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VIEWPOINTS

Carnage Shows Value Of Emphasizing Basics



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This coming year is shaping up to be the most momentous one for finance in our lifetimes.

The shape of finance to come will be forged in the crucible of near-Depression era economics and increasing financial failures. For most institutions, it is impossible to change course, but for many, trimming the sails in ways I will suggest below will mean the difference between a modestly successful year and a much worse one.

Stimulus and government intervention will get us through the storm sooner or later, but the fact of the matter is that we are not nearly through the financial hurricane at this point.

Dozens of books will be written about what went wrong over the past decade, particularly last year, and we will learn important lessons as the real details emerge.

Certainly when we look at the wreckage of the past year, it is heart stopping. We have witnessed the failure or disappearance as independent entities of Bear Stearns, Lehman Brothers, Merrill Lynch, Wachovia, Washington Mutual, Countrywide, and

National City; the nationalizations of Fannie Mae, Freddie Mac, and American International Group; the partial nationalizations of the nine largest U.S. financial institutions; and the \$50 billion Madoff fraud case affecting a remarkable number of what would have been considered astute investors and investment advisers.

From this list of calamities, which could readily be expanded by an additional page or two, certain facts on the ground have emerged.

- The traditional bank/bank holding company charter, with its insured deposit base, will be the core for the American financial system for much of the 21st century.

- Retail deposit funding has a much greater value than has been perceived for decades.

- A fortress balance sheet with deep wells of liquidity is the bedrock of survival in troubled times.

- Strong management teams that understand their risks and rely on traditionally strong underwriting standards do materially better than those that do not.

- Strong risk management and compliance systems differentiate winners and losers and will do so even more in the coming decades.

- Quantitative constructs and complex structures that are not fully understood by

executives and boards can be toxic, as can excessive leverage.

- Ventures where the customer is taken advantage of come to no good.

- “Too big to fail” is not a theory — it is a reality.

These facts and new realities, among others, suggest steps to take this year that will help good companies avoid being shipwrecked as the storm continues to rage.

You cannot have enough solid, customer-based deposits. Of course, longer-dated deposits, particularly those that match bank asset strategies, are of particular value, and this is the ideal time to collect them, since customers will turn away from the turbulent markets.

For the next year, at least, the rewards will rarely offset serious risk-taking. Conversely, strong underwriting standards, where repayment sources include strong cash flows and good collateral values, will pay real dividends.

Your first loss is your best loss. Vigorous efforts to collect and restructure on stronger terms when customers go delinquent are essential to any substantial recovery.

At the same time, going the extra mile to help homeowners and solid customers work through this difficult period will enhance the value of your bank, both with regulators and in your community.

Examinations will be tougher this year

and next, and those who are ready for their exams will be rewarded for it. Safety and soundness — credit, market, and operational risk — will be at the core of bank exams, but compliance with the CRA and other rules will continue to be important.

The more you and the banking industry as a whole rely on government money, the more the government will be in your business. You may have taken Tarp funding, and you may have to take Tarp money, but you need to understand that it will increasingly come with strings attached.

The longer the banking system is on the public dole, the more demanding the public and Congress will be with the recipients. Lim-

its on executive pay and profitability, along with required lending programs, will be some of the costs for government support.

I realize that none of this is particularly cheery news. However, for those who are unusually cautious in the coming year and follow the historic tenets of sound banking, the coming years will be sunny.

Marginal competition will be taken out of the market, pricing will be more rational, and customers will come back to the bank as the home base for their financial futures.

Hugh McCulloch, the first comptroller of the currency, was right in 1863, and he is right today.

In his letter articulating the principles by which banks should operate, he wrote:

“Every banker under the national system should feel that the reputation of the system in a measure depends upon the manner in which his particular institution is conducted and that, as far as his influence and management extend, he is responsible for its success; that he is engaged in an experiment which, if successful, will reflect the highest honor upon all who are connected with it, and be of incalculable benefit to the country, but which, if unsuccessful, will be a reproach to its advocates and a calamity to the people.”

Mr. Ludwig was the comptroller of the currency from 1993 to 1998. He is now the chief executive officer of Promontory Financial Group LLC, a Washington consulting firm.