LOAN GRADES

by Steve Brown

The number of internal loan grades varies considerably across banks. For that matter, we have seen several situations where loan grades vary even within the same institution as one bank charter uses a different set of underwriting grades than another in the same holding company. In the past, we have discussed at length the importance of having more credit grades both in terms of risk management and in terms of marketing. In short, having too few grades ensures that a bank overprices the good credits leaving themselves open for prepayment risk and competition, and under prices the lower tier credits providing a substandard compensation level to shareholders. The question comes up as how many credit buckets should a bank have? The answer is that internal ratings should reflect the major categories of risk in which the bank lends. For banks only focused on commercial lending in a limited geographical area, 5 categories could be sufficient. On the other hand, a large bank with a state-size lending area and various lending lines, would most likely require a minimum of 25 credit buckets. For the sake of comparison, our last survey shows that the average independent bank has 2 passing credit buckets for which pricing differs and 1 "watch" grade. Our recommendation, however, is to have a minimum of 5 credit buckets and at least 2 watch categories. At this level, banks have the greatest ability to segment both the retail, small business and commercial markets, while providing adequate categories to understand ongoing credit performance. Most banks either utilize a single number (e.g. "1" through "5") or letters to denote credit grades. A few banks use our favorite method of credit grading which is an alphanumeric system, whereby the letter represents the risk of the borrower (basically the probability of default), while a separate number represents the quality of collateral basically the loss given default). Some banks make the mistake of trying to mirror Fitch, S&P or Moody's ratings, which ends up creating nothing but confusion when discussed with an outside party, as "AAA" now takes on different meanings. With regard to the credit agencies, it is helpful to spend resources attempting to map your bank's credit buckets with those of either S&P or Moody's. This can be done by looking at both the fundamental underwriting criteria such as LTV and DSC, but also looking at actual loss data (the real test). By doing this exercise, a great deal of liquidity and understanding can be gained, as rated loan data is plentiful and can help a bank with subsequent analysis such as pricing, selling or reserving loss allocations. In the last 2 years, credit grading understanding has grown by leaps and bounds among independent banks. With credit at record high quality, grading has become somewhat less important. However, during the next 5 years, banks that have expanded their grades will have a competitive advantage in both booking high quality loans, but staying away from substandard ones.

BANK NEWS

Housing Sector

In a sign some froth is getting blown out of the housing market, sales of existing homes fell for the 6th straight time in January, dropping to their lowest level in 2 years.

New Homes

A survey by the National Association of Realtors finds 43% of 1st time homebuyers paid no money down, up from 28% 2 years ago.

Economic Outlook

In a sign businesses see a bright future, the most recent CEO Economic Outlook survey soared to its 2nd highest level on record. CEOs felt one of the strongest areas was in hiring, while energy prices remained an area of concern.

Consumer Stress

As a share of disposable income, total debt payments including housing and consumer loans, climbed to an all-time high of 14% in the 3Q. Meanwhile, mortgage interest payments, as a share of disposable income, climbed to a 14-year high of 6.1%. Analysts and researchers remain concerned about consumer's ability to handle higher payments and point to hybrid and interest only mortgage loans - most of which will begin to reset to higher rates later now thru 2008.

Expanding Reach

The NY Credit Union League has launched a shared branching network with 44 other credit unions. The network allows customers of participating credit unions to bank at any of the 65-shared branches.