Quizzing Bankers About Lending & Risk

by Steve Brown

There's a tinge of cool in the air, the kids are back in school, and they're asking for help with homework. We don't want to pile on, but we have a bit of a pop quiz for you. We figure it's worth sharing, because it was the fine folks at the FDIC who crafted the question.

Bank A and Bank B each have $500mm in assets and an ROA of 1%. There are differences, though. Bank A previously had an ROA of about 0.8%, but boosted it through a rapidly growing, high-yielding, higher-risk lending program launched a year prior. The bank's loan-loss reserve has been "dwindling" due to the program's losses, and the capital ratio has fallen due to the growth. The bank's board "has not placed limits on loan growth, and management has been unable or unwilling to forecast how large the high-risk loan portfolio will become."

Bank B, by contrast, has reported a 1% ROA through several business cycles, while growing steadily. Management and the board are preparing a new product for launch, and have forecasted its financial effects for the next 3Ys. They've also placed limits on growth by introducing risk-tolerance "circuit breakers." New lending stops when the bank can't produce the income necessary to build loan-loss reserves and capital required.

So, the FDIC asks--would you rate the earnings at these banks the same way? The answer, if you haven't caught their drift, is no. Bank A "appears to have some credit-risk issues and risk-management problems that would indicate earnings may be falling short of what they need to support operations and build capital and reserves." Bank B, on the other hand, "appears to have done a good job of maintaining earnings, and management's decision to 'look before they leap' into a new product shows they have considered the risk/return of the new strategy and have built in a contingency plan if it doesn't work."

"Managing to earnings targets without regard to risk," the FDIC notes, in its understated fashion, "would be inadvisable."

All of this may be head-slapping obvious to you, but the FDIC notes that events of the past few years mean it won't take these maxims for granted. They state, "One important lesson we learned from the financial crisis is that poor planning can harm institutions, their communities, and the financial system as a whole." They further state that "many financial institution failures were traced to management engaging in a new or expanded business line without adequate planning, controls, and understanding of the risks related to the new activity."

That was then, but what now? The FDIC suggests banks that want to participate in new lending opportunities engage in a "prudent, diligently executed strategy." The approach should include considering whether a new lending strategy will contribute to sustainable earnings vs. the long-term risk of hurting performance through losses. Significant changes in lending policy, the FDIC notes, are likely to require board-level approval.

The presumed exit from our historically low interest rate environment provides another area for strategic planning, the FDIC reminds us. "Perhaps the most important advice is that planning for the potential impact of rising interest rates is too important to be left entirely to those who run the interest rate risk-management systems and models," they say. Senior management and the board "should actively question how the bank would fare under rising interest rates," including what would happen if depositors prove more rate-sensitive than expected.

BANK NEWS

Small Biz

A TD Bank survey of small business owners finds 56% use a checking account for both business and personal finances and 53% do the same with their credit cards.

Settlements

1) Deutsche Bank will pay $258mm to settle claims related to processing billions of dollars in illegal transactions with blacklisted nations including Iran, Libya, Syria and others. 2) Wells Fargo has agreed to pay almost $82mm to settle claims it violated bankruptcy laws and denied homeowners a chance to challenge mortgage payment increases. 3) Goldman Sachs has agreed to pay $50mm to settle charges related to one of its previous employees that stole documents from the NY Fed. That 30Y old employee by the way has been permanently barred from banking.

Millennial Banking

Community bankers should note the oldest millennials are now 35Ys old, just tipping them into the next BLS category of spending that includes home and other purchases. This is important to note because Merrill Edge reports 61% of millennials say they will spend more in 2016 vs. only 26% of Gen X and Baby Boomers.

SNCs

Bank regulators have released their latest annual report on the loan quality of $3.9T in shared national credits. It finds: the leveraged SNC portfolio grew 31.8% YOY to $1.04T; 9.5% of the $3.9T in loans were rated classified or special mention; oil and gas loans classified substandard, doubtful or loss jumped to 15.0% vs. 3.4% prior year; the volume of non-pass leveraged loans has "declined sharply" since regulators issued new guidance on leveraged lending in 2013, but gaps still remain.

Buybacks

S&P Dow Jones Indices reports the number of stock buyback announcements has jumped 50% this year vs. 2014. The move boosts EPS and is also happening because companies have more cash on hand, interest rates are low and some are doing so in response to increased investor activism.

Online Revenue

USA Today reports just 5 Internet companies collect 70% of all online dollars spent. The companies and percentage captured (rounded) are Amazon (33%), Alphabet/Google (24%), eBay (6%), Facebook (5%) and Liberty Interactive/GVCA (3%).

Channel Usage

TowerGroup research finds people go to branches most often to open accounts, get financial advice, change their address, resolve disputes, get a cashier's check or deposit a check.