

briefing

INSIDE BRIEFING

Will strong and simple banks inherit the business?

Sandler's Dunne thinks so p. 12

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"Then & Now" returns in December

BANKING 2.0

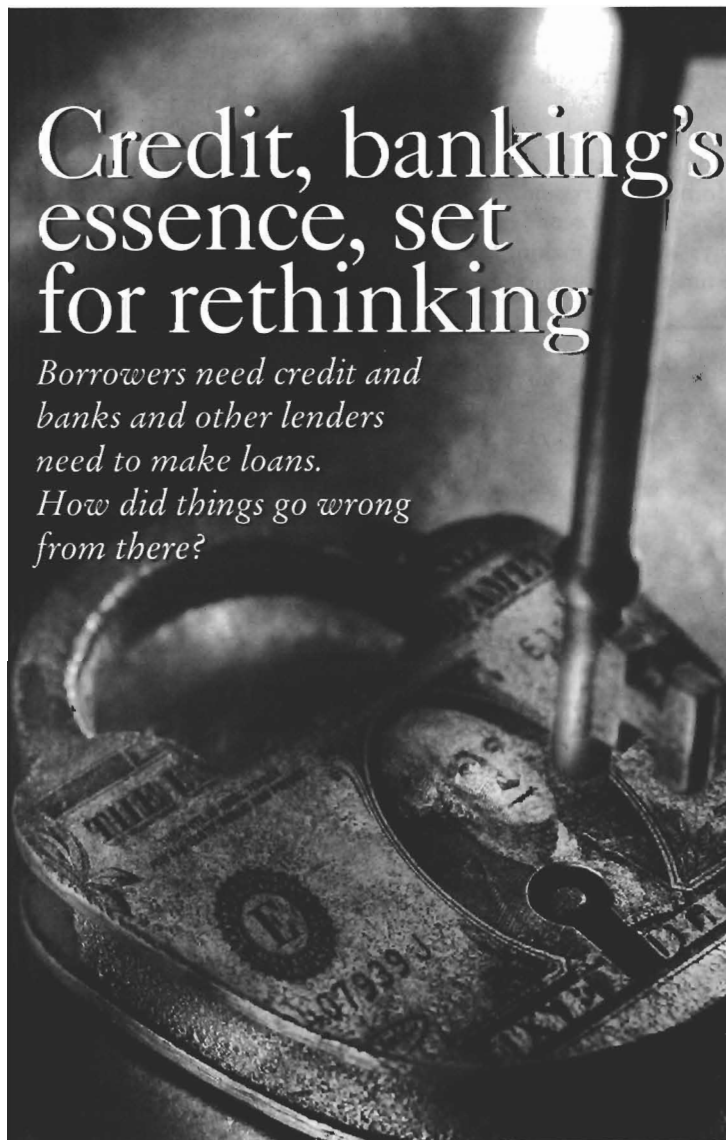
A series looking at how U.S. banking has changed, may change, and will change in the wake of the 2008 crisis. This month begins the series with a first look at credit.

After the crisis

Banking 2.0

Credit, banking's essence, set for rethinking

Borrowers need credit and banks and other lenders need to make loans. How did things go wrong from there?



Former banker Bill Barksdale is either a card-carrying cynic, or, at least, a realist with a respect for history. When he retired from a senior vice-presidency at Wachovia in 1997, he sold his company shares shortly thereafter.

Friends asked him why. "I was in the risk management business for 30 years," Barksdale told them, "and I know that every 12 years or so, lenders screw it up."

Retired Wachovia chief John Medlin used to say, "Real estate is the cocaine of the banking business," says Barksdale. Invariably, he says, real estate somehow underlies many periods of credit turmoil, and it's not unusual for many to get religion.

"Every time you have a blowout," says the veteran banker, who still teaches some credit courses, "there is an 'How did we ever get led astray? It's back to basics!' movement." However, he says if many of the aphorisms of the credit business had been heeded, it would have kept the nation's lenders out of trouble.

Case in point was a Barksdale favorite: "Show me a deal that's too good to be true, and I'll show you a deal that isn't true."

How much rot has been exposed? And how much remains to be?

Breakdown of basics

Alas, Barksdale is spot on. Other veterans among bankers, consultants, and former regulators interviewed agree that some of what the industry and the nation are seeing these days is a cyclical reckoning for excess. But others agree with his other point, as well, and see today's conditions as a result of a breakdown of fundamentals that is going to take a great deal of pain to fix.

Take Bert Ely, principal of Ely & Co., Alexandria, Va.

"Our financial system has been built on a platform of myths and regulatory arbitrage, and that platform is collapsing," says Ely. "We're facing absolutely enormous

By Steve Cocheo, executive editor

changes." Ely predicts that 2009, when Congress is expected to consider the financial regulatory system, will turn out to be the most significant legislative year for banking since the 1930s.

What bankers have been watching in recent weeks "is shaping up to be worse than the S&L crisis," says Nicholas J. Ketcha, Jr., principal now at consultancy FinPro, Inc., Liberty Corner, N.J., and previously director of the N.J. Division of Banks, and FDIC Director of Supervision. "This is going to be the biggest downturn in the economy in a while," continues Ketcha, and comes down to a liquidity-eroding crisis of confidence.

How'd we get here?

The blame game is something that Congress will spend much time on, in the months and years ahead. It could be argued that we all own a piece of something that became inevitable; an economy that was 70% driven by consumer spending coupled with a fair amount of irresponsible borrowing and lending, with people often living beyond their means, was headed for trouble.

"This is a matter of people going where they thought they would find money," for what have you, says a long-time observer of the credit scene.

Homeownership is one example: "We've got the notion in the U.S. that everyone needs to own a home," says the veteran, preferring not to be quoted by name. While such societal attitudes play a part, so do some structural issues.

The panorama of companies that lend money in modern America is wide, but one factor used to be fairly common among the players: the lending officer who found a loan evaluated the loan, and, after other officers or committees passed on it, *lived* with the loan.

Increasingly, those roles have been busted apart, both internally and externally. Think of internal "silos." Think of securitization. Think of loan brokers versus loan officers.

"That was a watershed event," observes Edward T. O'Leary, banking consultant and former banker, and *ABA Banking Journal's* "Talking Credit" blog-master. "The guys who are making the deals today are not the guys who fully

understand the deals."

This evolution occurred for all kinds of reasons, including the metamorphosis of many banks into sales-oriented organizations. O'Leary's point is that once the roles of hunter and analyst break apart, there is a tendency in good times not to listen too closely to the analyst.

The flip side has been that with increasing specialization, lending organizations lost internal cross-pollination.

"The best loan review guys," for instance, says O'Leary, with over 40 years in credit experience, "are the guys who have actually loaned money."

In many organizations the front-end lender isn't performing credit judgment, says Barksdale, but is simply gathering items on a checklist that will be bundled for backshop troops to make sense of.

What's your lender up to?

Another factor is lack of experience. While most community banks, even those with significant exposure to commercial real estate lending, don't appear to be in serious trouble at this point, banking has seen a shrinkage in its active

Snapshot

The few, the proud, the banks that can raise capital

Although capital adequacy remained the central focus of the banking industry, the pace of underwritten public offerings nearly fell off a cliff in the third quarter.

Banks and thrifts faced a hostile environment in which to bring an issue to market. With the trust-preferred securities market closed to all but a few large institutions and the debt markets in deep turmoil, most banks and thrifts issued preferred and common stock to raise capital.

Thomas Killian, a principal at Sandler O'Neill & Partners LP, said that three different types of banks and thrifts can tap the markets in this environment. The first type is a company with relatively strong credit quality that looks to raise opportunistic capital, which Killian said would enjoy the best reception in the market.

Companies with credit quality challenges arising from their geographic location or particular types of lending are the second possible issuer in this market, Killian said.

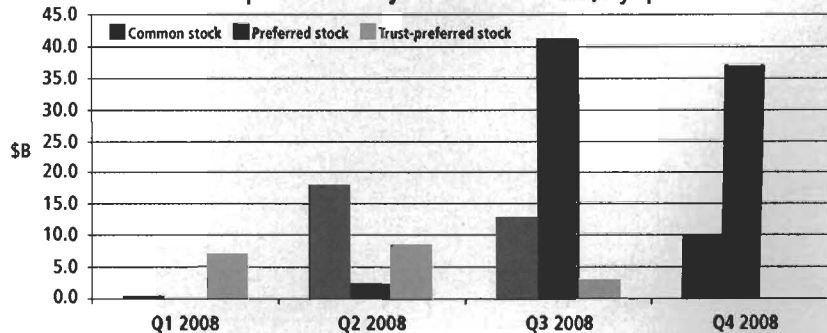
Killian said the other companies raising capital are small banks that might have problems with a single loan portfolio,

such as notable losses arising from construction and development loans, that need to fill a small capital hole, often achieved through private placements. He said those companies can no longer access the trust-preferred market, and their capital raises are not large enough to attract major private equity firms.

"I think that's where you might see smaller common equity deals being done. And we're seeing more of those every day," Killian told SNL.

—Nathan Stovall, senior industry editor nstovall@snl.com

Capital raised by banks and thrifts, by quarter



experience base in credit.

"In my 40-year career in banking, how you analyze credits, structure loans, that hasn't changed," says Thomas A. Bracken, regional president at TriState Capital Bank, a \$750 million-assets de novo serving multiple states from Pittsburgh, Pa., and satellite offices. Many of the techniques—obtaining guaranties, and such—remain constant, like basic industrial processes. The only significant change in those building blocks has been that more is done using technology, he notes.

"The basics are the basics," says Bracken. "So if you stuck to that, you probably have a limited amount of pain."

However, something that has changed is the age and sophistication of front-line lenders. "Unfortunately," says Bracken, "there aren't a lot of veterans left."

This can lead to some significant laps-

New on abaj.com
Understanding the
"Digital Native"

"Digital natives," also referred to as the Millennials, Generation-Ts, or Late Gen Ys, comprise the segment of the population born after 1985. The difference between the digital native and "digital immigrants"—those born prior to 1985—is that the digital native has grown (or is growing) up immersed in technology, while digital immigrants did not grow up with it. Digital natives do not refer to a "digital camera," they simply call it a "camera." (What's "film"?). Text messaging is their preferred communication.

Author Dan Fisher, head of consulting firm The Copper River Group, explores the unique characteristics of this emerging segment both from the perspective of bank customers and bank employees on www.abaj.com (under "Exclusives"). As he writes, they are accustomed to speed, graphics, flat panels, and games, and are not inclined to sit in a training room and endure hours of PowerPoints.

Fisher suggest bankers attend the Consumer Electronics Show in Las Vegas (usually in January) to get a better understanding of digital natives.



**"There's a real turnoff on securitization, for a while. The self-correcting mechanisms didn't seem to kick in as quickly as they should have."
Securitization allowed lenders to "pass the buck" on credit problems**

—Bert Ely, Ely & Co.

es. One example is the revelation, to some younger front liners, that collateral values not only rise, but fall. Another, he continues, is why covenants are part of commercial loan contracts to begin with.

"Veteran bankers know that covenants are one of the most important factors in a loan contract," says Bracken. Covenants serve as an early warning system; as they are broken, a savvy lender knows it's time to talk—or act.

Younger players "are getting a master's degree in a matter of months," he says.

Ed O'Leary worries about that process, because of its impact on these bankers' future efforts. Loan officers in their 30s are in their "formative years," according to O'Leary. Those who make it through the current period—especially if commercial real estate lending and other asset types follow the curve taken by residential lending—will be forming very conservative attitudes. O'Leary says such attitudes have a way of hanging on even after things turn around.

For now, that is a remoter risk than others. Indeed, consultant Nick Ketcha notes that one message his firm keeps stressing to community banks is not to be tempted in bad directions by the growth of small business borrowers who want to shift to their institutions.

"We've cautioned them not to grab at business," says Ketcha. "This is not a time to be complacent, or thinking, 'We're isolated,' or, 'We're removed from what's going on.' We expect to see spillovers of trouble in all parts of the banking business."

Securitization, hero turned villain

Securitization accomplished financial miracles for a good part of its history. But then it became a big part of the problem.

"Many of these structures did not pass

risk off to anybody, and even if they did, the risk came back," says David D. Gibbons, special adviser to Promontory Financial Group, LLC, Washington, and former Deputy Comptroller of the Currency for Credit Risk. Regulators and the industry struggled for years with the issue of recourse, and some of that effort became moot in the event.

"The separation of an actor from the consequences of his action is a recipe for pathology in every other human endeavor," says Randal Quarles, "so there's no reason to think credit organizations are any different." Quarles is managing director, The Carlyle Group, Washington, D.C.

As the securitization engines repackaged debt and risk, leverage was piled on leverage.

"It was bad," says Quarles. The risks were spread, and broadly. "But it was like a manure spreader, if you will."

The government conservatorship of Fannie Mae and Freddie Mac cast a pall over the granddaddy of securitization, the secondary residential mortgage market. Ely doesn't see "normality" returning to securitization markets for several years.

"There's a real turnoff on securitization, for a while," says Ely. "The self-correcting mechanisms didn't seem to kick in as quickly as they should have." Securitization allowed lenders to "pass the buck on credit problems," says Ely. He suggests that covered bonds, explained in detail in last month's Briefing (p. 12), have the potential for displacing much of the need for securitization. He observes that covered bonds are more efficient than securitization.

Other observers point out that some means of providing liquidity to the mortgage markets must be found. As homes begin to move again, there will be a need

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for capital to fund them, without tying up lender balance sheets.

"Simply going back to only portfolio lending will not be good for the home buyer," says Jo Ann S. Barefoot, principal at Jo Ann Barefoot & Co., Defiance, Ohio.

Securitization changed the dynamic of big portions of the credit granting business, says Quarles. Securitization increased the pools of capital available for many activities and provided more robust support for economic activity, he says. "Those were real benefits that are worth preserving, as we go forward." But it is essential some form of accountability be considered.

Changes in the works

Observers think that some areas of lending will change more, in the months and years to come, than others. The controversy over the degree to which the Community Reinvestment Act played a part in current conditions, to be treated in a

subsequent part of the "Banking 2.0" series, will have its own resolution.

Credit consultant Ed O'Leary suggests there will be both temporary shifts in attitude and practice, and more structural shifts. It may be some time before it becomes clear which is which.

To a degree, at least in the short term, lenders are going to retreat to the tried and proven techniques that they were weaned on.

"This is truly a back-to-basics time and that's good," says Ed O'Leary. "But a lot of people are going to get squeezed out." To a degree, he argues, back to basics means hewing more to the strict view of things, with somewhat less flexibility for the out of the ordinary, the borderline, the not-quite-there credit.

"This is a time for careful analysis and a close review of the bank's risk tolerances," says FinPro's Nick Ketcha. "I can guarantee you that that's the marching orders that examiners are getting."

O'Leary sees this return to conservatism affecting both commercial and consumer credit types. To a degree, though, he says, "the consumer market will tend to wag the dog."

In extreme cases, some banks may find that their best short-term strategy is to shrink the bank, says O'Leary. This will preserve capital, and help bring capital ratios in line with regulatory requirements. The jury is still out on whether smaller banks will make use of any of the federal efforts to inject capital into the banking system.

As Congress examines the ongoing controversies in banking next year, it's likely that regulators will come in for their share of bashing. When made into scapegoats, says O'Leary, they will react by coming down harder on the institutions that they regulate.

Regulatory attitude

Going forward, there's a matter of how

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much room—or rope, depending on one's starting point—the banking regulators will grant the organization. A relatively permissive period has just come to an end, with a jerk.

Promontory's David Gibbons notes that in the period before the crisis, some regulators clearly believed that something bad was coming, if trends they saw went unchecked and unlimited. But it took a long, long time, he points out, for any formal action to come out, in interagency form. In the meantime, top regulators jawboned in this or that forum, hoping to put their point across through oratory. This was seen in the areas of nontraditional and exotic mortgage instruments, home equity lines, and commercial real estate, notably.

And when interagency documents were issued, what came out were not rules and regulations, but "guidance."

For Gibbons part, he wonders how things might have turned out if regulators had shut some forms of lending down



Ripple effects from current loan issues are a concern.

"We are actually not out of the woods on this"

—David Gibbons,
Promontory Financial
Group LLC

two or three years ago.

Going forward, Gibbons expects that regulators will tend to be more counter cyclical with credit than ever. They will have to be, if, playing off a 1980s regulator's statement, they are to be able to take away the punchbowl before someone drowns themselves in it.

"You need to have regulations with some supervisory teeth," says Gibbons. This is not something he feels the system

currently has.

Analyst Bert Ely sees the regulators' task becoming wider and deeper, with the outcome of congressional inquiry and their own revisiting of their role resulting in major regulatory restructuring. This will not only affect who regulates whom, but what is regulated. Such unregulated creatures as hedge funds and credit default swaps, won't remain so for much

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longer, he predicts.

Regulators' challenge going forward will be to rein in risk, enabling the industry to heal, without going overboard. The hardest days will be now.

"We've got a wound that's bleeding," says Nick Ketcha, former regulator. "You can put a pressure bandage on it and you may stop the bleeding. Or you can put a tourniquet on it." While the tourniquet stops the bleeding, it stops all circulation.

"My biggest fear," says Ketcha, "is knowing when to loosen the tourniquet."

As banks and regulators try to find the path back to moderation, there will be casualties. "I think people with good credit will continue to be able to borrow," says Bill Barksdale, the ex-Wachovian. "But people with marginal credit, they won't be able to get financing." Glimmers of this have already been seen, such as GMAC's ratcheting up of acceptable credit bureau scores.

Over the horizon

Some observers are worried that what we have seen thus far is not the end of trouble.

What concerns Promontory's David Gibbons is that the extent of the ripple effects from subprime and related developments isn't clear. He sees coming troubles from construction loans made for retail projects going bad. And he suspects that there will be trouble in hotels and motels catering to both business and personal travelers, as the recession bites harder.

"We are actually not out of the woods on this," says Gibbons.

There is simply an enormous amount of debt out there, points out Quarles of Carlyle Group. He cites these figures as one example: In 1980, all public and private debt represented 160% of Gross Domestic Product; in 2007, the figure came to 346%—and the public debt piece hadn't changed, by share, all that much. In the same period, household debt doubled as a percentage of GDP.

Indeed, O'Leary likes to quote Machiavelli on this point, from *The Prince*:

"In the beginning of the malady it is easy to cure but difficult to detect, but in the course of time, not having been either detected or treated in the beginning, it becomes easy to detect but difficult to cure." *BJ*

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