Editor at Large

Conspiracy Theories on Low Failure Rate Don't Hold Water

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By Barbara A. Rehm

We are on pace for fewer than 100 failures this year even as the government's "problem" list sits at 888 banks. That has a lot of people puzzled — and spinning schemes that blame imperious federal or rebellious state regulators.

Other, less personal presumptions have been floated, including whether the Federal Deposit Insurance Corp. is simply overwhelmed by its workload. Or maybe the agency is holding troubled banks off the market until the economy improves so it can attract more and better bids.

Neither of those rings true to me. The agency is built to resolve failed banks and has had plenty of practice, and it has an institutional bias, bred during the savings and loan crisis, to sell inventory as soon as it's ready.

The conspiracy theories are even less convincing. The dominant one goes like this: Sheila Bair, whose term as FDIC chairman ended last week, purposely slowed the pace to make it appear that the industry was recovering just as her term was ending. But trust me. Bair wouldn't do that, and the FDIC staff wouldn't let her.

Others conspirators claim state regulators are fed up with the FDIC and dragging their heels on closing banks. "They are sick and tired and they are protecting banks from the FDIC," said one bank consultant working with troubled banks. Maybe in isolated cases, but most state regulators are working hand in hand with the FDIC.

The truth could be a lot less exciting. The slowdown may simply reflect a stabilized industry. While plenty of banks continue to struggle, many are not getting any worse, and if they have enough capital and a strong management team that is cooperating with regulators, then regulators are giving them some rope.

"They are not jumping on banks as fast as they were when the trend lines were steadily going down," said Nick Ketcha, a former FDIC director of supervision who is now executive managing director at FinPro Inc., a consulting firm in Liberty Corner, N.J. "They are not giving them forbearance, but they are using more flexibility."

Matt Anderson, a managing director at Trepp LLC in New York, which tracks bank failures closely and compiles its own list of weak banks, agreed.

"By putting more time on the clock a lot of those banks will be able to improve on their own, or more likely, raise capital and improve that way," Anderson said. "As long as the bank isn't doing something reckless and throwing what little good money they have after bad there is not necessarily a downside to the FDIC stretching the whole process out."

With the regulatory reins pulled tight, there is little risk of repeating the S&L days when weak institutions were allowed to double down by making risky loans or to skew competition by paying above-market rates for deposits.

That's not to say there are no costs. Weak banks lose talent and customers, and in turn franchise value. And for the weakest banks, waiting merely delays the inevitable. Trepp has identified 248 banks in deep enough trouble that failure is a near certainty, and letting them continue to operate prolongs uncertainty in their markets.

"The real problem is we aren't recognizing the losses," said L.T. "Tom" Hall, the chief executive of Resurgent Performance Inc., a consulting firm in Alpharetta, Ga. "We have this malaise, this kind of impasse. Asset values are frozen. Until you dump those, everyone has an artificial idea of asset values."

The failure pace may accelerate in the second half, particularly if the economy doesn't improve and real estate prices fall further.

"I think the biggest driving factor right now for a lot of these banks is what happens to real estate values," Ketcha said. "If they hold or inch up a little it'll be fine. … But if they drop 20%, the [failure] pace will accelerate."

But remember the FDIC has repeatedly said the failure tally this year will be lower than last year's when 157 banks were shut down. And Anderson said Trepp is predicting the 2011 total won't be much above 100 failures.

Still, it's easy to understand why so many folks expected more than 48 failures in the first half. (There have been three more since June 30.) Take the ratio of failed banks to banks on the problem list over the past two years. In 2009, failures amounted to 19.9% of the problem bank list. In 2010, that figure was 17.8%. Taking an average of those two years, 167 of the 888 banks could be expected to fail this year.

The FDIC frowns on questions about the pace of failures or the size of the problem bank list. But the agency's official line is that it merely takes a bank for resolution when its primary regulator determines capital has fallen below the 2% trigger contained in prompt corrective action rules. But determining a bank's capital is not simple arithmetic. Regulatory judgment plays a huge role; capital can vanish the instant regulators force a bank to move capital to loan-loss reserves. And if a bank has liquidity problems, it may not matter how much capital it has.

Of the 375 banks that have failed since early 2007, only 138 had between 0% and 2% capital, according to Bert Ely, an industry consultant in Alexandria, Va., who keeps an updated analysis of bank failures. Another 156 had more than 2% capital and 81 had negative capital.

The data "certainly doesn't say they are ironclad in closing the bank as soon as it reaches 2%," Ely said. "In a number of circumstances it was negative, which suggests they were too slow in closing."

According to Trepp's analysis, of the 248 banks it views as most likely to fail, 136 have been on its watch list for two years or more; 90 have been on for four to seven quarters.

But maybe focusing on the pace of failures is misplaced. Maybe the real question is why the problem list is so huge. If the industry has stabilized, why are so many banks still considered a problem?

"They are not taking banks off [the problem list] as quick as they did," Ketcha said. "In the past, if the bank complied with every provision, they got capital where it needs to be, they got earnings stabilized, generally the orders would get lifted at the next exam. Now they are coming in and saying, 'Alright you are in compliance with the provisions of the

enforcement order, but we want to see sustained performance and we aren't going to lift the order until we go through another cycle.' "

"I think that's simply a recognition that real estate values" may retreat, he said. "That's what's holding the numbers up. There is a reluctance, until there is recognized stability in the market, that they are not lifting the orders or improving the ratings."

John Harrison, the commissioner of the Alabama Department of Banking, agreed. "We are not as quick to take a bank that has improved off that list as we are to put one on that list that has suffered some problems," he said.

But keeping banks on the problem list, refusing to lift enforcement orders or boost a bank's Camels rating makes it tougher for a bank to raise outside capital. (It also keeps its FDIC premiums elevated.)

That creates a classic Catch-22. While regulators don't want to remove a bank from the problem list too quickly, they do want these banks to raise capital and prosper.

That leads me to one last conspiracy theory. Everyone knows that as long as the failure parade continues, banks will have a tough time raising capital. Potential buyers will simply wait until a target fails and get a better deal, and loss-sharing on the assets, from the FDIC. But what if the failure pace slowed? What if loss-sharing terms tightened? Would that entice buyers off the sidelines? Is that perhaps the grand strategy behind the slower failure pace?

So far investors aren't biting but a few more months of single-digit failure totals might convince investors to do more deals.

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