increasing 1.5% in 2013.