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“Where’s the Next Enron?”

Wall Street Journal, Money & Investing – June 18, 2002

“Not in the Regional Banking Sector”

Joseph A. Stieven - Stifel, Nicolaus – July 11, 2002

Over the past year, the actions of a select number of institutions and executives have been truly horrendous. These actions have cast a serious shadow of doubt over corporations, the legal and accounting professions, and all of Wall Street. Given the actions of this small group, it would be hard for us to say that some level of distrust is not warranted. These issues led to a recent *Wall Street Journal* article asking “Where’s the Next Enron?” While we can’t tell you where the next Enron is, we can tell you where we believe the next Enron isn’t: The Regional Banking Sector.

Setting the banking industry apart from others is the fact that it has a truly independent, “extra set of eyes” analyzing the industry and the individual companies. This watchdog group is comprised of the various banking regulators that look at banks throughout the country on a daily basis. In most cases, the average regional banking institution will have at least two different regulatory agencies looking at it. There are three separate, totally independent federal agencies along with each state’s own banking department that issue and enforce regulations related to commercial banks and their activities. The three federal agencies are the Federal Reserve (Fed), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC).

In general, banking regulators are trained to spot situations before they become problems. Are they perfect? Of course not. Do they make mistakes? Obviously. Do they do a good job? Very good. Banking regulators, and more specifically bank examiners, are trained not to simply believe. They are trained to ask tough questions and demand supporting facts. Corporations cannot hide behind the defense of “full public disclosure” as safety and soundness examination findings are not disclosed to the public. Some might say examiners don’t trust anyone. I should know. I was an examiner/analyst with the Federal Reserve Bank – St. Louis from 1983 – 1985. As you could probably guess, I’m still very proud of my training.

The FDIC recently issued a report that the banking industry reported its highest quarterly profit ever in the first quarter of 2002. In general, most experts view the overall health of the banking industry as quite sound, and we agree. More specifically, we believe regional banks will continue to be one of the safest and most consistent sectors within the banking industry. For the most part, we have found that banking regulators are tougher on the regional banks than the larger banking institutions. So you might ask, why is this? For the most part, the answer is quite simple, that’s how life works. Its sort of like asking, why do older siblings pick on younger ones? Because they can. I know this from experience, as I had an older brother. In addition, as a father with six children, my oldest son always reminds me that he is just making the smaller and younger ones tougher. He has never analyzed a bank, but he is correct. I am not here to complain about this tougher regulation on regional banks. Additionally, I can’t recall any of the CEOs of the banks in our coverage complaining either. The truth of the matter is, we are very thankful! In our view, this form of higher scrutiny has actually helped to make regional banks and their stocks a safer, less volatile place to invest. For example, over the last ten years the average bank in our Stifel, Nicolaus Bank Index (comprised of 62 banks predominately headquartered in the central part of the U.S.) has compounded earnings 13% annually. During this ten-year period, the consistency was quite impressive, as the worst year still represented an 8% increase.

Furthermore, over that same time period, our average bank stock has appreciated 16% annually. Regional banks on average possess certain positive characteristics when compared to their larger rivals. These include: being more highly capitalized, having a lower level of problem loans, and a more consistent earnings track record.

At the same time, we feel it is important to remember that banking regulators alone cannot prevent all abuses or even bank failures in certain situations. Banking regulators cannot completely eliminate all the risk involved in the business cycle or guarantee that bank management teams will make sound decisions or act ethically. However, banking regulators are highly independent. They don't get paid more to find "good", they get paid to find small problems and prevent major ones. They don't get caught up in the search for esoteric accounting issues, instead they focus on economic reality. For example, as numerous organizations have spent millions of dollars on determining the amount of goodwill and core deposits intangibles (CDI) that are created from acquisitions, the regulators' response is simple. Put it in my own words, "account for it any way you want, but when we calculate capital, goodwill and CDI are worth zero, zilch, nada." Banking regulators are not perfect. In fact, they are sometimes not liked, no different from the police officer giving you a ticket for speeding (both my wife and I would know). But the truth of the matter is the banking regulators are keeping the "banking highway" safe. While it might hurt to say this, the banks and their management teams are thankful for the regulators. Even more importantly, we bank investors are truly grateful!

So, the question still remains, Where's the next Enron? We are not smart enough to tell you where it is. However, we are confident in our beliefs where it will not be: The Regional Banking Sector.

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