A CANARY IN THE LOAN MINES

by Steve Brown

If you believe the mythology, somewhere around the year 1815, miners started to take canaries into mines to protect against Carbon Monoxide and Methane. In the presence of these gases, the bird, who was presumably singing like a canary up to that point, would get woozy and pass out. Miners would then safely high-tail-it-out-of-there and their lives would be saved. This is apropos because 2006 will mark one of the first years that independent banks began using a variety of systems to predict problems loans before they surfaced. One such methodology for monitoring CRE credit exposure is based on property valuation. Bankers inherently know that when property values go down, delinquencies go up. Therefore, in a down market, it is likely that both property incomes are falling and capitalization rates are increasing. Lower cashflow and deterioration of equity sets the stage for the borrower to walk away from their loan. In fact, when back-testing is performed, the correlation is so strong that delinquencies are more than 7x more likely to occur with properties that are falling in value vs. those that are rising. This correlation gives banks an opportunity to develop an early warning system for monitoring loan and risk exposures. Banks may want to consider setting up a formalized system to capture and track property improvements, income, capitalization and area comparables, in order to come up with a proxy for value. Bankers should note that our preliminary research finds that once values dip more than 8%, loan delinquencies increase. As we update our Loan Pricing Model ("LPM"), we are starting to notice a wide range of discrepancies in property values. Perhaps more foreboding, we have not seen this large a disparity since the early 1990's. At a minimum, this means we are in for more loan earnings volatility. By January, we will be releasing state-by-state information within the LPM and by April, we will be getting down to the metro/zip code level. As we collect data each month, we are starting to see some material changes in property values. To name a few areas and property types bankers should monitor (that have seen property values drop 9% to 25%) include multifamily in Indianapolis, Detroit and Charlotte; retail in New Mexico and Honolulu; offices in Dallas and Houston; and industrial property around San Francisco. Of course, the opposite is also true and in a majority of markets across the country, appreciation has risen. Specifically, Los Angeles and Atlanta office; San Diego, Seattle and Orlando retail; and San Francisco multifamily are up an average of 42%. For properties that are down more than 8%, banks can expect an approximate 8 to 18 month time lag before cashflow starts to get tight and delinquencies occur. During this time, banks can increase surveillance, try to restructure the loan (to lower risk or increase pricing), or look for refinance opportunities with other banks that don't have access to this data. As property values continue to change, we will continue to monitor the situation and provide access through LPM. This will give bankers an edge as they utilize property valuations as an early-warning problem indicator. Hopefully, with such early warning, banks will have time to shift risk if the singing suddenly stops.

SPECIAL NOTIFICATION - CRE GUIDANCE IS OUT

It is official - the regulators have released final guidance on CRE concentrations just in time for the holidays. In a nutmeg shell, the 100% and 300% demarcations on Tier-1 capital to CRE and construction, respectively, stand as benchmark ranges of when banks should employ additional resources in risk management. The same goes for banks where the loan portfolio has grown more than 50% in the last 3Ys. As you know, we have been keeping a close eye on this process throughout the year and have been telling bankers to expect it by the end of November (ok, we were a few days off). Anyway, as we read and analyze the 20 pages of just-released regulatory guidance, grab yourself a hot cup of cider and we will be back to you later today with our synopsis and white paper highlighting key issues and explaining practical ways bankers can use to address this issue.

BANK NEWS

FDIC

The Agency released a 2nd proposal that would institute a methodology for tracking depositors in the event of a bank failure. A portion of the methodology will require assigning and registering a unique ID number as well as having operational systems in place to manage these accounts (placing and removing holds, etc.). While the proposal only pertains to the top 159 banks, look for derivations on the theme for smaller banks in the coming year.

Customers

Wescom Credit Union reports it is finding good success originating new loans under a pre-approval program. Under the program, members are proactively offered loans for specific amounts, at stated interest rates, through a link under their online banking service. The CU says about 30% of customers approached with such offers accept loan terms.

M&A

Credit union mergers have jumped 16% through the 3Q (to 242), compared to the same period last year.

IT

Experts say banks spend about 90% of their IT budget on maintaining legacy systems.