



## **From Wall Street to Main Street: Bank Insolvency and the Credit Crisis**

Robert Huebscher  
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While pundits focus on the fate of larger banks like Citibank, Wachovia and Washington Mutual, far less attention is paid to the 8,500 smaller banks that are the backbone of Main Street America. Some, but certainly not all, of these banks are exposed to the same risks in the housing market that are plaguing their larger counterparts, as loan defaults strain their balance sheets. A wave of defaults, similar to what occurred during the S&L crisis, is in many ways investors' worst nightmare and could cause thousands of these local banks to fail.

We spoke with the CEOs of two firms that specialize in analyzing risks in the banking system. Both agree banks are experiencing stress, but say the overall system is healthy. However, the current data available is as of June 30 and, as we discuss below, third quarter data could reveal a very different picture.

### **Institutional Risk Analytics**

Chris Whalen, founder and CEO of [Institutional Risk Analytics](#) (IRA), says the broader banking system may face some challenges, but the risk of widespread failures is small and the problems facing these banks do not pose significant challenges to the economy.

Whalen founded IRA in 2003 and now collects data on banks directly from regulatory agencies. He tracks approximately 400 data points at the individual bank level and about the same amount of data at the bank holding company level. Whalen organizes his analyses to be accessible to both analysts and the general public and, more importantly, he tracks trends and changes, particularly at the individual bank level. IRA's original initial clients were bank auditors, who look for signals of insufficient disclosure which might be indicative of fraud or a failure of internal controls. IRA's clients now extend to all segments the investment community and, through a new product we discuss later, to the general public.

IRA monitors banks' compliance with Basel II standards, which include default ratios, capital ratios, recovery rates, loan maturity distributions, and levels of exposure to potential default. Whalen said his data break down usage of bank clients' credit card lines, in order to see the number of clients that have "maxed out" their credit limit. "We can see why a bank like Wells Fargo is so healthy,"



said Whalen. "They keep their clients on a tight leash, as measured by the bank's level of unused credit lines to total assets."

One of the most critical metrics Whalen follows are banks' efficiency ratings. Whalen has seen industry-wide efficiency levels rise from the mid-60% level to approximately-80% over the last year. He notes that Bank of America and J.P. Morgan are very strong, with efficiency levels around 50%, but that Citibank is above 60%, meaning they must spend 60 cents to generate each dollar of revenue. This is why Citibank CEO Vikram Pandit and his team have their work cut out for them," said Whalen.

### **Balance Sheet Risk**

But the real uncertainty driving fear is whether unhealthy bank balance sheets are signs of pending insolvency. Whalen has seen a rise in write-offs across the industry, which are now 1.5 to 1.75 times levels a decade ago and still unlikely to peak until the second quarter of 2009.

[Financial Information Systems](#) (FIS) of Bedford, Texas analyzes banks, using publicly available data such as call reports and regulatory filings. Charles M. Hebert, president of FIS, says they calculate a series of ratios in each regulatory category, and combine this to determine a rating for each bank. Ratings range from one (the best) to five (the worst). FIS' clients are large financial institutions and some government agencies.

Through the end of June, the most recent data available, 603 banks reported 25% or more of their capital was in non-performing assets, Hebert says. Looking more closely, he says the largest category of non-performing assets are in interim construction and real estate development loans, and banks collectively have greater exposure to these loans than to non-performing securities, including subprime debt. But Hebert cautioned that the data do not yet reflect exposure to Fannie Mae and Freddie Mac securities, which will be reflected in third quarter reporting. He says this exposure cannot be identified based on publicly reported data. Many banks held Fannie Mae and Freddie Mac preferred stock, which lost 90% of its value as a result of the GRE conservatorship. This preferred stock was held as Tier 1 capital (the least risky capital), and the data reported as of September 30 will reveal the extent of this loss throughout the system.

### **Watching on the Watch Lists**

The FDIC currently has 117 banks on its watch list. Using roughly the same criteria as the FDIC, IRA forecasts 110 bank failures between July 1, 2008 and the end of 2009,. Hebert says, "When a bank's rating hits a four it is a problem," and FIS now has 86 banks with a rating of four or higher. "We also have a lot of



3.7, 3.8, and 3.9-rated banks,” he says, adding that the number of troubled banks has increased roughly 20-25% over the last year. FIS’ ratings have proven to be very accurate, as only one bank has failed recently that wasn’t rated 4 or higher. “The only way our ratings do not foretell a failure is when a bank reports erroneous data or there is a bad intervening examination,” says Hebert, adding that this occurs typically with less sophisticated banks.

Neither the FDIC, Whalen, nor Hebert disclose the names of the banks on their lists.

Whalen says the banks of his watch list represent approximately \$850 billion in capital. “This is not the end of the world,” cautions Whalen. The loss rate, which is what really matters, will be 25% to 35% on this capital, “which is something the industry can handle,” says Whalen. “Many banks will be bought and, in most cases, acquiring banks will pay a premium for access to deposits,” he said. Hebert agrees, and expects recovery rates of 50% to 60%, with a minimum of 20% on assets.

The failure of Lehman places additional strains on the banking system, since it was the largest underwriter of prime commercial paper, a critical source of short-term funding for large corporations. Corporations are now drawing on their standby lines of credit, and this will show up in the third quarter reports from banks. Until firms fill this gap in the commercial paper market, Whalen expect this stress to remain in the banking system.

### **Can Citibank Fail?**

No financial institution has written off more than Citibank, who has reported \$55.1 billion in asset writedowns and credit losses since the beginning of 2007, forcing it to raise \$49.1 billion in capital. Some claim Citibank would be insolvent today if it were forced to mark-to-market its remaining distressed debt, and big questions remain regarding Citibank’s future.

Whalen says Citibank has some asset quality and earnings issues but is not insolvent. “The bank is above the industry levels of our Banking Stress Index (noted at the top of the [report](#)), but this is not a significant issue, given that Citibank is always noisier and above-peer in terms of loss rates,” says Whelan. He added that Citibank has more consumer subprime risk than most banks, but they also earn higher yields on their loans.

Hebert says FIS has a 3.32 rating on Citibank, but the FIS rating system does not always reflect the increased access to capital markets that large banks enjoy as compared to their smaller brethren. “Citibank, like other large banks, has a tendency to run at a lower capital ratio to improve their return on capital,” says



Hebert. He says the 3.32 rating overstates Citibank's risk. Citibank's rating was 3.31 in December, and there has been no significant deterioration based on publicly reported data through June 30.

### **Should the Public Worry?**

Whalen has been very proactive in correcting erroneous reporting of certain events, such as stories that the FDIC was running out of money and might not be able to insure deposits. "The FDIC does not and will not run out of money," he said. "The FDIC has the ability to gather new insurance premiums from banks, increase insurance premiums and ultimately borrow from the Treasury. There is nearly \$1.3 trillion in private bank capital behind the FDIC. Consumers should place their confidence in the professionals at the FDIC and other federal agencies to handle the problems in the banking sector."

Whalen sees a spike in the general level of anxiety in the public regarding the safety of their banks and deposits. In response, he created a new service called "How's My Bank" that, for \$50/year, provides retail clients with reports on individual banks taken from his firm's institutional IRA Bank Monitor ratings system. He has seen a five-fold increase in use of this product over this year. "Americans have been put to sleep by not having to worry about bank solvency," and are now waking up to a brand new era of risk. The prudent consumer, however, can take some fairly easy steps to ensure that their bank is sound by looking for institutions that are profitable and have capital levels above the regulatory minimums.

#### **Researching Banks**

Consumers can go any of the bank ratings services listed on the [FDIC web site](#) to research the solvency of their banks.

Hebert says the FIS data demonstrate that the banking system overall is well capitalized. However, the system is clearly under stress, and institutions anxiously await the analysis of third quarter data in the coming weeks.

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