Country Club Bank

The Learning Curve

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BANKING'S BRAVE NEW WORLD

Double, double toil and trouble;
Fire burn and cauldron bubble.

Macbeth, Act 4, Scene 1

We are now in month four of the credit crunch and no one thinks we are at the bottom of this mess yet. How could the oh-so-smart Wall Street class get the pricing on sub-prime debt and the other culprits in this wreck so wrong? Will the banking regulators surveying this wreckage ever allow bankers to value these securities with their own devices again?

Remarkably, the answer to this second question is yes. The OCC and OTS have just approved the use of an "Internal Ratings Based" (IRB) approach to credit evaluation for institutions adopting the new Basel II capital guidelines.

What does this big bank stuff have to do with community banking? The connection is through FAS 157 and FAS 159, both effective for financial reporting after November 15, 2007. This means year-end financials for most of us.

Consider what else is going on:

- Basel II is rolling down the tracks. As the matter stands, the big banks will adopt Basel II. Community banks will not because of the additional cost and complexity of the new rules. That will give the big banks a capital advantage over smaller banks, in some cases a substantial advantage. There are various proposals to address this problem. Who knows where this will end up.
- As noted, Fair Value Accounting (FVA) continues to roll down the track toward implementation. Obviously, IRB is tied to this because it quantifies the credit spread in lending. Most of our customers have heard our presentation on product pricing. A loan rate is composed of four components: spread for interest rate risk, credit risk, option or prepayment risk and profit. Once each of these components are modeled and quantified, the last impediment to FVA is removed.

All of this leaves community bankers with a witches' brew of new issues to address. Bowing to the inevitable, we can show you the mathematical skeleton on which IRB is based. This Learning Curve will deal with the IRB on single loans. The math gets a bit more involved for pools with uncorrelated risks, but the basic idea is described below.

The credit spread for a single loan should be sufficient to compensate for the "expected loss" on the loan. That is mathematically equal to the probability of default on the loan (PD) (a number between 0 and 1) times the loss given default (LGD) (in dollars). Loan Principal is P in dollars. Mathematically, the spread should equal:

$$\frac{PD * LGD}{P}$$

So, what are PD and LGD equal to? That, of course, is the problem. You have heard recently of "marking to model" which, in some circumstances can become, "mark-to-make-believe". The proposals just blessed by OCC and OTS allow the institutions to determine these inputs (or some other approach).

Hence the sub-prime mess.

Is there a better idea? No, there is not. Sub-prime loans reported on a traditional basis would be carried at amortized cost. Does anyone think these loans are worth what the owners paid for them? That is what amortized cost would represent.

Consider one of your bank's loans. You make a $1 million 5-year fixed rate loan at 7% in today's market. Debt-service-coverage (DSC) is 1.3. In one year, let's assume rates have risen 100 basis points and the borrower's DSC has fallen to 1. To say that the loan is worth its amortized cost is to say that you would make the loan at the same rate at which it was written. Is this not "make-believe"? Proponents of the amortized cost approach say that the loan will pay off at maturity. Who knows? If not (you don't know; none of us knows), what is the true statement of the loan's worth?

If we don't really know, how much capital should be allocated to this loan?

We face the following situation: we can't stay where we are and all possible paths of change are fraught with problems. Notwithstanding the problems, FASB is pushing forward full-bore toward full FVA. International capital standards are being redefined according to Basel II. This will not be your father's bank in five years.

The market faces the further problem of what happens when there is no market for salable loans. FAS 157 will affect your bond portfolio at year-end. It defines three Levels of pricing precision. Level 1 is open market bid/offers, like treasuries. Level 2 is, in effect, matrix pricing—input well-defined market variables into a model/matrix to determine price. Level 3 is used when Levels 1 and 2 are unavailable. That is, perhaps overly-simplified, discounted cashflow analysis using IRB.

Fortunately, some fundamentals of banking will never change.

- Hire, pay and keep good people.
- Make loans to borrowers who are good credit risks (the C's never change).
- Have enough capital to cover inevitable mistakes.
- Manage liquidity carefully through healthy deposit growth and prudent bond investments.
- Have a good A/L model which can give you correct, complete and timely information.
- Price assets and liabilities accurately. Be good at "picking up the nickels."
- Use capital market tools wisely - FHLB advances, interest rate swaps, caps, floors, brokered deposits, structured repurchase agreements, etc.
- Manage your balance sheet with a prudent and healthy bias regarding where we are in the rate/credit/capital cycle (call us for a copy of the Easy-Button Matrix that is based on our regression analysis of interest rates).

One more thing we strongly recommend: with all of this change, designate one financial type at your bank, as part of his or her job description, to follow all of this change. The ABA is abreast of all of this and is an invaluable source of information but they do not have time to contact every banker every time something happens, which is daily it seems.

At Country Club Bank, we have been preparing for these changes and are prepared to assist you. Our AMG model is capable of handling much of this change already and we are improving it all the time. We don't think we need to talk about our bond desk. Knock on wood, we have never handled a bond that later defaulted; we have always preached looking at the underlying credit, regardless of its rating. We believe we use capital market tools prudently and can show you how also. The proven tools for managing the balance sheet are time tested.

We do not believe community bankers should concede anything in the Brave New World of Banking. We intend to be the survivors.

Tom McKernan
Senior Vice President

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