CLEAN WATER, CLEAN BALANCE SHEETS

by Steve Brown

Summer is just around the corner and many will soon be headed to the pool to splash around. As you do so, we warn you to watch where you swim, as you seek to cool off from the intense sun. You see, that crystal water in the pool may not be so clean and clear after all, if a recent survey is any indication. It found that one in five people say they pee in the pool! Have that 20% become so lazy that they cannot be bothered to pull themselves out and take 5 minutes to keep the water clean? We should, because the Centers for Disease Control say even when chlorine is maintained at the proper level, some illness-causing organisms can survive for up to 10 days. Maybe more frequent and better testing is in order to keep our pools safe nationwide? Speaking of the need to conduct testing, regulatory agencies yesterday clarified their position on stress testing released on Monday. The guidance focused on banks with assets above $10B, but the introduction paragraph indicated regulatory agencies expected all banking organizations to have the capacity to understand their risks and the potential impact of stressful events and circumstances on their financial condition. They also indicated stress testing was one way for banks to better understand a range of potential risk exposures. They closed by indicating a key lesson learned from the financial crisis was that banks needed to incorporate stress testing into their risk management processes, to be better prepared for stressful events that could threaten financial condition or viability. While the agencies indicated the threshold for the specific stress testing guidance released was $10B and above, they quickly reiterated that previously issued supervisory guidance on the subject of stress testing was applicable to all institutions. They said stress testing should be used as a tool to measure, monitor and control certain aspects of risk (such as commercial real estate concentrations, liquidity risk and interest-rate risk). The good news is that while stress testing of capital, liquidity and credit risk remain important risk management tools for community banks, regulatory agencies will not require community banks to do the same extremely robust level required of larger banks. Community banks do not have to do enterprise-wide stress testing large banks must do under the capital plan rule, nor the proposed rules implementing Dodd-Frank Act stress testing requirements, nor those described in this most recent guidance. It is good that regulatory agencies have recognized a simple community bank balance sheet probably does not need to go through such a rigorous testing process as larger and more complex banks. That does not mean, however, that stress testing isn't necessary or required. The key distinction appears to be that community banks won't have to do enterprise-wide stress testing (which takes into account adverse outcomes as a whole, when credit losses, interest rate-sensitive instruments, funding sources, liquidity levels and capital levels all interact together in a "cause & effect" or "chain-reaction" event); but will have to individually stress test interest rate risk, loan concentrations, liquidity and possibly capital (if the bank is seeking to pay dividends, effect an M&A transaction, etc.). Put another way, community banks still must stress test (on an individual basis) certain key elements of risk, but will not have to evaluate the "cause & effect" or "chain- reaction" that occurs across the organization (enterprise-wide). Using stress testing helps in determining which loans and asset classes inefficiently use capital, where risks lie and the effect of mitigants you are considering applying. As you review the guidance to see what is or is not applicable, consider what practices you might want to utilize to maintain a "clean" balance sheet and remain a top performing bank. As for swimming this summer, we don't know about you, but before we jump into a crowded pool, we will look around first for those who seem to have a relieved look on their faces so we can stay away and reduce our risk in that area.

Related Links:
[PCBB 2012 Executive Management Conference]

BANK NEWS

M&A

Central Bank ($1.2B, MN) will purchase Bank of Naples ($147mm, FL) for an undisclosed amount.

Branches Sold

In order to improve capital levels, First Federal Savings Bank of Elizabethtown ($1.2B, KY) will sell 4 branches to First Security Bank of Owensboro ($369mm, KY) for $3.6mm. The deal includes a 2% premium on $160mm in deposits, a 1% premium on the rest of the deposits and $74mm of performing loans at a 1% discount.

Slashed Costs

After Capital One announced that it was eliminating the assistant manager job at branches and will be laying off 500 people, First Merit ($15B, OH) announced the same tactic yesterday as it will lay off 338. First Merit cited the decline in branch traffic and the need to improve efficiency as the reasons.

Fed Minutes

Yesterday's release of FOMC minutes revealed little and just restated growth has been moderate and the outlook for the economy is uncertain. The only take away that was interesting was that there were implications that while the Fed believes the ECB will step in to mitigate some of the Euro debt risk, the US "fiscal cliff" poses a greater risk.

Op Risk

In a surprise comment, the OCC said operational risk, not credit risk, has become the biggest risk for national bank. The OCC referenced 3rd party vendors, anti-money laundering procedures and flawed models as examples and concluded by saying the ominous - "These themes are a supervisory priority for us at the OCC today." Be prepared.