



Unraveling the Economy & Regulatory Outlook

*Presented by: Steve Brown
President & CEO*



Goal of Presentation



- Economic
- Regulatory
- Preparation



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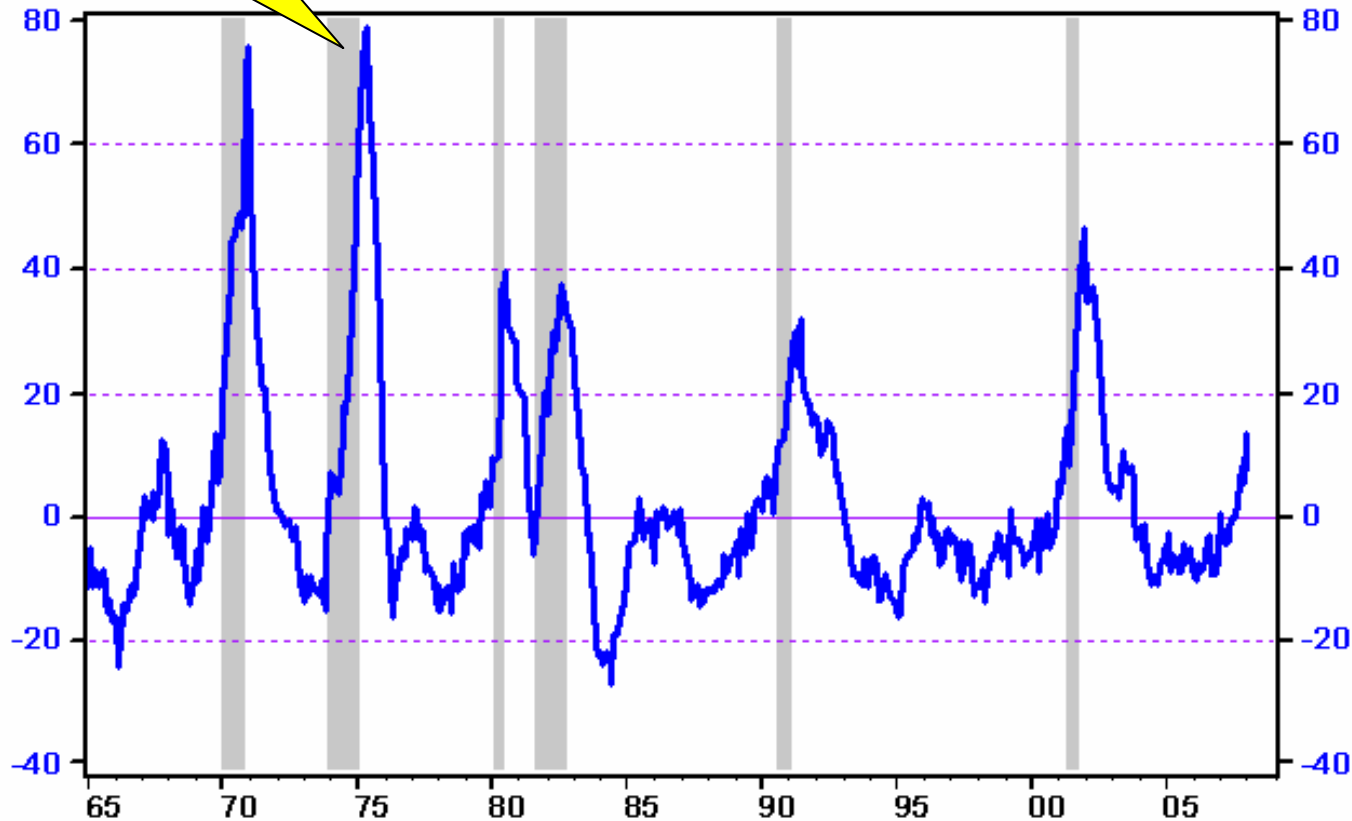
Unemployment Is Up



Gray bars are stated recession periods

Number of Unemployed

% Change - Year to Year



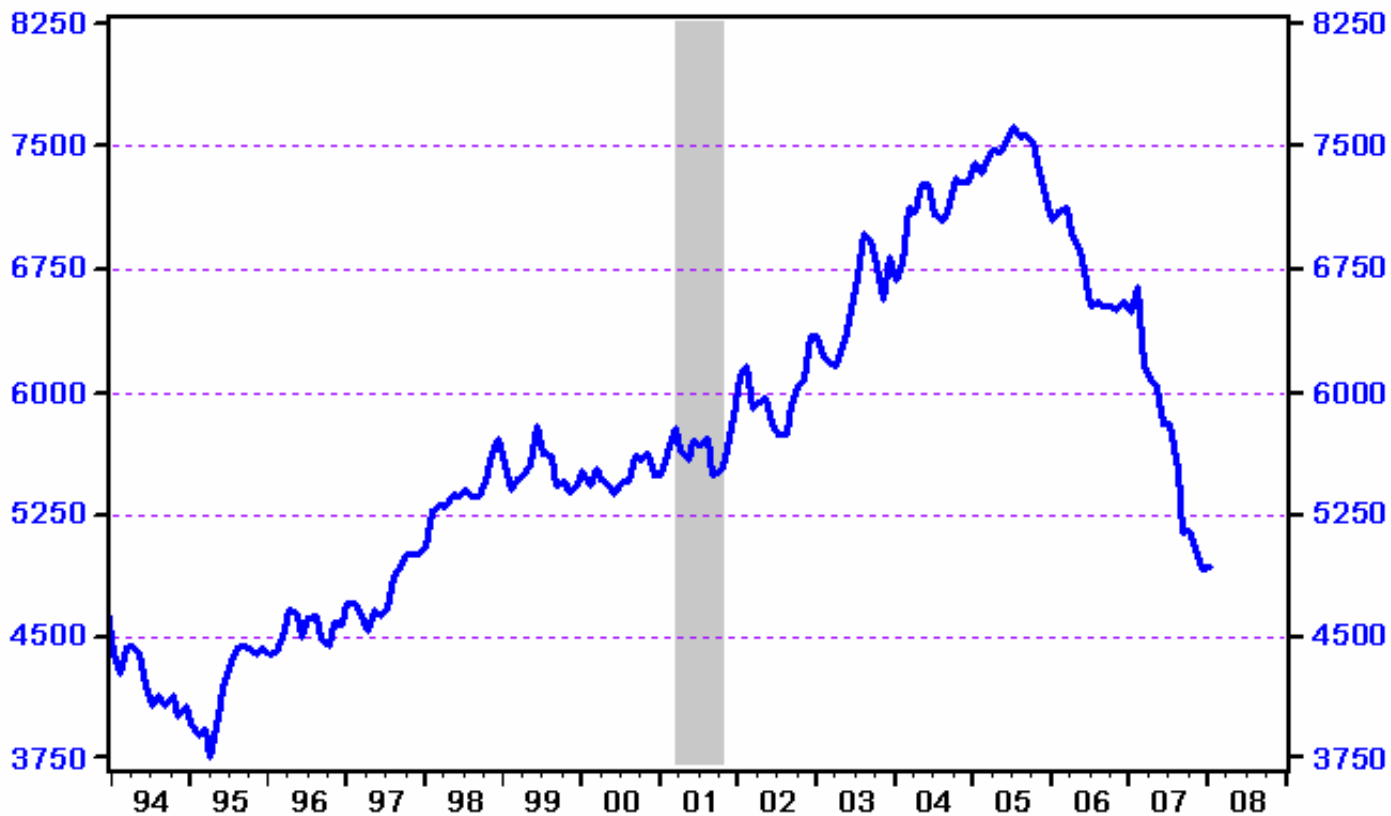
Source: Bureau of Labor Statistics /Haver Analytics

Home Sales Have Collapsed



Home Sales

Thousands of Units



Source: Haver Analytics

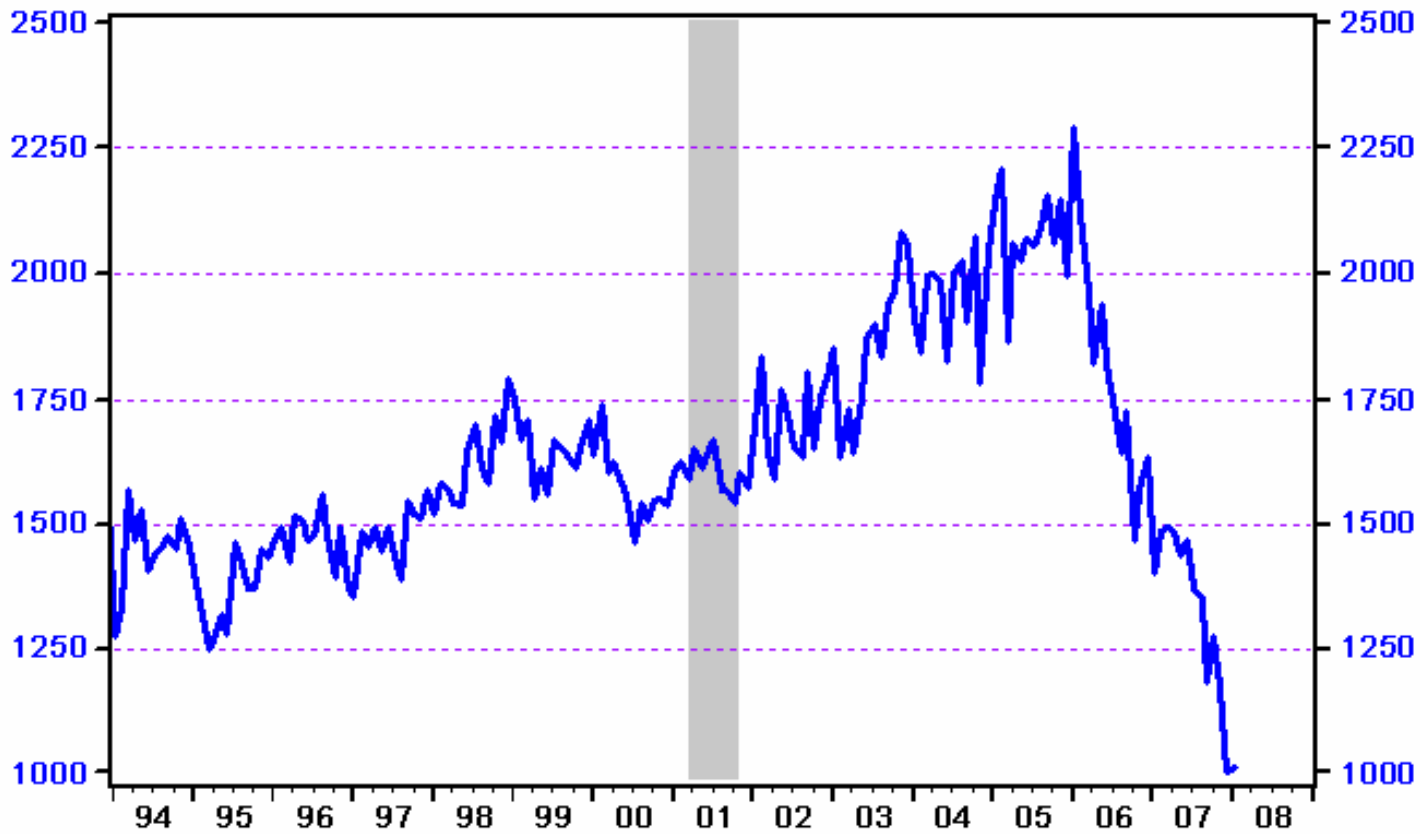


Housing Starts Have Plunged



Housing Starts

Thousands of Units



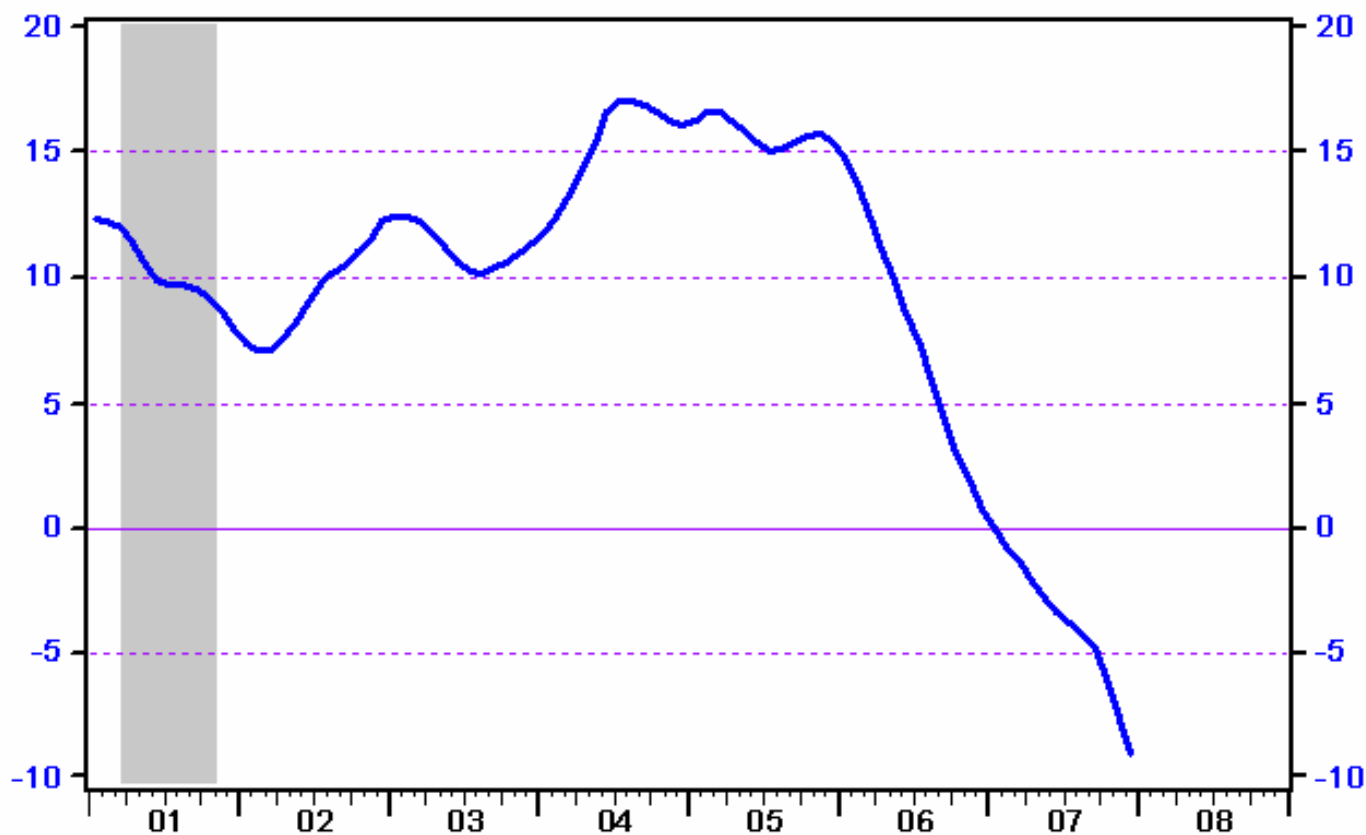
Source: Census Bureau /Haver Analytics

Home Prices Have Tanked



Case-Shiller Home Price Index: 20 Metro Areas

% Change - Year to Year



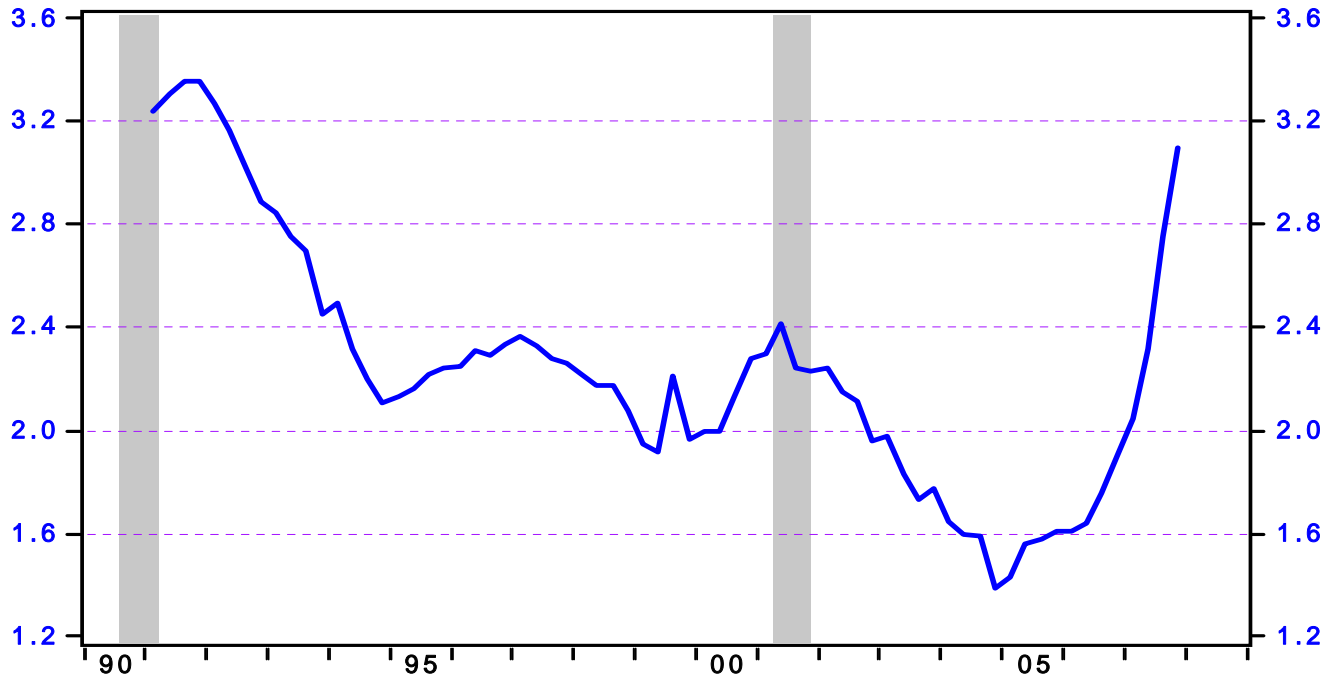
Source: S&P, Fiserv, and MacroMarkets LLC /Haver Analytics



SFR Delinquency Is Up



Residential Real Estate Loan Delinquency Rate
Percent



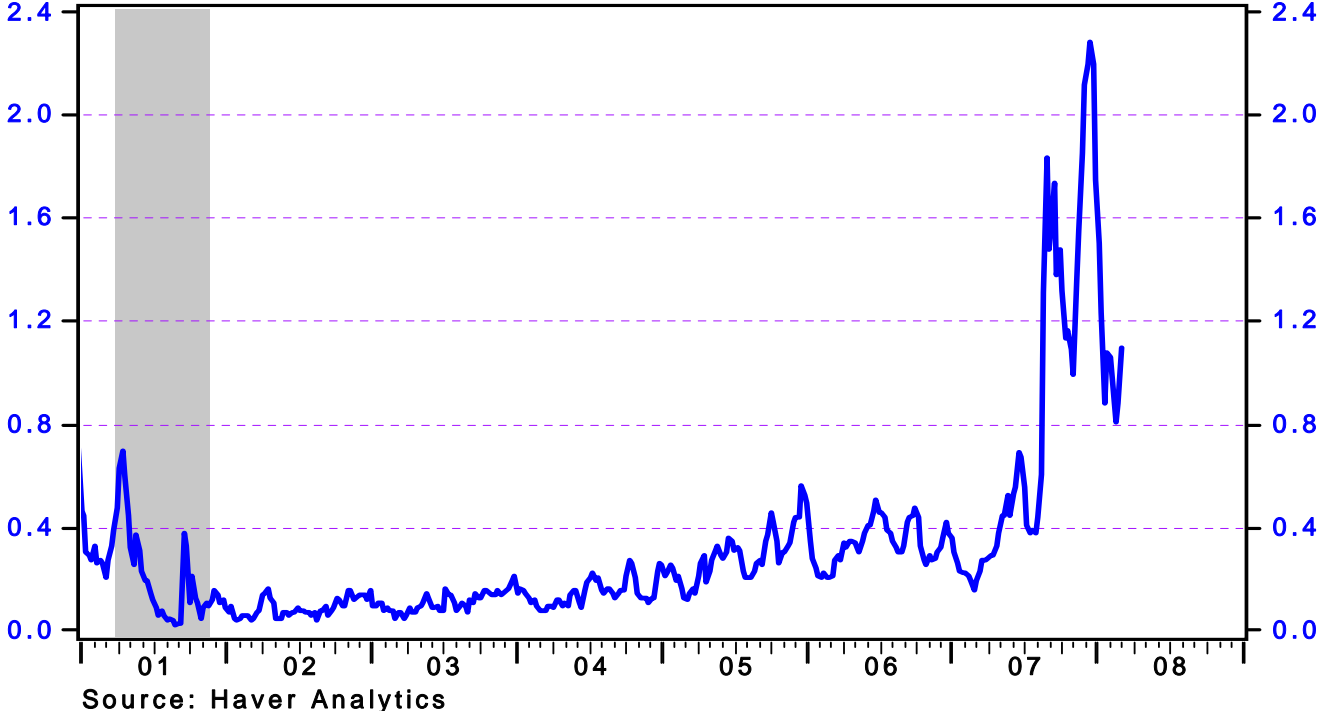
Source: Federal Reserve Board /Haver Analytics



Result Is A Liquidity Crisis



Liquidity Spread: 3-Month LIBOR minus 3-Month Treasury
Percentage Points

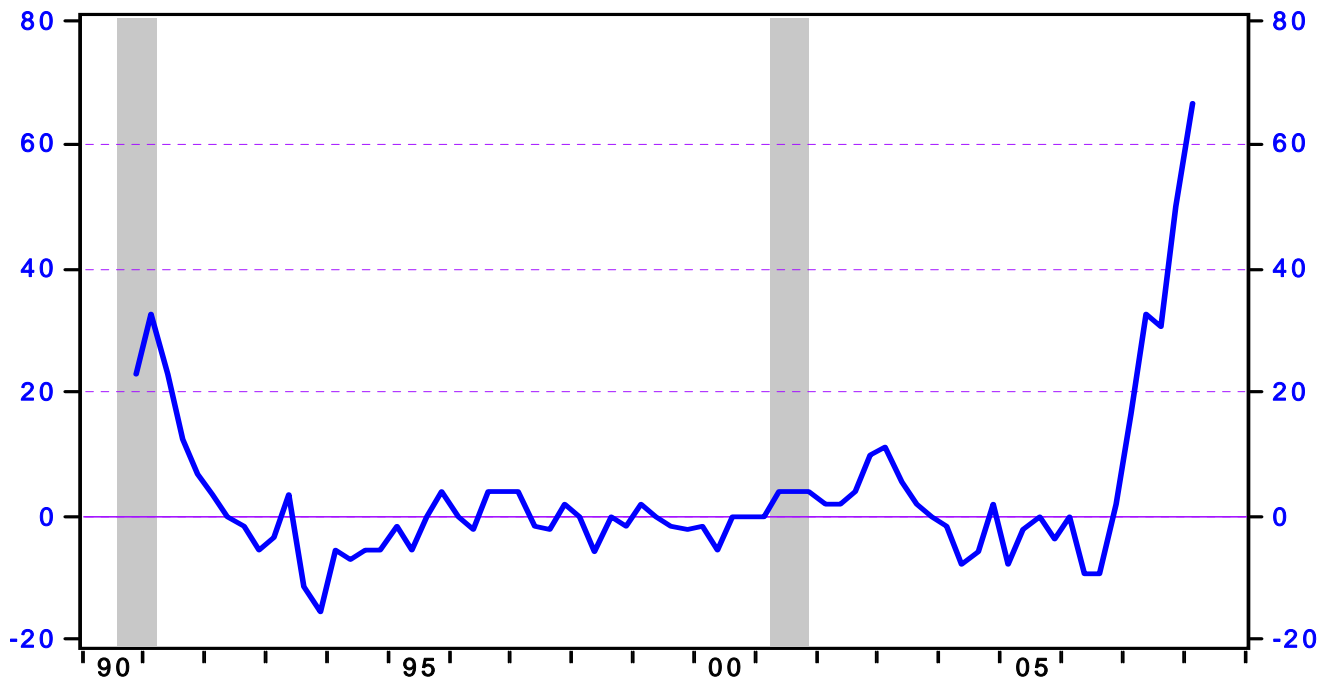


In Response, Banks Have Tightened Credit



Banks Tightening Residential Mortgage Standards

Percent



Source: Federal Reserve Board /Haver Analytics



Spreads Have Widened Sharply



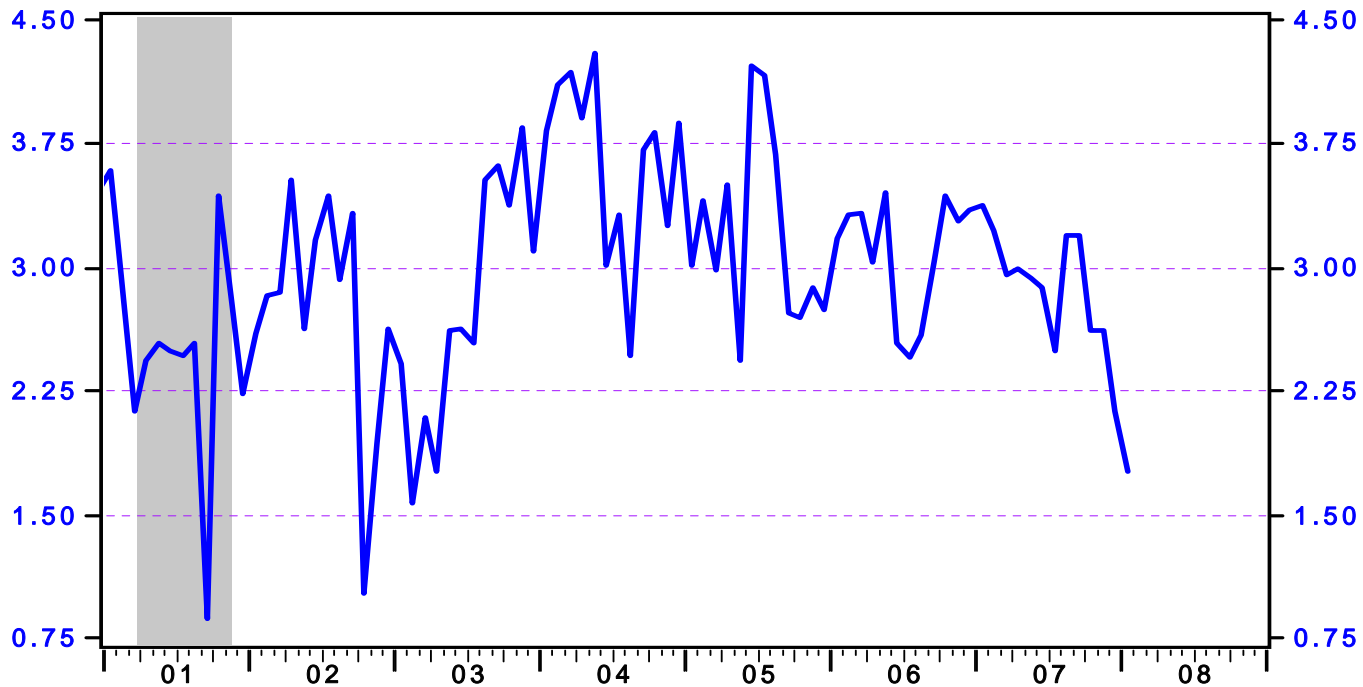
Yield Spread: 30-Year Fixed Mortgages minus 10-Year Treasuries
Percentage Points



Consumer Worries Have Jumped, Reducing Spending

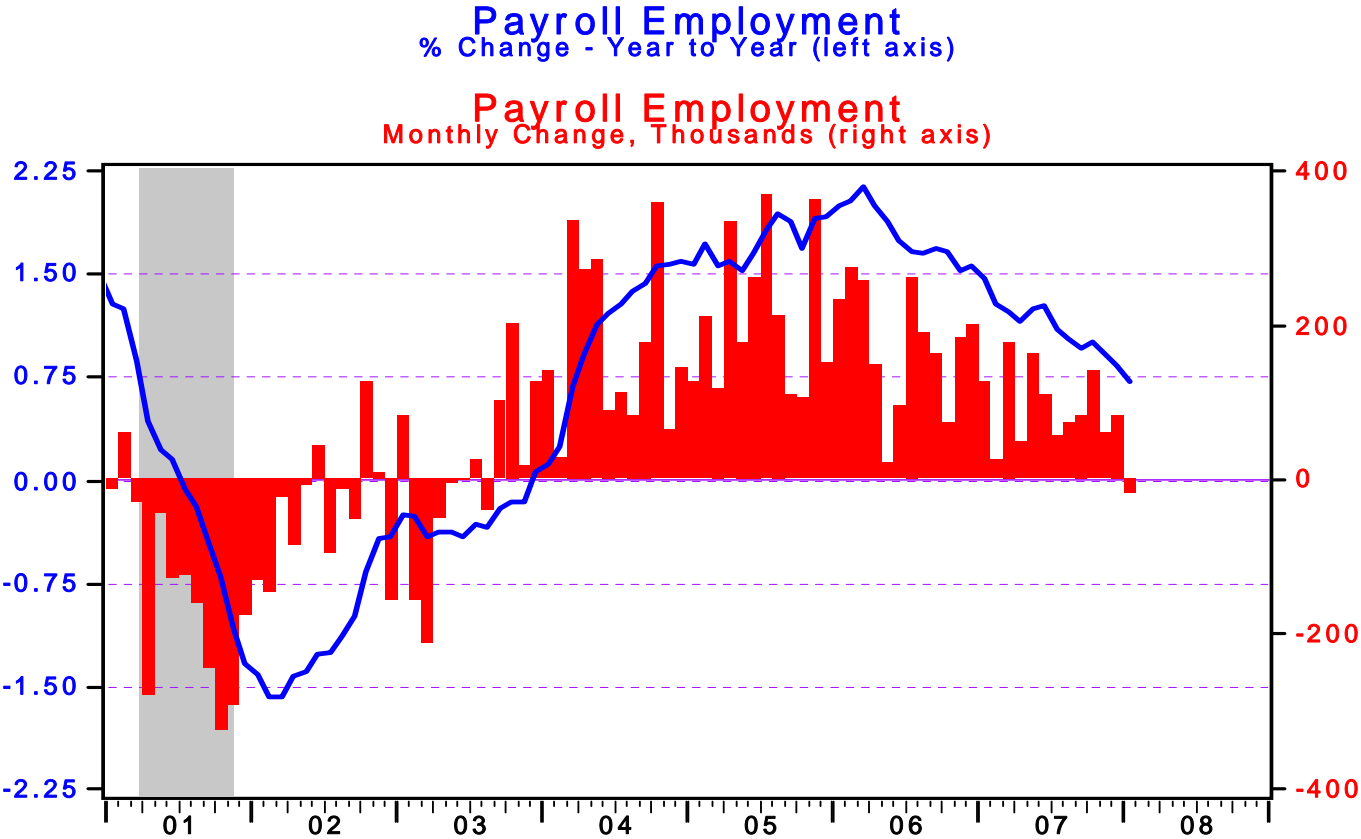


Real Consumer Spending
% Change - Year to Year



Source: Bureau of Economic Analysis /Haver Analytics

Hiring Is Also Way Off

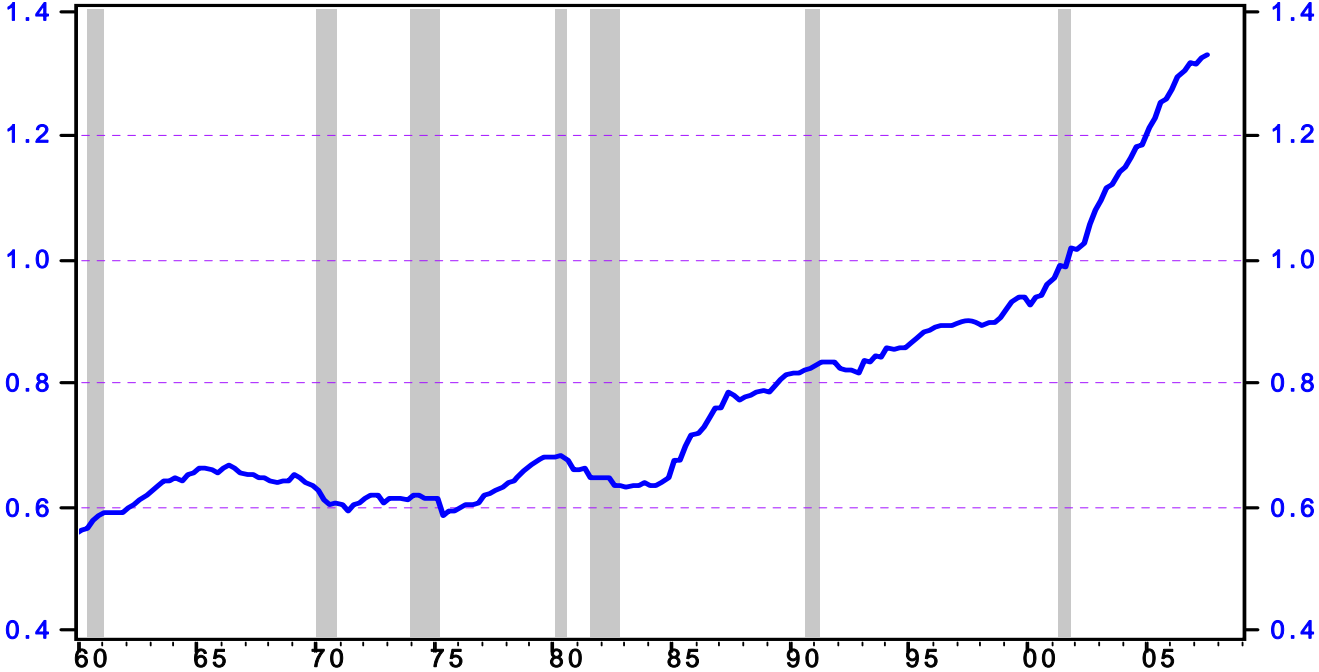


Households Are Highly Leveraged



Household Debt-to-Income Ratio

Percent



Source: Haver Analytics

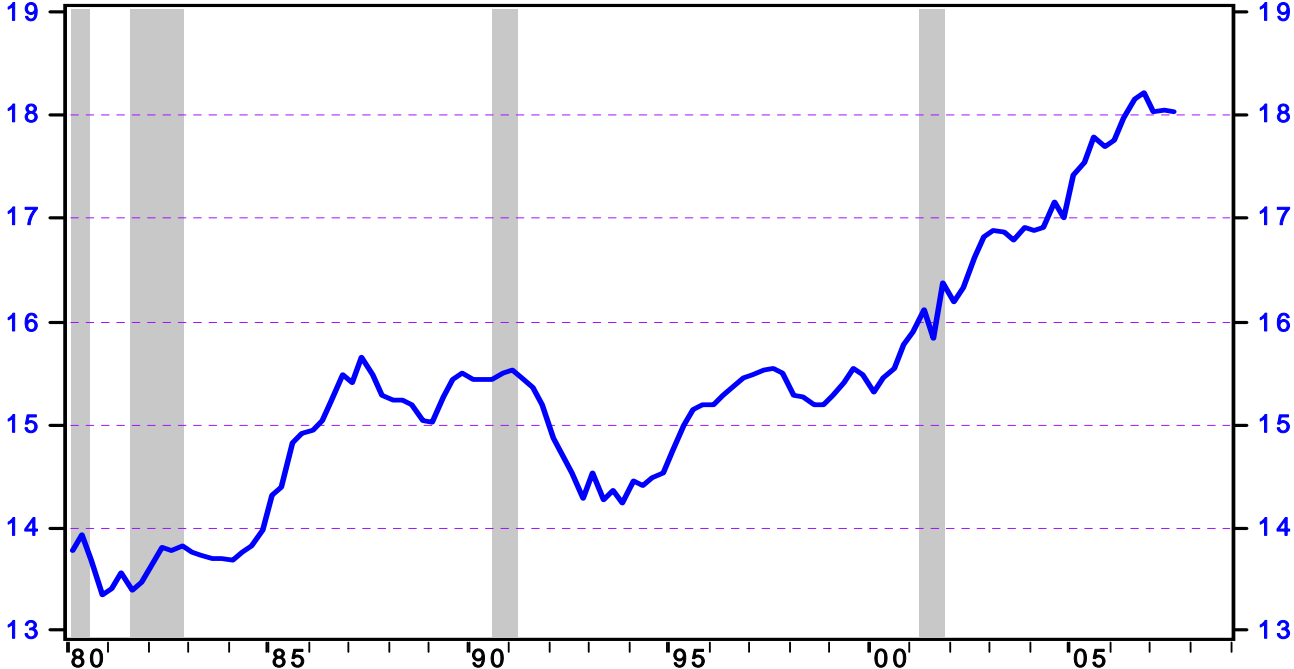


No Room For More Debt



Homeowners Financial Obligation Ratio

Percent of Disposable Income



Source: Federal Reserve Board /Haver Analytics

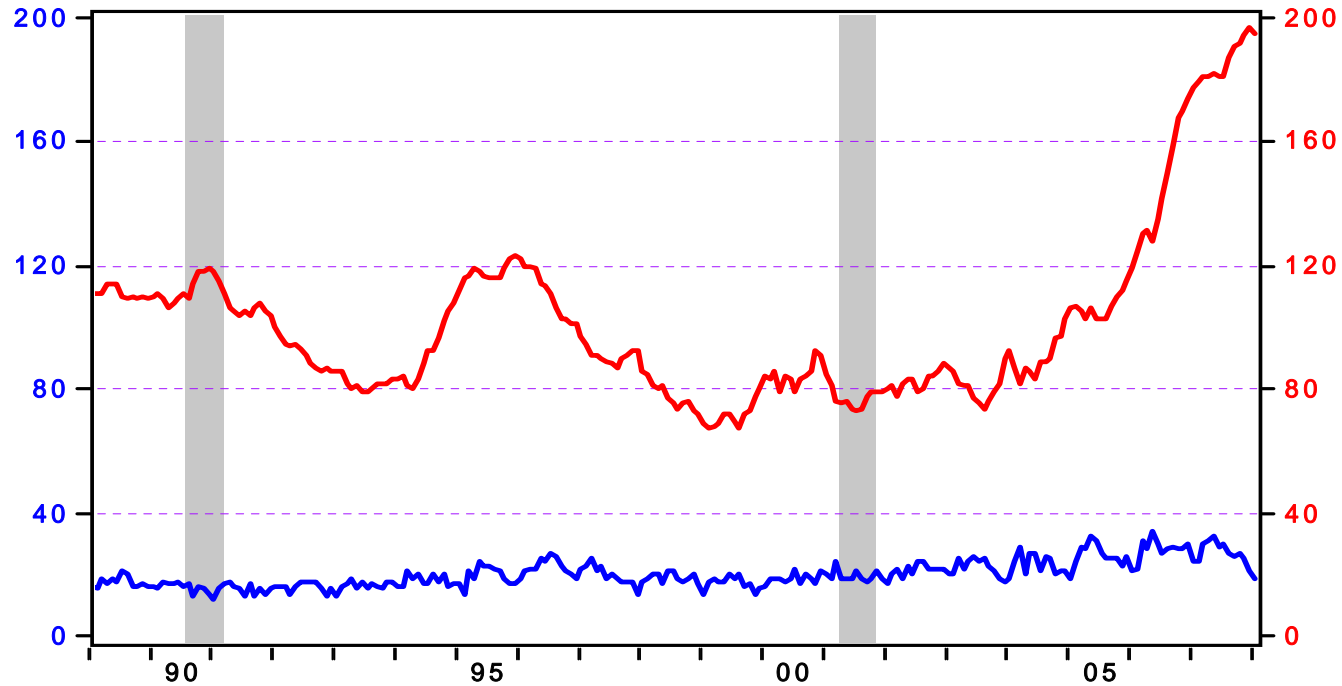


Lots Of Work To Do In Housing



Sales of Completed New Homes
Thousands of Units

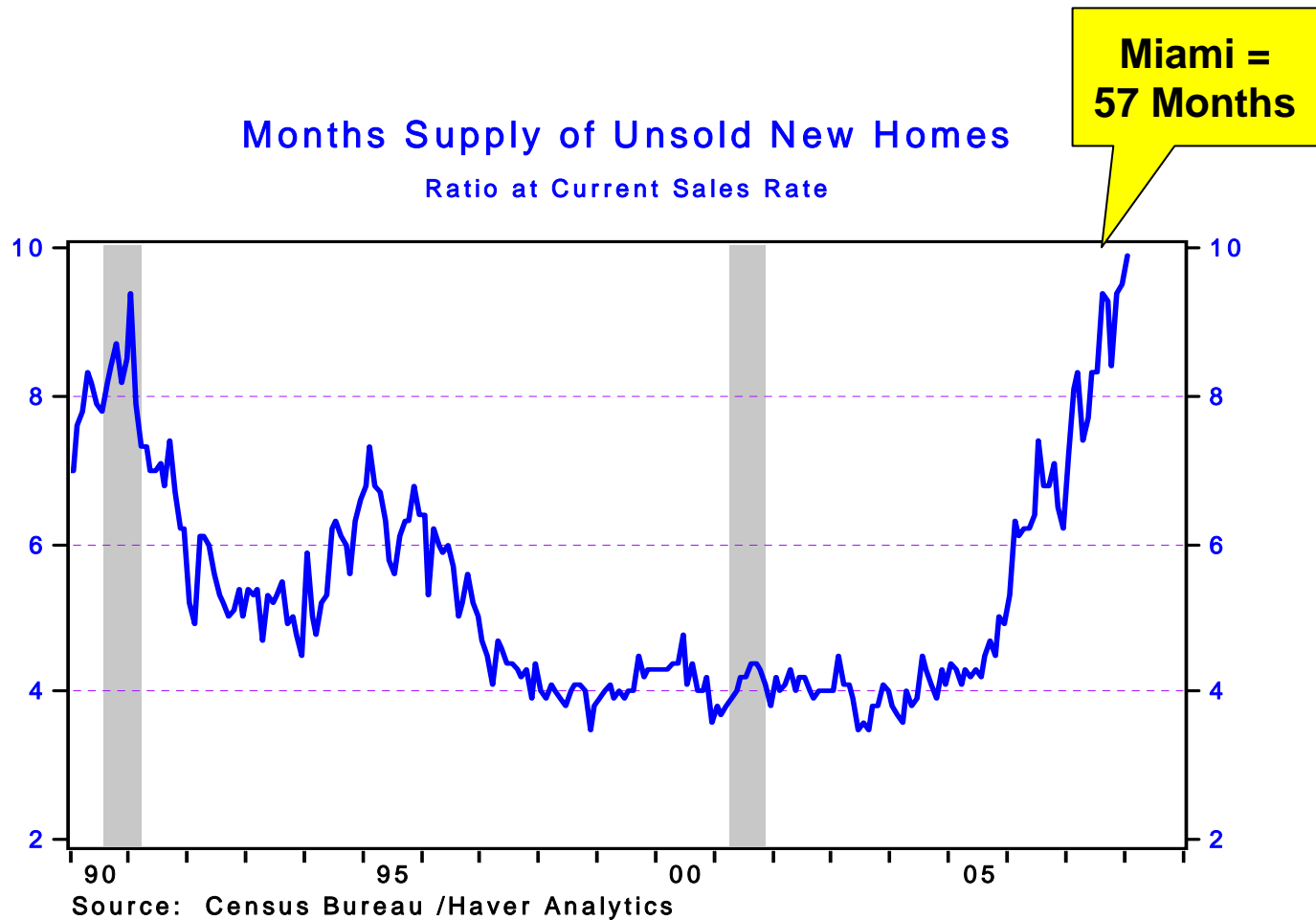
Inventory of Unsold, Completed New Homes
Thousands of Units



Source: Census Bureau /Haver Analytics



Need More Time To Fix



- Housing needs time to correct itself
- Commercial is slowly softening
- Recession is already underway
- FRB is acting, but recovery will be slower than expected



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- California had 57,000 properties with foreclosure filings – one of the highest in the nation and 120% higher than last year
- January 2008 6th straight month with more than 200,000 foreclosure filings



Construction

- The second largest U.S. builder held an “Unauction” in February with prices cut as much as 50% in 23 developments in Southern California.
- Another large builder auctioned 450 properties in 2007 for \$170 million at prices 85% - 90% less than the homes’ listings.



Commercial Real Estate (The Next Shoe to Drop?)

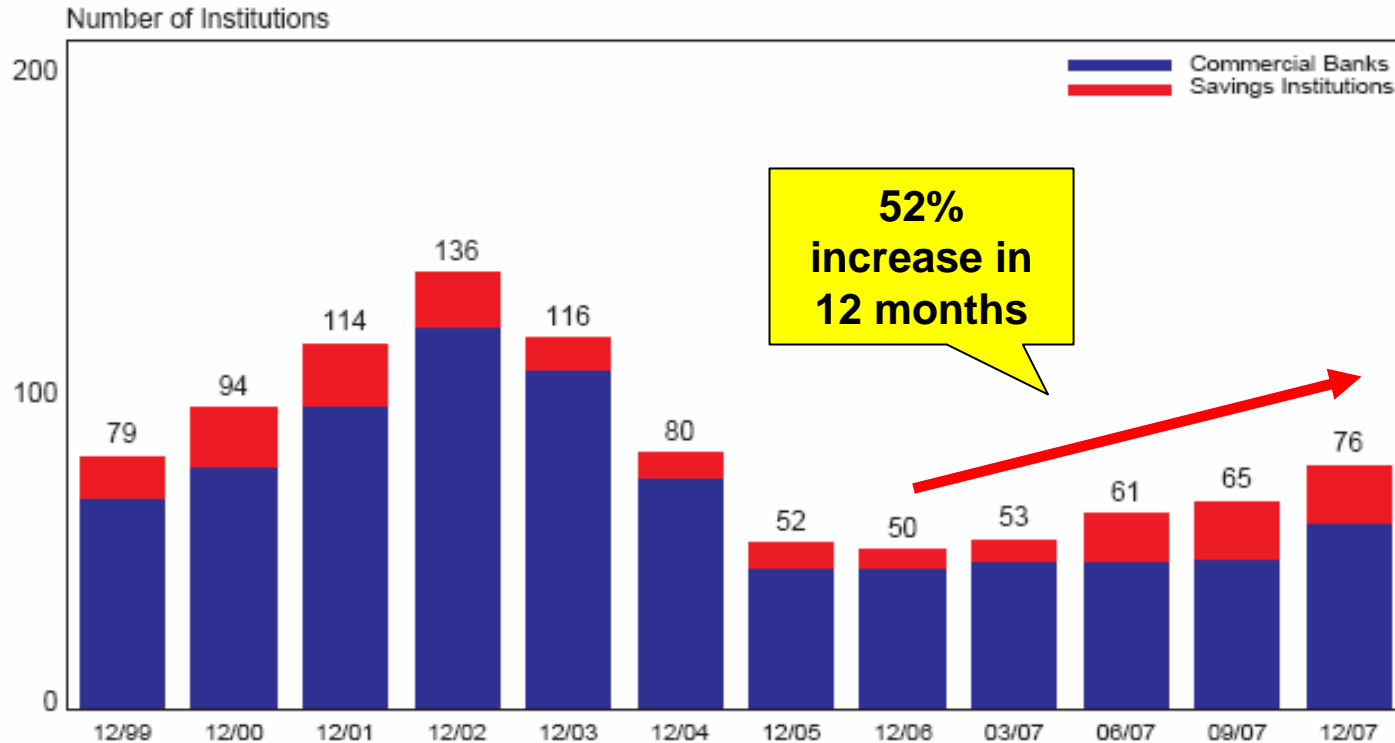
- Moody's expects CRE values to decline over the next two years, perhaps by 15% - 20%

Problem Banks Rising



Number of FDIC-Insured "Problem" Institutions

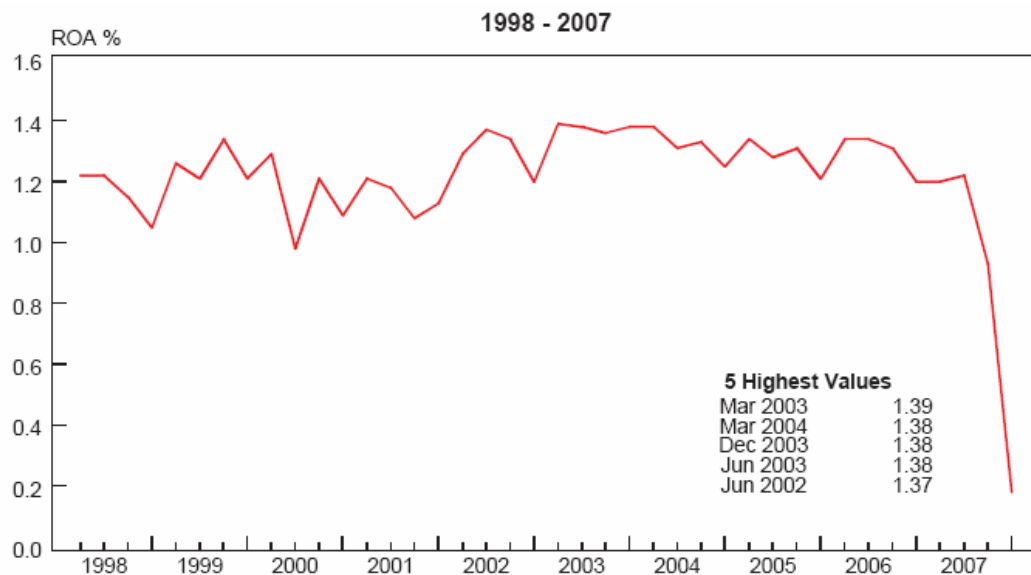
1999-2007



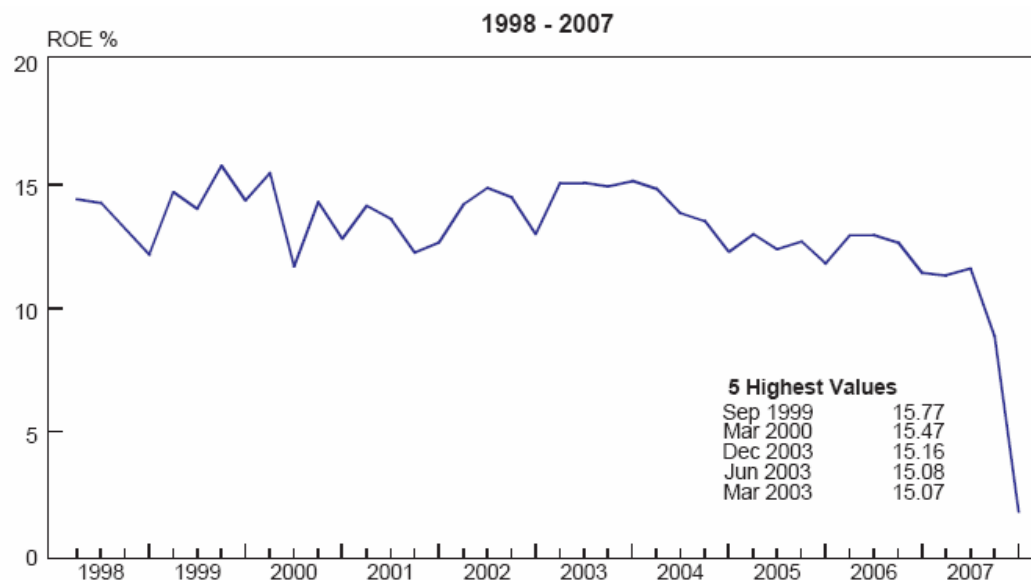
Savings Institutions	13	18	19	17	10	8	8	6	7	15	18	18
Commercial Banks	66	76	95	119	106	72	44	44	46	46	47	58



4Q Performance Was Ugly



ROA = 0.2%



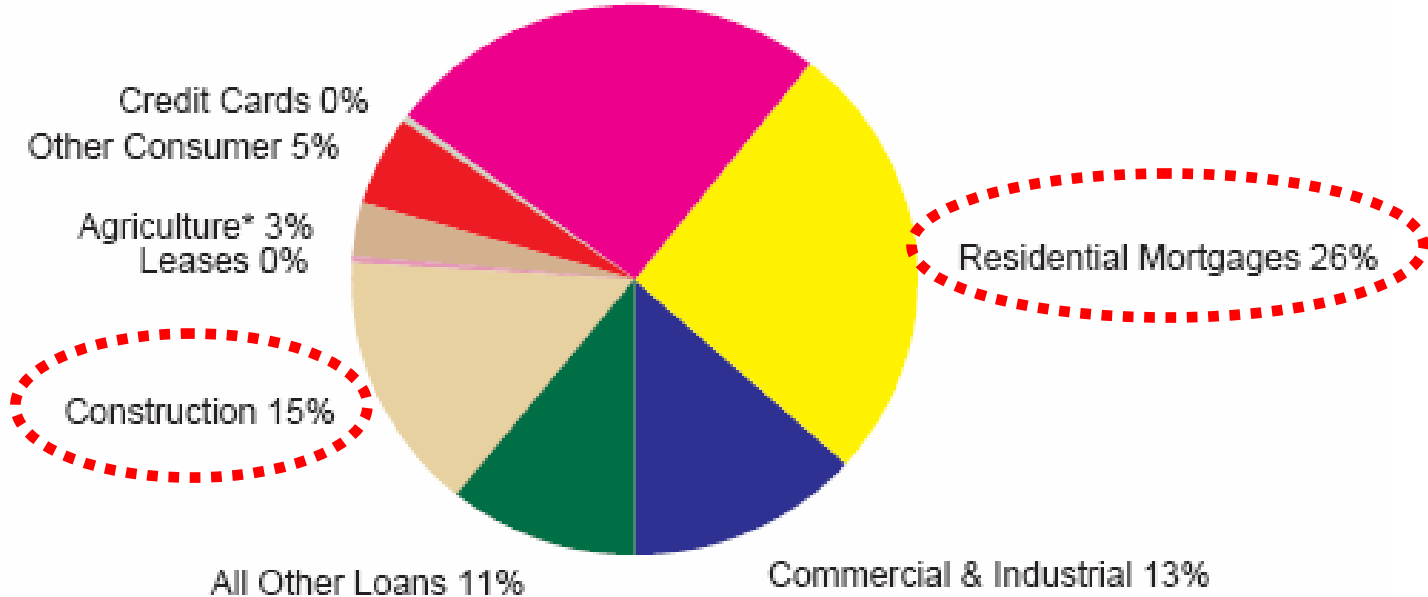
ROE = 4.0%

Problems In 41% of Loan Portfolio

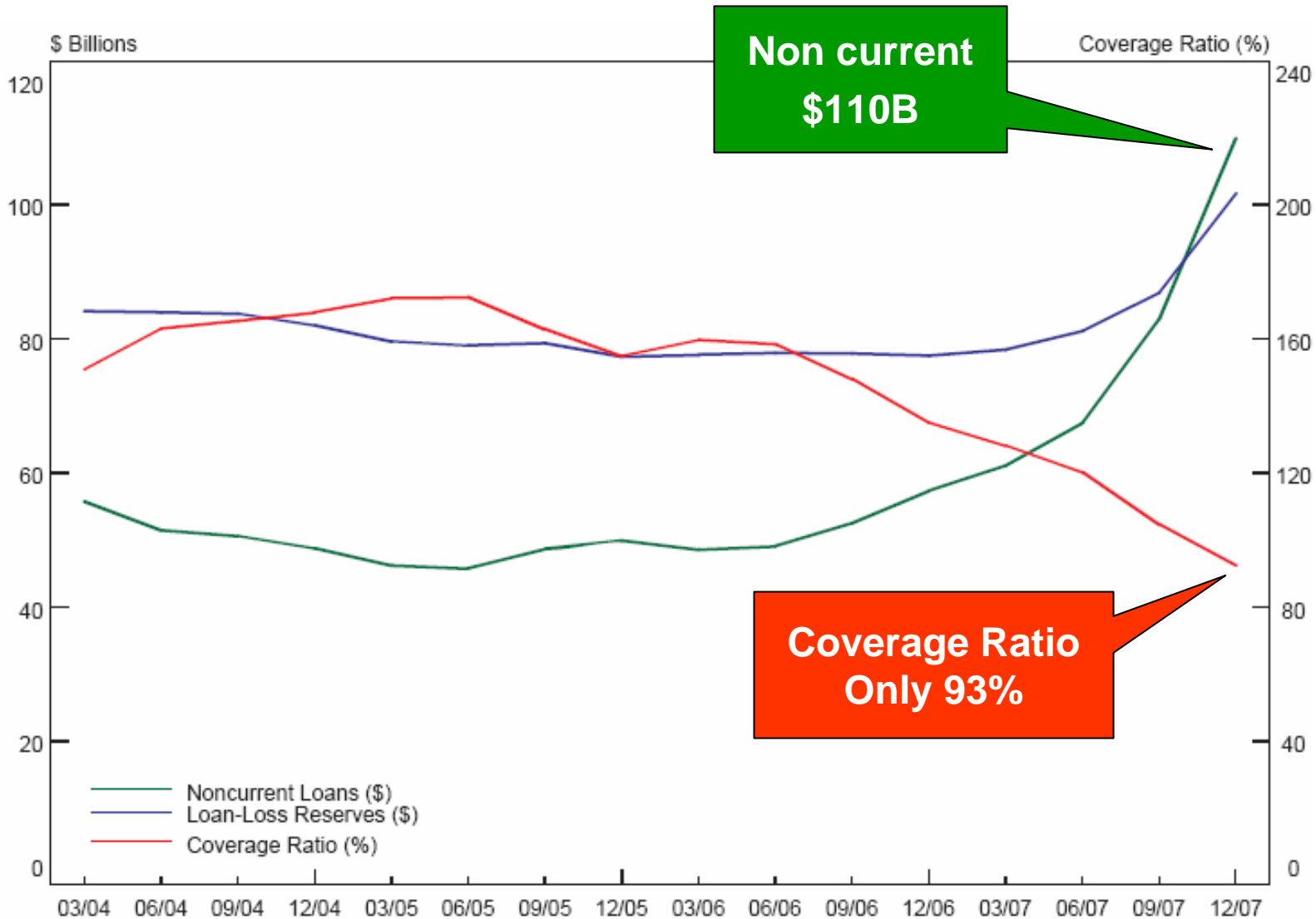


Assets < \$1 Billion

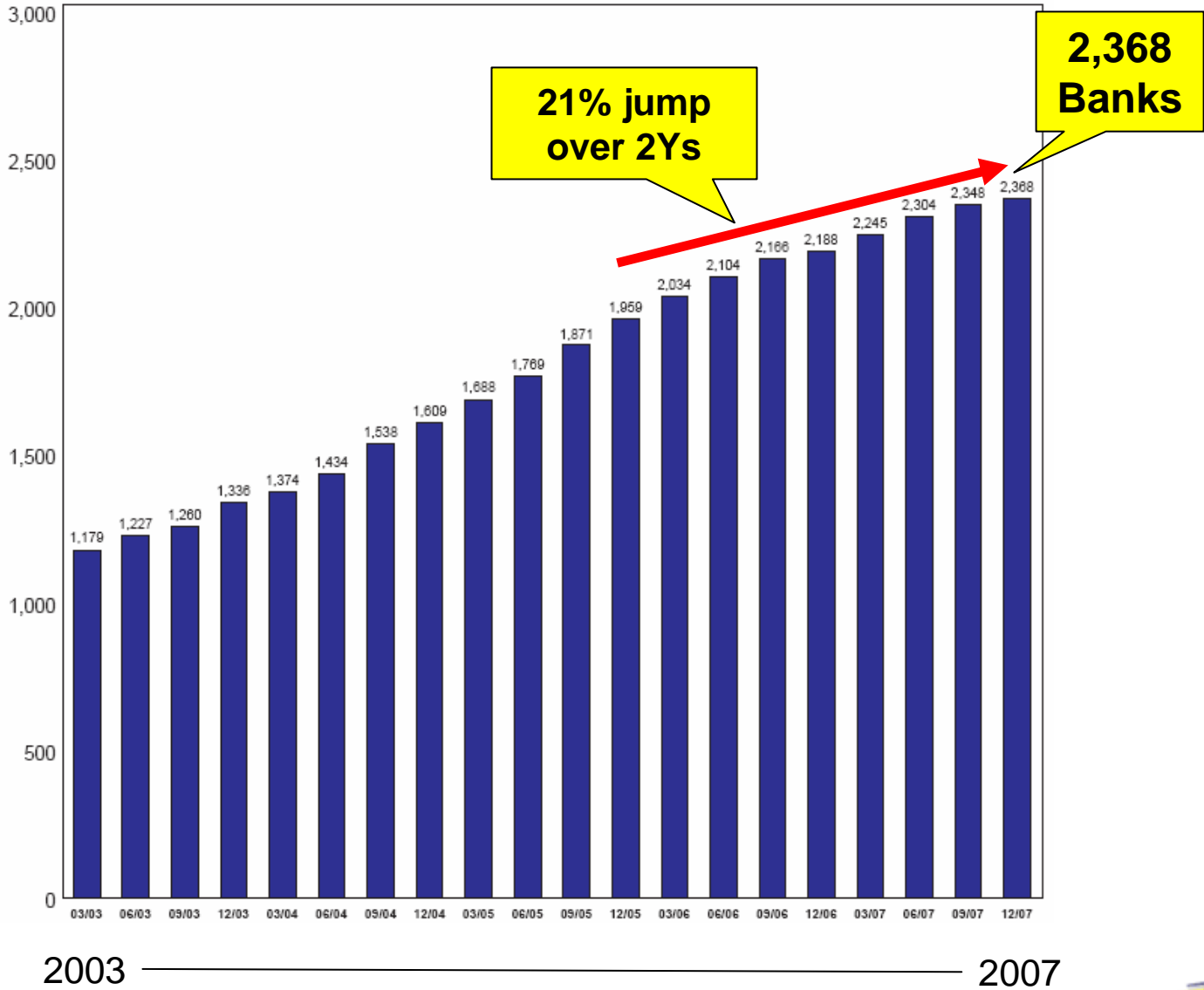
Nonfarm Nonresidential Real Estate Loans 26%



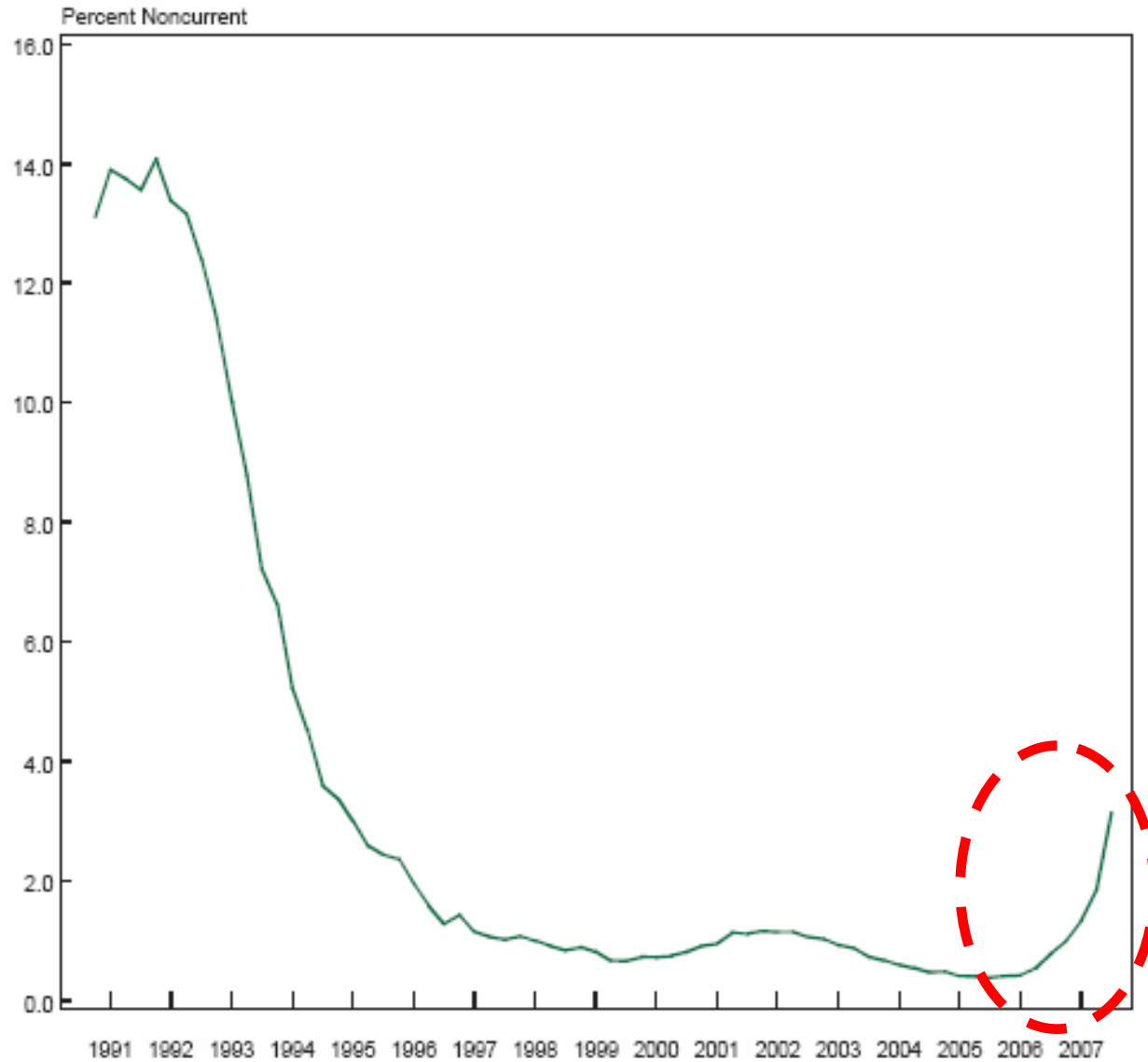
Getting Much Worse



Construction Concentrations



Noncurrent Construction/Development



- On February 29, an FRB study increased total forecasted losses from the subprime collapse & credit crisis will reach \$2T
- FRB Chairman Bernanke said there will probably be failures among smaller banks



A Compendium of Knowledge From Recently Examined Banks



- +75 banks contacted regarding safety & soundness exam (CCOs)
- Exams completed within last 5 months
- On average 66.6% of regulatory scrutiny allocated to credit functions. (An omen?)



Findings and Results



- Inadequate capital in relation to type & quality of assets
- Ineffective risk management policies & procedures
- Operating without an accurate, rigorous and properly documented ALLL methodology.
- The level and trend of classified assets warrant heightened supervisory attention relative to CRE concentrations, controls and practices.



More Findings and Results



- Designate a separate Board committee to review and approve loans
- Provide a thorough, written explanation of any deviations from the loan policy
- Finalize contingency funding plan to reduce liquidity event risk



Exam “Hot Topics”



- SFR Construction Review
- Appraisal “desk” Reviews
- ALLL Validation
- Portfolio Stress Testing
- CRE Concentration Levels
- Portfolio Monitoring



- Document current values (last sale is market!)
- Keep product moving-it's all about the price!
- Fully fund interest reserves
- Verify liquidity of borrower-and ownership
- Contingent liability reviews are critical

Appraisal Reviews



- Test comps for reasonableness
- Keep them fresh – in some markets, 90 days is outdated
- Use current market data for updates
- Expand your review appraisal policy to match current needs

- SFR downgrades by product type
- Manage credit migration logically
- Rationale for adjustments



Portfolio Stress Testing



- Capture critical loan data in core
- LTV model is less relevant—use cash flow
- Hit residential hard-by region if possible
- Measure capital levels in each scenario
- Have a liquidity plan to fix any shortfalls



CRE Concentration Levels



- Product type break-out
- Identify potential problems
 - Zip code break-out
- Participate with other banks
 - Offset product differences
- Diversify and hold smaller pieces



Actively Monitor The Portfolio



- Full review of all problem loans
- Downgrade mercilessly
- Have a plan – up and down
- Update market data and disseminate!
- Manage reporting requirements constantly
- Document your efforts



- A sound risk management practice
- Regulatory requirement
- “Sorting” isn’t the same as “stressing”
- Loan risk and portfolio risk are different
- Must be part of strategic plan
- Board must approve strategy

Key Stratification Points



Stratify loan portfolio by these and others:

- Property type
- Geographic area and sub area
- LTV
- Debt service coverage
- Policy exceptions
- Credit exposure to borrower
- Loan purpose
- Risk rating
- Loan structure
- Industry



5 Step Regulatory Preparation



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Step 1 – Gather Information



Know your market

- Go to FRB web site, get information, talk to developers
 - *Document this*

Know your customers

- Gather market data and downstream to lending teams
 - *Document this*



Get appraisal reviews

- Internal and external
 - *Document this*

Step 2 – Take Action



- Timely recognition of issues is key.
- Fully document your ALLL
 - Rationale for factor adjustments
 - Sector/product downgrades are acceptable
 - FAS 114 logic is critical



Step 3 – Be Proactive on SFR



- Identify potential problems:
 - By past due status
 - By zip code

DON'T WAIT FOR THE EXAMINERS TO FIND THEM FOR YOU.



Step 4 – Don't Cut Corners On SFR



Once you've identified your suspects:

- Desk Review of Property
 - New Appraisal
 - Updated Title
- New Fico Score
- Hire a broker for short-sales and foreclosures



Step 5 – Slice, Report, Manage



You will get regulatory pressure if you can't:

- *Slice and dice the portfolio*
- *Report risks to the board so they can set strategy*
- *Explain how you are managing risk concentrations in CRE*
- *Provide updated policies that lead to triggers if risk profiles change*



Questions?



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