PREPARING FOR AN EARTHQUAKE

by Steve Brown

Here in earthquake country we know that tremors can be strong enough to bend railroad tracks and destroy buildings. CRE credit cycles can be as difficult to predict as earthquakes and history has shown us they can also be severe. Lest we forget, collapsing property values in the Southwest and New England in the 1980's led to nearly 2k financial institution failures. Look, we know not all the failures were directly attributable to CRE lending, but it is interesting to note that during that period, the value of office buildings as a sector declined by nearly 57%. Today, with current CRE concentrations at many institutions running higher than levels seen during that ugly period, is it really any wonder that regulators seem worried. While the concern does little to alter this risk, it is fair to say significant industry changes have occurred since that period. Literature indicates regulators will often measure the severity of a downturn by decline in rents, deterioration in property values, increased vacancies and higher loan defaults. Perhaps this is why regulators are pushing so hard for bankers to get up to speed on the value of credit stressing the loan portfolio and in particular, the CRE sector. There are many complexities that can emerge when banks move down this path. To begin, cycles in CRE lending are often product specific and usually not consistent across property subtypes. For instance, research on the national market for July shows credit quality to housing developments is sliding, multifamily is improving and industrial is unchanged. Further, exposure to CRE in certain geographic areas of the country can increase risk, while others may actually decrease it. While that is the risk side of things, what about return? We begin by examining the evolution of the commercial mortgage backed securities ("CMBS") market. Consider that in 1994 CRE loans held by CMBS conduits (as a percentage of total CRE loans outstanding) were a mere 5%. By the end of 2005, however, this number had soared to 20%. Meanwhile, market capitalization for REITs has also jumped, rising from $44B to $331B over the same period of time. As a strong substitute for lending that would otherwise be done by banks, REITs and conduits have increased pricing pressure (particularly for longer maturity projects). While many will argue conduits require borrowers to meet uniform underwriting standards and are incredibly restrictive, such significant growth indicates that belief may not hold water any longer. Independent banks have done a great job of expanding their loan opportunities within the CRE sector over the past few decades and the sector remains a bright spot. Given technological changes, greater risk management tools, overall interest rate levels, the rise of conduits and a renewed focus by national banks, the risk/return profile has become skewed. Increased risk and lower returns have potentially opened up independent banks to an impending earthquake. As such, banks should remain flexible, explore alternatives, asses risk management practices, monitor market conditions and choose risks wisely. This is particularly important since the gauges point to some tremblers over the next few years.

BANK NEWS

Acquisition

PrivateBancorp ($3.5B, IL) will acquire Piedmont Bancshares ($217mm, GA) in a transaction valued at nearly $46.6mm or 3.17x book.

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Possible Target

An investment banker quoted in Business Week magazine said First Horizon National (the parent company of First Tennessee), is ripe for a buyout by a big bank, such as Wells Fargo or Wachovia. The investment banker said margin pressure, due to a slowing home mortgage business, were likely drivers that could put Tennessee's biggest bank in play. First Horizon, meanwhile, declared it is committed to staying independent.

No Way

A federal judge has ruled states cannot regulate gift cards issued by banks. A recent case brought by the New Hampshire Attorney General claimed that a bank-issued gift card violated state law. The bank deducted $2.50 a month from cards with an unused balance after 6M months and charged a fee for reactivation.

Fewer Taxes

The FCC's Do-Not-Fax Rule went into effect on 8/1. The rule allows companies to send faxes to their customers and venders, as long as there is already an established business relationship in place. The rule gives those receiving faxes the opportunity be taken off of the list.