

# **Prospects for California Banking in the New Environment: Implications for Board Governance**

**California Bankers Association**  
Directors College 2011

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# Topics for Today

- California bank demographics, trends, and conditions
- The economy and the banking challenges ahead
- Lessons learned. What should banks do now?

- California bank demographics, trends, and conditions

# State / National Bank Comparison

## California Headquartered Institutions

(as of 3/31/11)

	<u># State</u>	<u>% of total</u>	<u># Natl</u>	<u>% of total</u>	<u># FSBs</u>	<u>% of total</u>
< \$100MM	26	13%	5	10%	0	0%
\$100MM - \$500MM	113	57%	32	65%	10	50%
\$500MM - \$2B	40	20%	5	10%	8	40%
\$2B - \$10B	13	7%	2	4%	1	5%
Over \$10B	6	3%	5	10%	1	5%
Total	198	100%	49	100%	20	100%

# State / National Bank Comparison

## Total Asset Size (as of 3/31/11)

	<u>\$ State</u>	<u>% of Total</u>	<u>\$ Natl</u>	<u>% of Total</u>	<u>\$ FSBs</u>	<u>% of Total</u>
< \$100MM	1.9	1%	0.3	0%	0.0	0%
\$100MM - \$500MM	26.6	10%	6.3	4%	3.0	7%
\$500MM - \$2B	40.3	16%	4.5	3%	9.2	22%
\$2B - \$10B	48.3	19%	8.0	5%	3.5	8%
\$10B and >	141.9	55%	156.2	89%	26.7	63%
Total	259.0	100%	175.3	100%	42.5	100%

Total assets in billions of dollars

# Changes Among State Banks 2005 – 2010

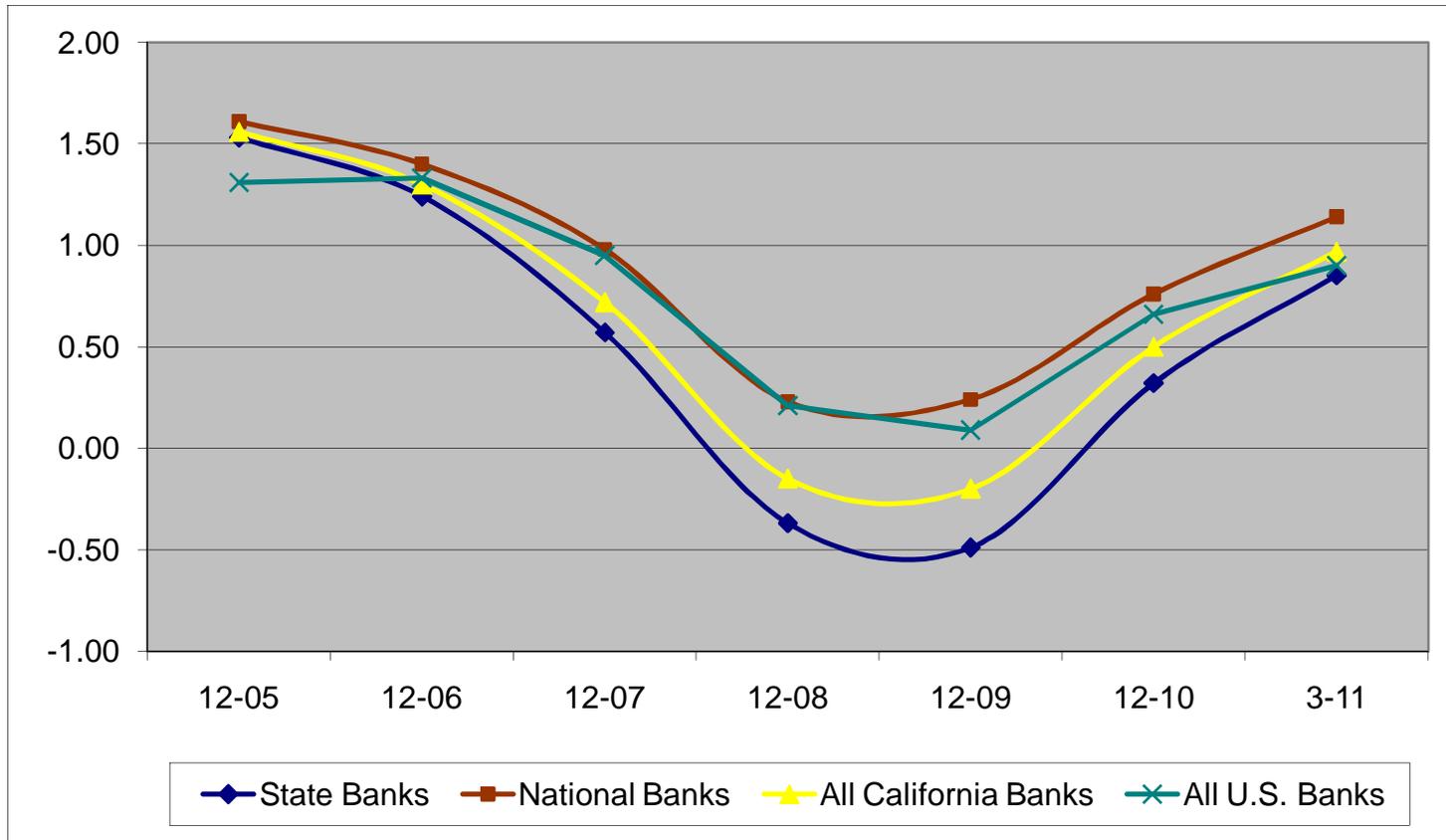
## Dollar Amounts in Thousands

	#	\$
<b><u>Number of state banks and total assets as of 1/1/05</u></b>	<b><u>189</u></b>	<b><u>172,470,243</u></b>
# Failed	(21)	(32,688,708)
# Merged out of business	(42)	(16,576,945)
# Converted to national charter	(2)	(4,456,770)
# Ceased doing business	(2)	(7,666,124)
# Opened	71	39,880,175
# Converted to state charter	8	13,442,416
State banks that acquired other banks	24	56,561,061
<u>State banks that did not acquire other banks</u>	<u>107</u>	<u>34,136,463</u>
<b>Number of state banks and total assets as of 12/31/10</b>	<b>201</b>	<b>255,101,811</b>
<b>Net change:</b>	<b>12</b>	<b>82,631,568</b>

# Quick Summary of Industry Conditions

- Improvements in ROA, NPL/TL, capital adequacy & other metrics that began in 2009 are continuing
- Number of problem banks starting to decline...finally! CAMELS 3's trending favorably, but not 4's & 5's
- Number of bank failures declining -- 17 in CA in '09, 12 in '10, fewer in 2011 – as are their size
- Since 2009, 46 CA state-chartered banks or their BHCs completed 91 private equity offerings that raised \$6.5B.
- TARP/CPA provided critical assistance to some community banks. SBLF could have a similar effect.
- Much talk of industry consolidation to come, not many deals yet

# Return on Assets



## Return on Assets by Quintile\*

### State Chartered Commercial and Industrial Banks

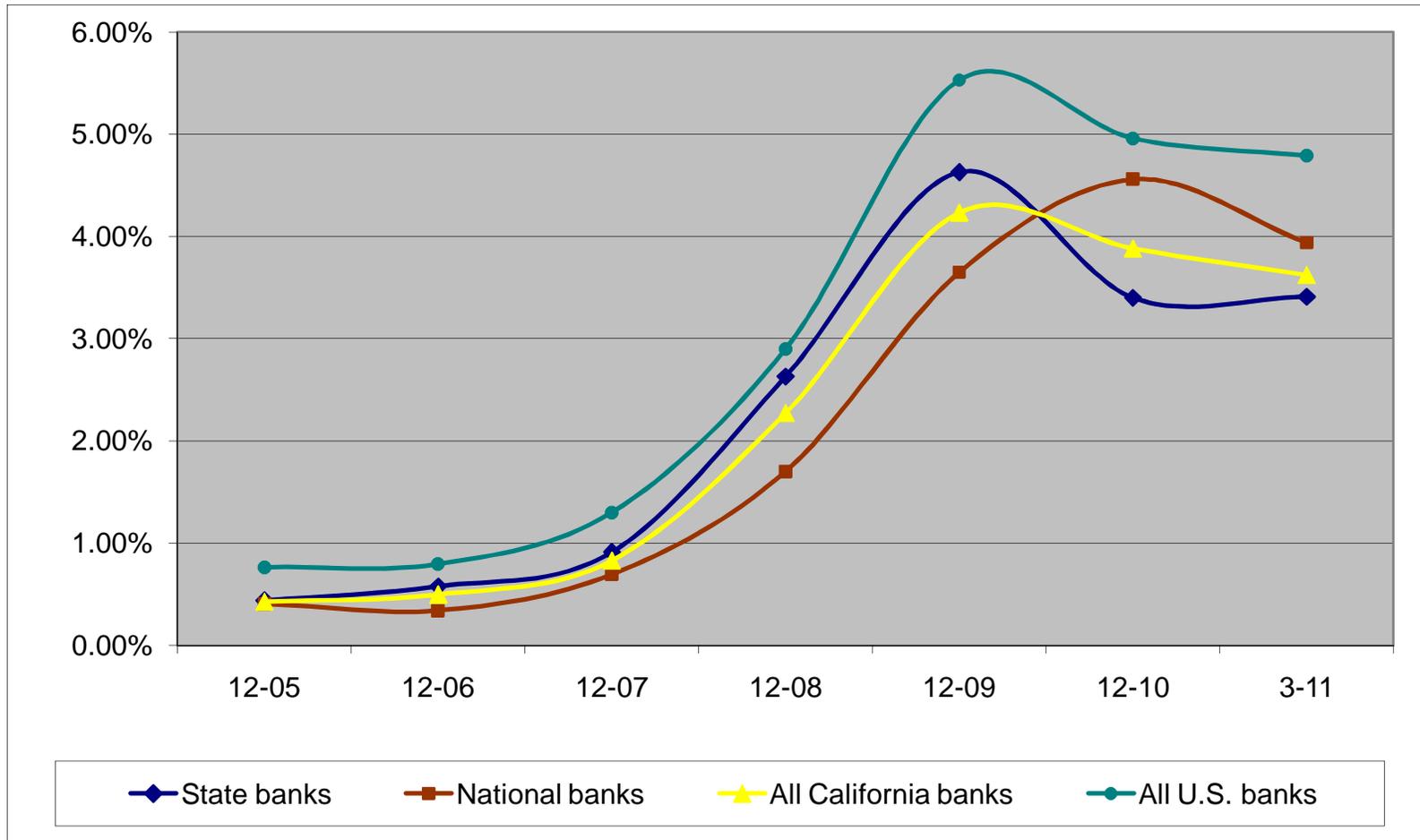
Annualized year-to-date through March 31, 2011

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	26	113	40	19	198
First Quintile	1.4	1.5	1.7	1.6	1.7
Second Quintile	0.6	0.8	0.8	1.1	0.9
Third Quintile	0.3	0.5	0.6	0.9	0.5
Fourth Quintile	-0.5	0.2	0.3	0.6	0.2
Fifth Quintile	-1.9	-1.1	-1.3		-1.3
Total	0.2	0.6	0.6	0.9	0.8

\* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

\*\* Due to the small population in this category, it was divided into four equal sized groups.

# Noncurrent Loans and Leases to Total Loans and Leases



## Noncurrent Loans & Leases / Total Loans & Leases by Quintile\* State Chartered Commercial and Industrial Banks

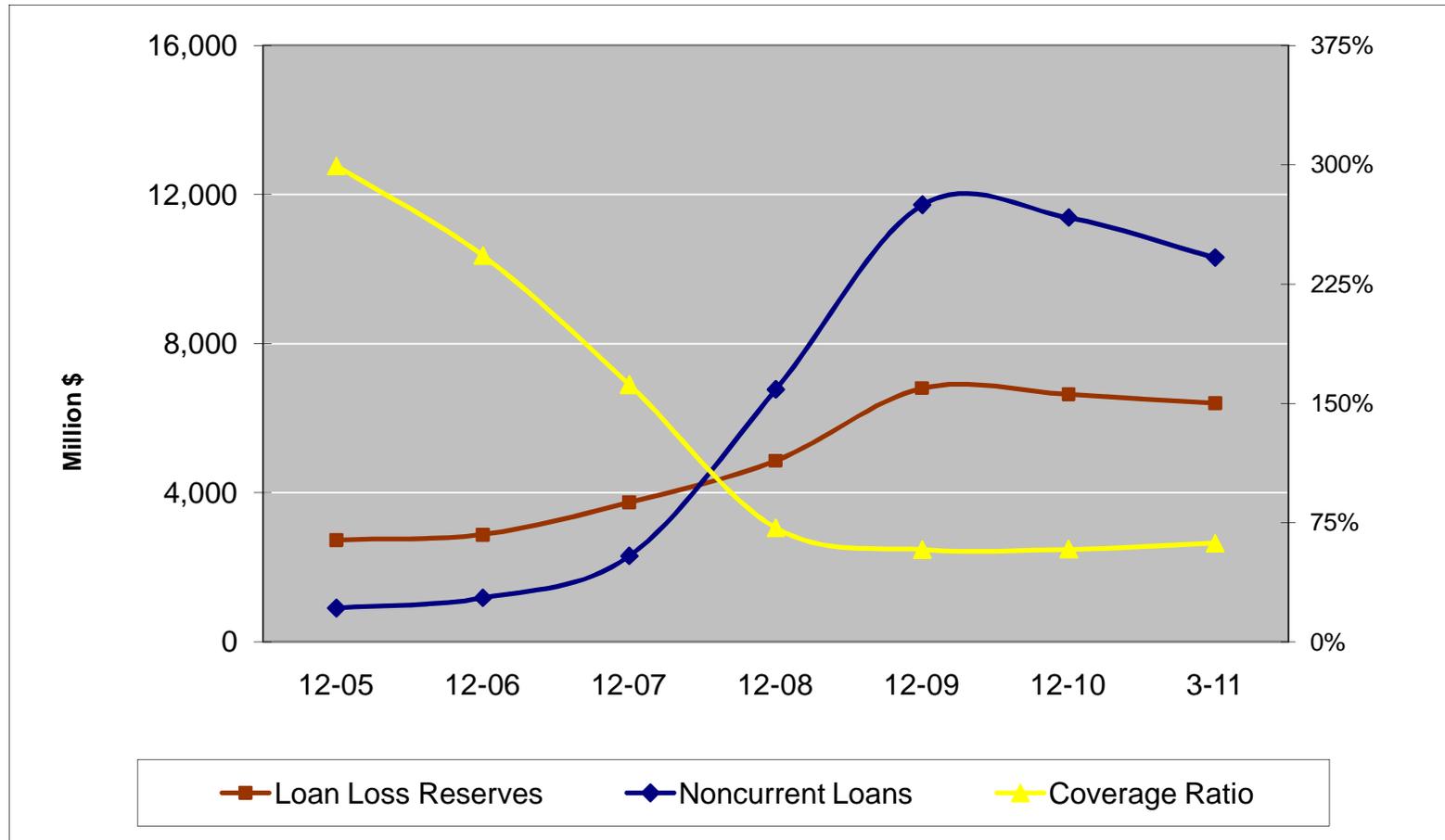
**As of March 31, 2011**

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	26	113	40	19	198
First Quintile	5.7	10.0	9.2	4.5	9.2
Second Quintile	3.3	4.6	5.2	4.2	4.5
Third Quintile	1.1	2.7	3.4	3.5	3.0
Fourth Quintile	0.1	1.2	2.2	2.0	1.3
Fifth Quintile	0.0	0.2	0.6		0.1
Total	2.5	3.7	4.1	3.3	3.4

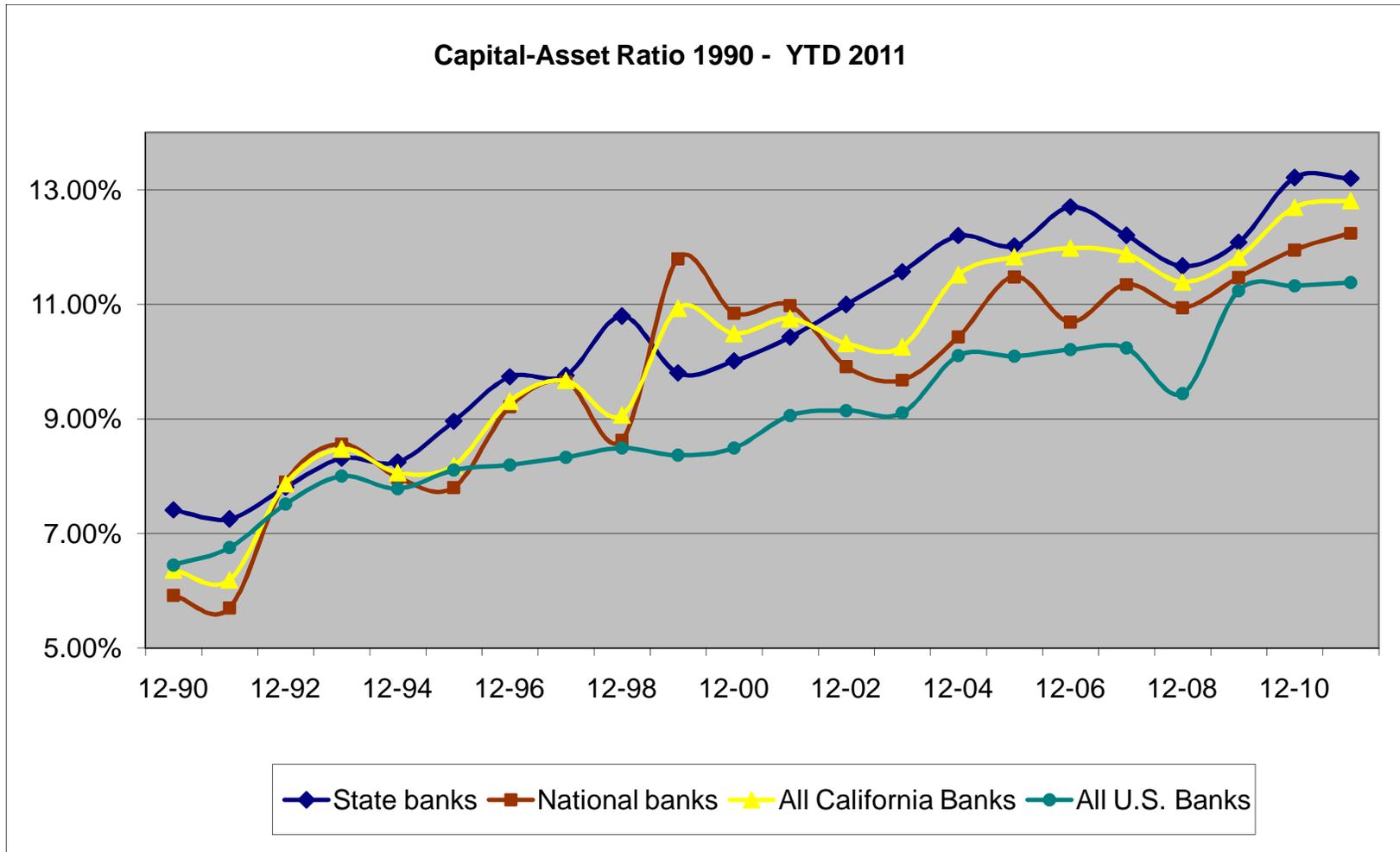
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# Loan Loss Reserves vs. Noncurrent Loans and Leases



# Capital Adequacy



## Equity Capital / Assets by Quintile\*

### State Chartered Commercial and Industrial Banks

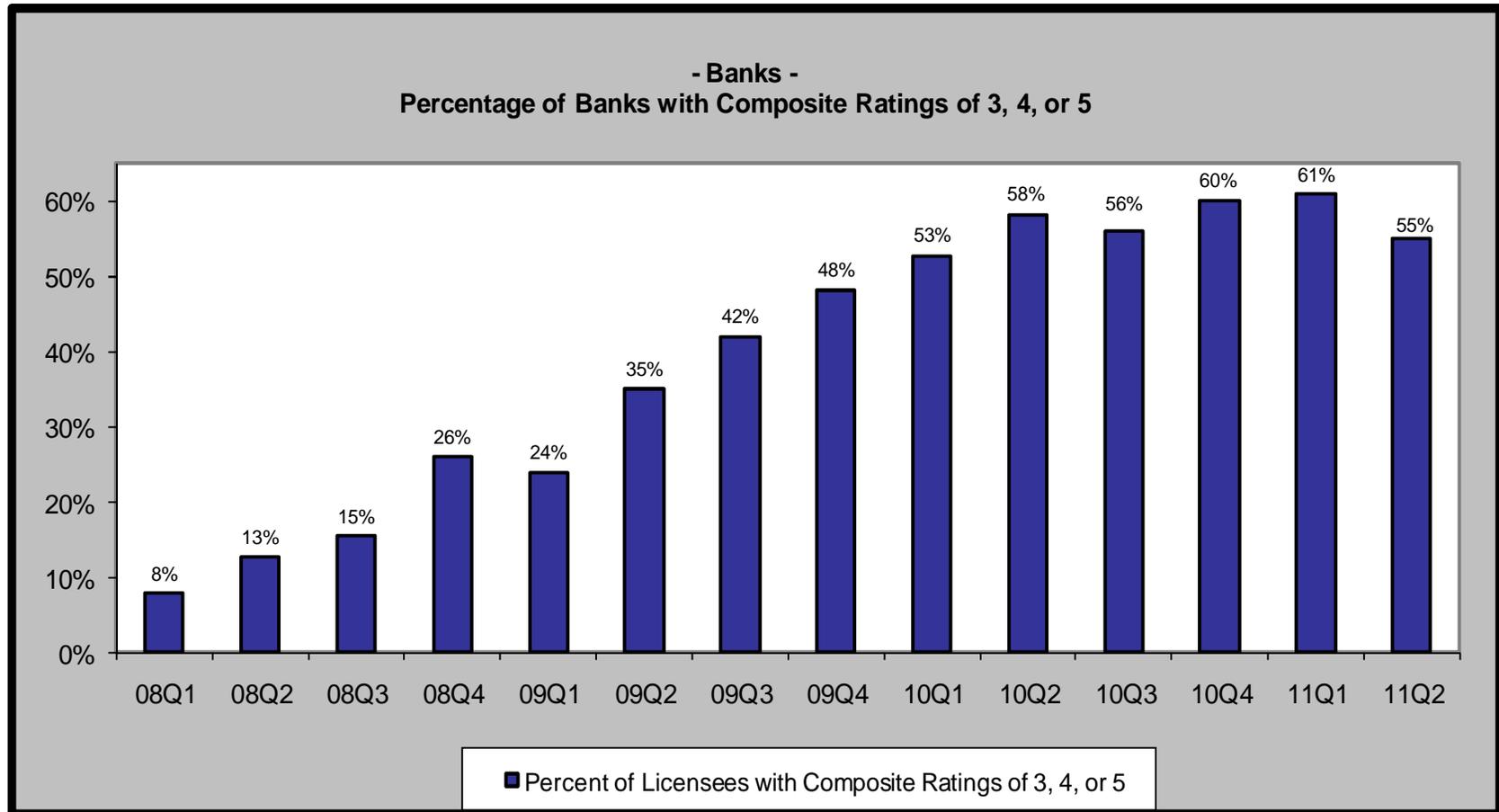
As of March 31, 2011

Asset Size	Less than \$100MM	\$100 to \$500MM	\$500MM to \$2 Billion	\$2 Billion and More**	Total
Number of Banks	26	113	40	19	198
First Quintile	27.1	19.5	21.2	13.9	21.9
Second Quintile	17.1	12.9	13.1	11.7	13.2
Third Quintile	12.3	11.4	11.5	10.3	11.5
Fourth Quintile	10.3	10.2	10.2	9.1	10.2
Fifth Quintile	7.1	8.1	7.7		8.0
Total	15.5	13.9	12.6	13.1	13.2

\* Quintiles of equal sizes are created by dropping off first the highest then the lowest ratio in each group until the number of institutions is divisible by 5.

\*\* Due to the small population in this category, it was divided into four equal sized groups.

# Decrease in Problem Banks



# Watch List Trending as of June 2011

<u>Exam Rating</u>	<u># Improving</u>	<u># Stable</u>	<u># Deteriorating</u>
3	27	23	11
4	5	8	13
<u>5</u>	<u>0</u>	<u>1</u>	<u>9</u>
All	32	32	33

# California Bank and Thrift Failures 2009 – Present

	State		OCC/OTS		Total	
	#	\$	#	\$	#	\$
2009	11	23,755,797	6	21,608,606	17	45,364,403
2010	9	4,626,697	3	4,650,500	12	9,277,197
2011 YTD	1	120,833	2	543,455	3	664,288
Total	21	28,503,327	11	26,802,561	32	55,305,888

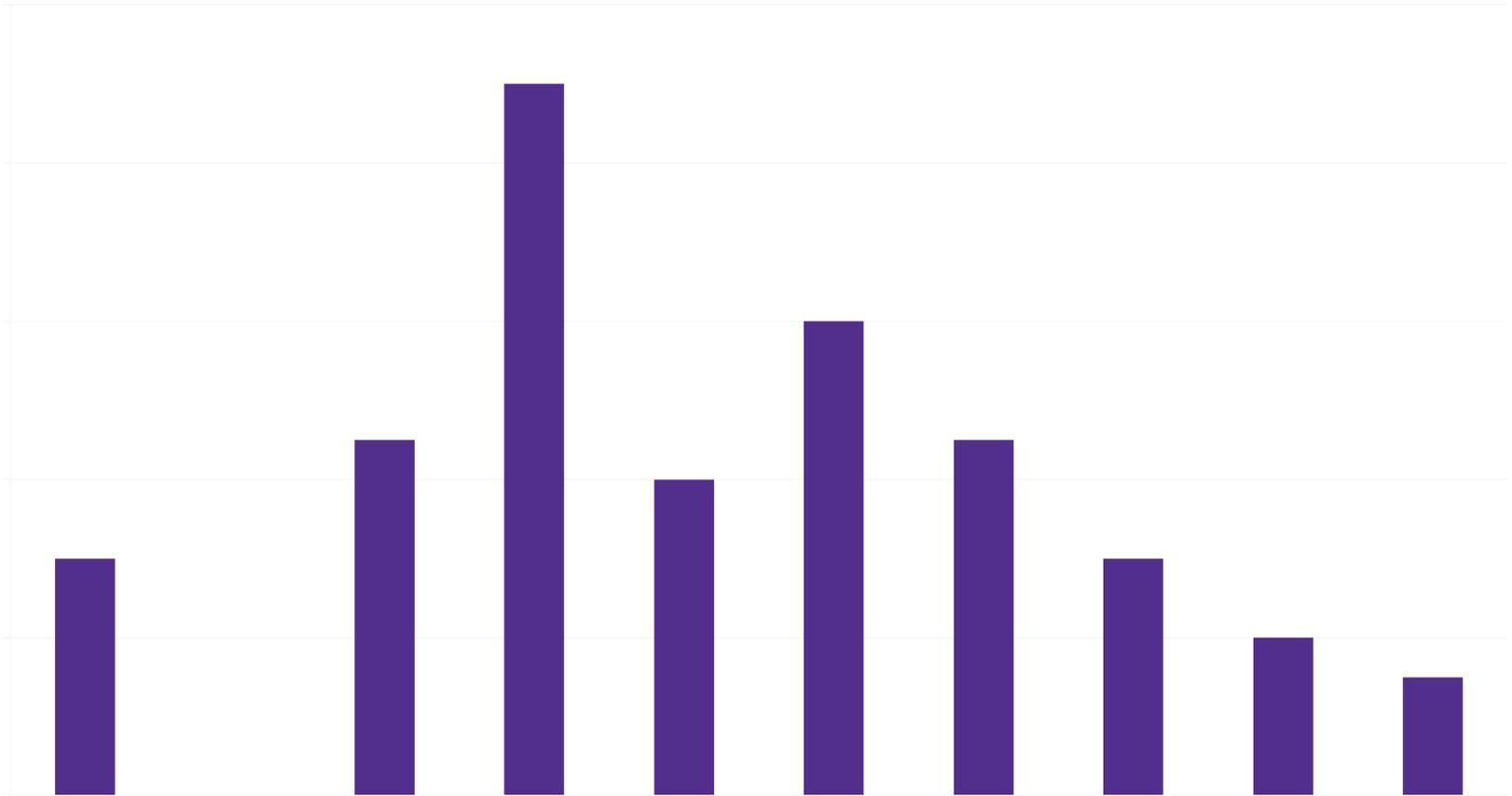
\* Total assets are in thousands as of quarter-end prior to failure.

# Equity Offerings by California State Chartered Banks Since 2009

- 46 state-chartered banks in California or their BHCs completed 91 equity offerings that raised \$6.5 billion.
- Number of completed offerings by CAMELS rating at the time of the offering:

<u>CAMELS</u>	<u>Rating at Offering Date</u>
1	0
2	25
3	34
4	19
5	8
<u>Unrated</u>	<u>5</u>
Total	91

# California Chartered Institutions Completed Capital Offerings by Quarter



# Capital Purchase Program All California Banks

Period Ending 6/30/2011 (in million \$s)

<u>Type of Bank</u>	Number that <u>Accepted</u>	Total <u>Purchase</u>	Total Capital <u>Repayment</u>	Total Treasury <u>CPP Investment</u>	Number of Banks <u>Remaining</u>
State Banks	53	1,948.8	800.7	1,148.2	40
National Banks*	15	686.7	417.6	269.1	8
Federal Savings Banks	5	46.5	24.2	22.3	3
Total	73	\$2,682.0	\$1,242.4	\$1,439.6	51

# Small Business Lending Fund

## State Banks - as of 7/19/2011

<u>Current Status - Applications</u>	<u>Number/Amount</u>
Application Review & Decisioning	33
Asset Manager Assessment	1
FBA/State Consultation	8
Preliminary Eligibility Check	4
Withdrawn During FBA/State Consultation	1
Withdrawn During Preliminary Eligibility Check	1
Applications funded	2
Total	50

# Small Business Lending Fund

State Banks - as of 7/19/2011

Current Status - Applications Number/Amount

## **Preliminary Eligibility Check**

Done 44

Pending 4

N/A 2

## **CPP/CDCI Refinance?**

Yes 25

No 25

# Small Business Lending Fund

## State Banks - as of 7/19/2011

Dollar amounts in thousands

### **Small Business Lending Fund**

Amount Requested:	\$631,345
Applicant's Maximum Possible Investment Amount:	675,080
Principal Remaining	422,832
Amount funded:	33,945

### **Other Applicant Information**

Applicant's Asset Amount	\$23,067,142
Applicant's RWA	16,972,553

Bank holding company: 19

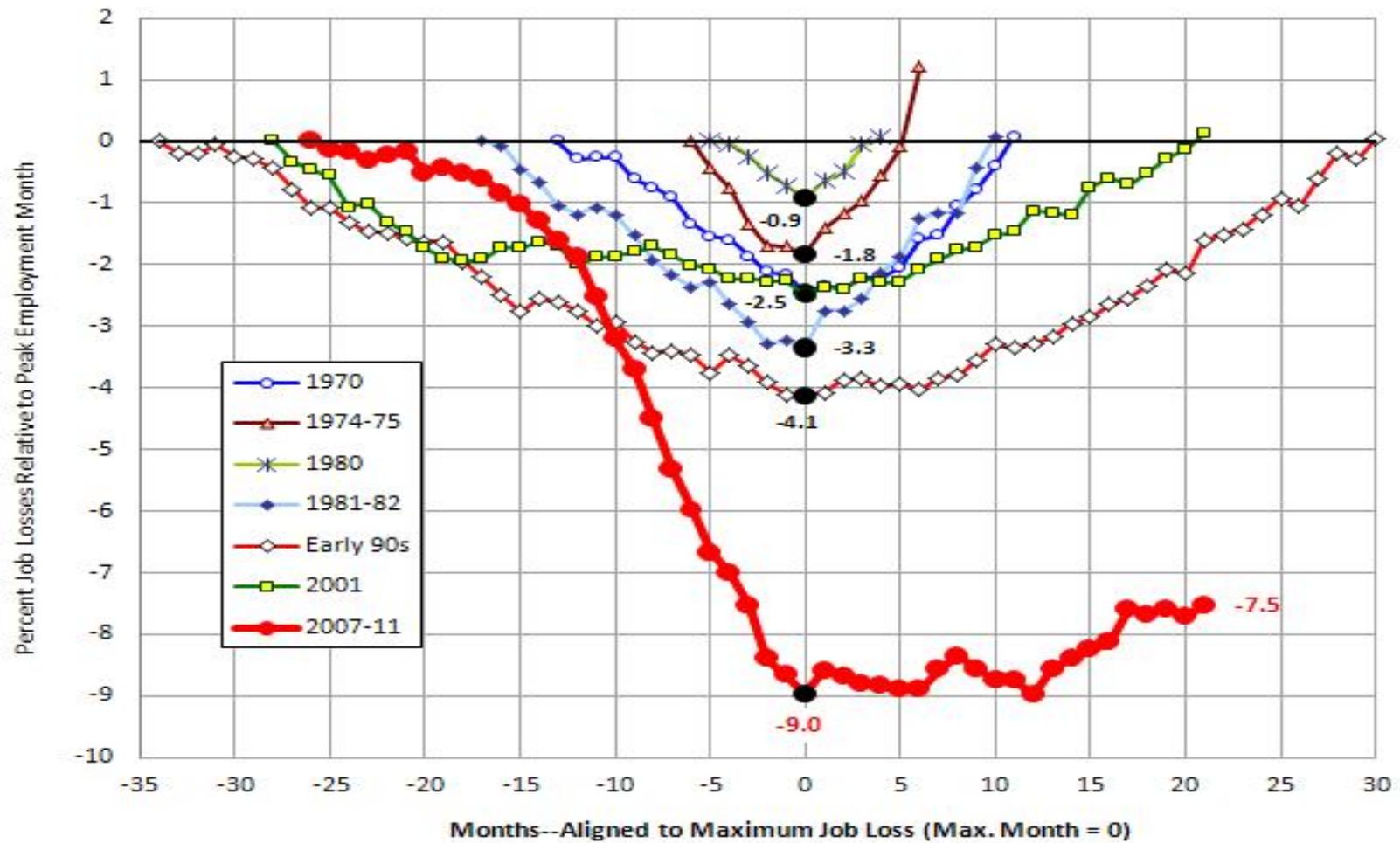
Bank: 31

## 2. The Economy and the Banking Challenges Ahead

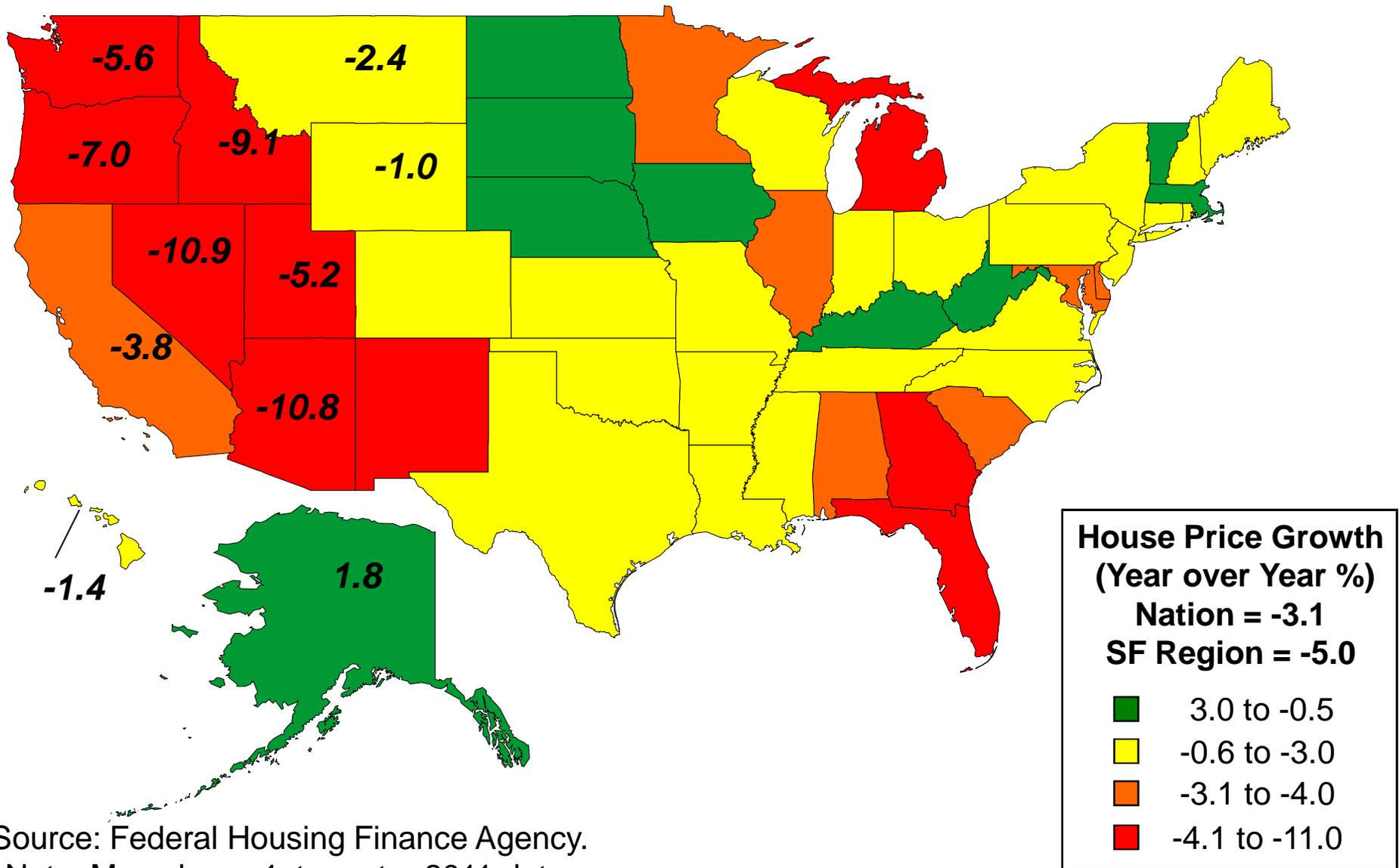
# Economic Conditions

- Economic recovery has been typically slow and faltering for a post-credit bubble environment
- CA underperforming the nation
- Pockets of improvement in real estate conditions, both commercial and residential, but valuations depressed
- Credit is contracting
- More than the normal amount of uncertainty over interest rates. Policy uncertainties elevated
- Global imbalances are a risk factor (e.g., Europe, China)

FIGURE 15  
**Percent Nonfarm Job Losses in California Economic Downturns 1970 to Present**  
**Aligned to Peak Job Losses**  
 (June 2011; Seasonally Adjusted Data)



# House Prices Still Falling in the West

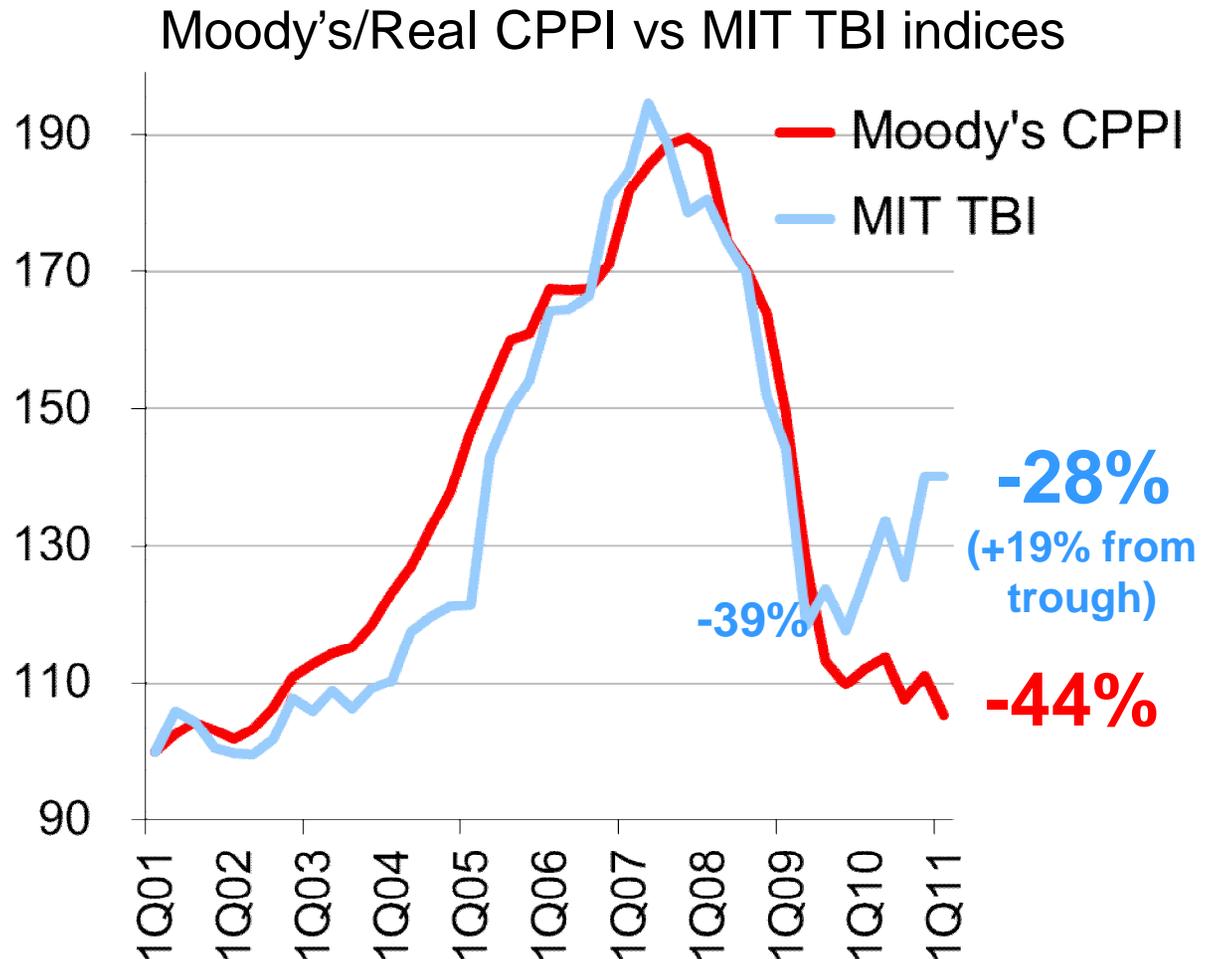


Source: Federal Housing Finance Agency.  
Note: Map shows 1st quarter 2011 data.

# CRE Values Down Sharply

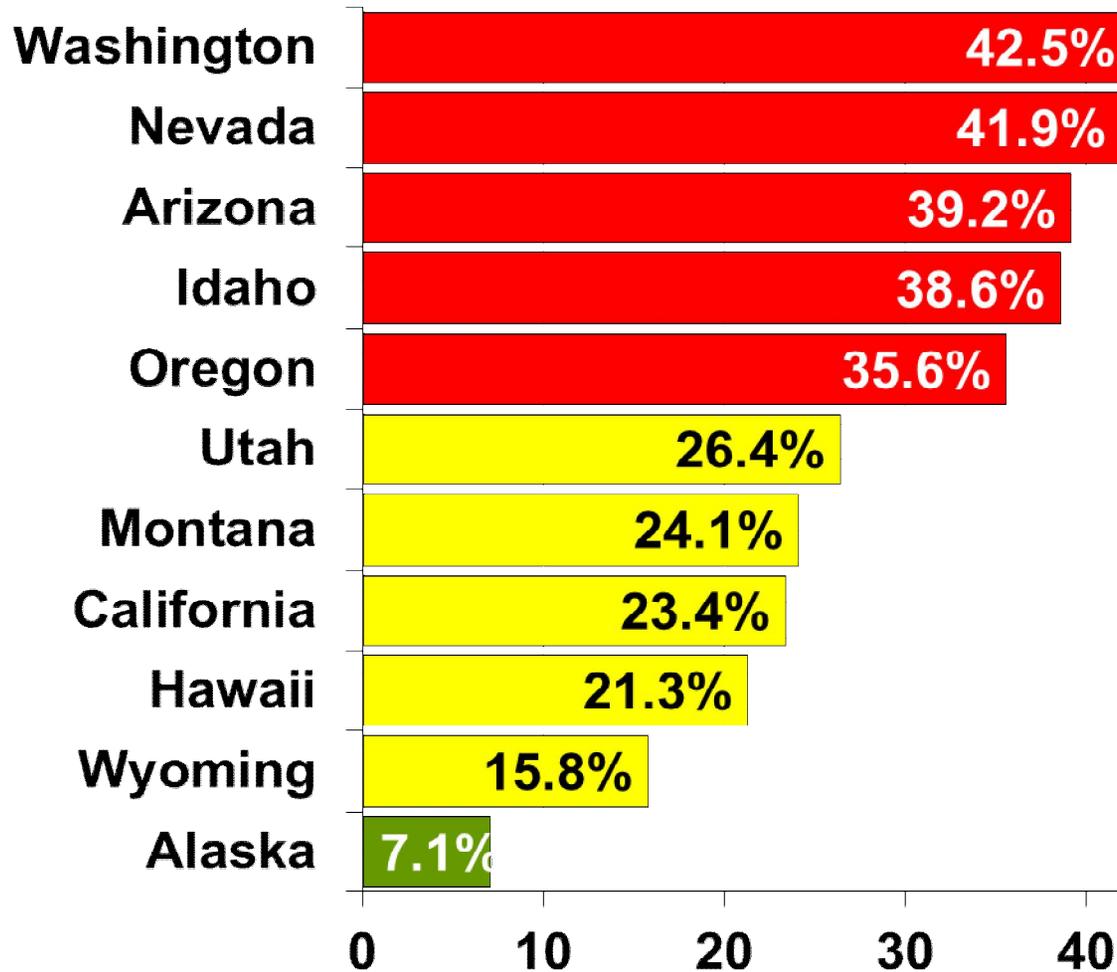
*MIT Index (Investment Grade Properties) vs. Moody's Over the Past Year*

- ▶ Moody's CPPI remains at lows, (impact of distressed sales)
- ▶ No recovery yet:
  - Secondary and tertiary markets
  - Class B/C properties
  - Nonstabilized (less than fully-leased) properties



Sources: Moody's/REAL Commercial Property Index; MIT Transaction Based Index, Haver Analytics; Indexed at 100 at 1Q2001.

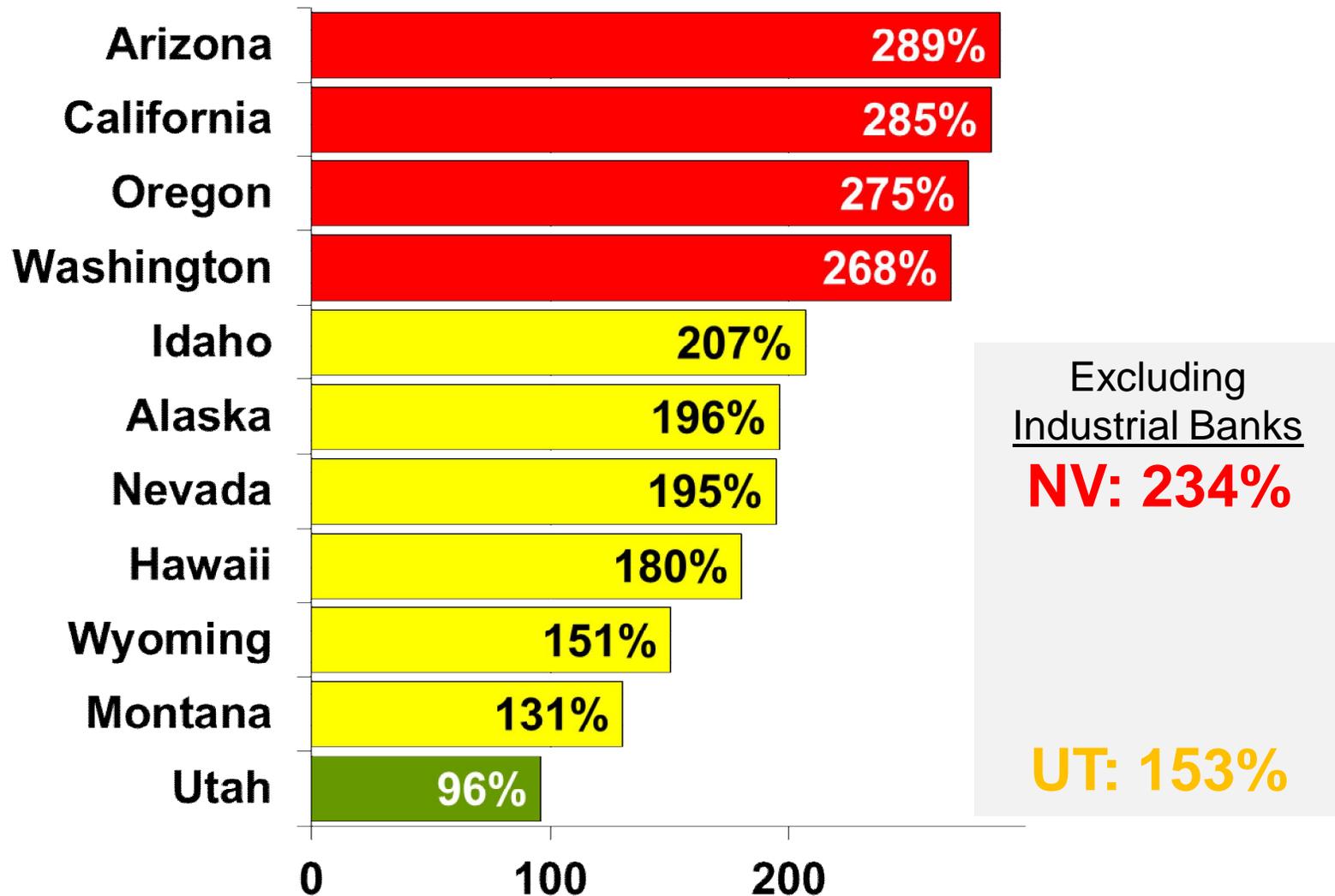
# Average Texas Ratio for Banks by State



Excluding  
Industrial Banks  
**NV: 63%**  
**UT: 45%**

Excludes De-Novo banks; Texas Ratio: loans past due 90+ days or on nonaccrual plus other real estate owned/Total equity + ALLL)

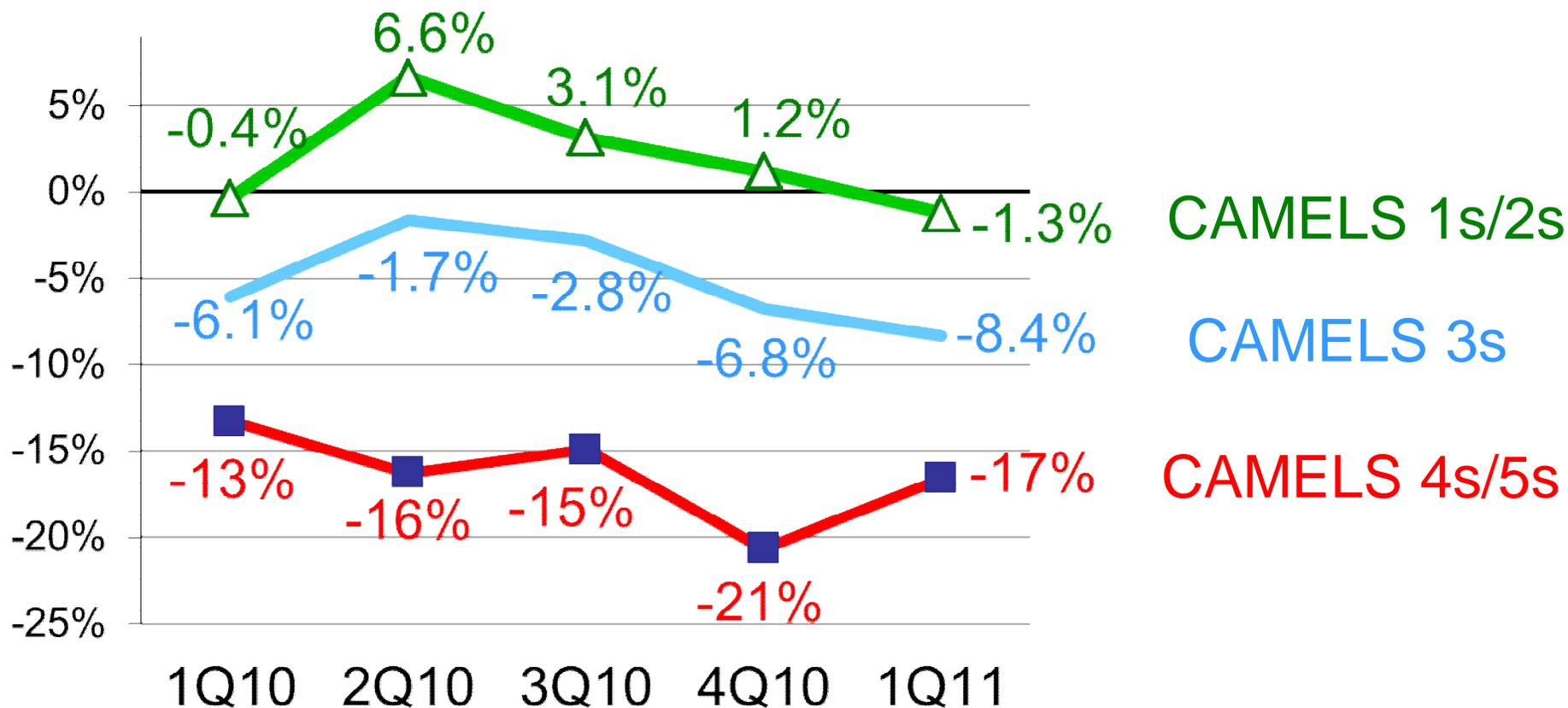
# Avg. CRE Income Property Loan Concentration Ratios (as of 3/31/11)



# Vulnerable by Both Metrics

<u>tier</u>	State	Texas Ratio Risk	CRE (NFNR) Concentration Risk
<b>1</b>	Nevada – commercial banks	<b>Very High</b>	<b>High</b>
	Arizona	<b>High</b>	<b>High</b>
<b>2</b>	Washington	<b>High</b>	<b>High</b>
	Oregon	<b>High</b>	<b>High</b>
	Idaho	<b>High</b>	Moderate
<b>3</b>	Utah – commercial banks	<b>High</b>	Moderate
	California	Moderate	<b>High</b>

# Annualized Quarterly Loan Growth by CAMELS Rating



Based on a panel of District commercial banks; excludes banks with significant mergers, loan sales or loan purchases over the period

# Regulatory Influences on Smaller Banks

- Banks < \$10B fared relatively well in Dodd-Frank. But regulatory expectations are rising.
- Indirect impact of Dodd-Frank on large banks and other “SIFIs” could level the playing field somewhat -- Have markets really accepted the idea that TBTF is over?
- Will CFPB really protect consumers? Will it be a compliance nightmare? Both? Neither?

➤ Lessons Learned.

➤ What Should Banks Do Now?

# Lessons Learned (Part 1)

- “Great moderation” created complacency.
  - Some banks lost their way in a drive to achieve ROE targets without fully understanding their risks
  - Credit and risk management disciplines eroded
  - Brokered deposits and transactional-based lending strategies didn't work
  - Too many banks competing for talent and customers

## Lessons Learned (Part 2)

- Key differentiator between successful and unsuccessful banks is quality of management and board governance.
  - Effective directors and good governance are essential
  - A risk management framework appropriate for size, strategy, complexity
  - Good execution against this framework
  - Ability to identify and remediate weaknesses promptly
  - Open and honest communication with regulators

# Key Elements of Effective Governance

- Board members and management have the expertise and integrity to fulfill their roles.
- Board and management have effective processes and committee structures to set objectives and achieve them.
- Information presented to the board is complete, accurate and presented in an understandable manner.
- Board has established processes to properly oversee and evaluate management and control functions and assess its own effectiveness.
- Internal audit function conducts independent, risk-based and effective audits.
- Board has knowledge of and controls over all potential conflicts of interest at board and management levels.

# Common Governance Weaknesses

- Board lacks experienced, capable financial professionals with knowledge of regulations/guidance.
- Board is dysfunction (e.g., factional, distrustful, dominated by an individual or small group, unengaged, unprepared, etc.)
- Board is too trusting of the CEO & management. Dominant CEO controls the bank.
- Lack of formalized processes for management evaluations – both management structures and executive competencies. Board relies excessively on regulatory assessments of management.
- Lack of independence & stature for risk management functions.
- Weak or inactive risk committee structures at board and management levels.

# What Should Banks Do Now? (Part 1)

- A sober-minded assessment of your condition, capabilities and prospects is a must
- Is your capital adequate for your risks and opportunities?
  - Capital is available for banks with good management, strong relationships with customers and a good base of core deposits for balance sheet repair, organic growth and acquisitions.
- Is your business plan viable in the new environment?

## What Should Banks Do Now? (Part 2)

- Honestly assess your capabilities as an organization
  - Management depth and quality
  - Approach to risk management
  - Board self-assessment
- A generation of bank CEOs is on the verge of retirement – do you have a viable succession plan or exit strategy?
- Regulatory relations – No surprises -- communicate! Timely resolutions of issues/MOUs/orders. Repair institutional weaknesses that regulators identify

And Finally,

Even in an uncertain economy, there are good lending opportunities and growing businesses to support!

Thank you!