FORK IN THE CREDIT ROAD

by Steve Brown

An interesting thing is happening in regard to the commercial real estate supporting bank loans that has not happened since the early 1990s. Capitalization rates and property incomes have seen a large divergence. Normally, a property's income drives cap rates in an inverse manner. That is to say more rental/lease income means lower cap rates, which results in higher property values. This has been the trend in almost every market in the U. S. over the past 20 years - until mid-2006. Now, we are seeing a deviation from that trend, as property values are going one way and income the other. One cause of this is the fact that capital remains plentiful and there are still too many dollars chasing too few quality properties. As a result, properties are still well bid, despite weakening underlying trends in projected cashflow. This unusual situation is making property underwriting more difficult for banks. If both income and property value move together, an accurate credit decision can still be made, whether it is positive or negative. This week, for example, we analyzed bank CRE loans in the Washington D.C. / northern Virginia markets. True to the data, while office property values are slightly higher, lease rates and terms are deteriorating. While this could be a short-term aberration, it appears to be more predictive in nature over the long-term. Office space in Dallas and Houston are also examples where real estate investor activity has been keeping values stable, while 2 to 3 year cashflow projections appear to be headed lower (due to projected excess supply and lower demand). The current split in the market has a couple of implications for banks. First it means that banks must place more emphasis on underwriting and forecasting a property's cashflow (instead of property value), since it will have a larger effect on loan performance. Second it means that banks, when forecasting future value, must take both of these into account. Banks will need to figure out if cap rates or income have a greater effect on projected value. After all, a loan with 80% LTV and 1.3x DSCR (but in an area of rising rents) is generically more desirable than a loan with 70% LTV and 1.3x DSCR (but in an area of falling rents). Lending structures have become more about cashflow risk than property values, so credit underwriting has accelerated to keep pace around that fact. Of course, this analysis works in reverse as well. San Francisco self-storage, Phoenix retail, New York office, Seattle retail and Los Angeles industrial properties all benefit from the opposite effect. In each of these markets, cap rates are slightly higher (property values down for the 4Q versus 2Q), but underlying income fundamentals remain strong. For bank lenders, this lowers the probability of default, requires fewer reserves and boosts returns. Further, banks can also gain the same return with tighter pricing, while building loan volume. Our take away point here is that credit underwriting of projected income, absorption and supply/demand activity has become more important than ever. In normal times, income and property values move in the same direction. These days, that is not necessarily the case. Because of this banks that spend more resources analyzing cashflow stand a better chance of deciding between a performing credit, or stumbling down a path that could lead to non-accrual.

BANK NEWS

Gift Cards

Wells Fargo said it sold 1mm branded and prepaid Visa gift cards since launching the program in October 2005.

Bank Deposit Outflows

A new report indicates money market mutual funds assets have reached a new record of $2.33T, as higher yields attract more investors.

Developing Trend

Bankers should be aware that a new study finds 39% of online Americans have used the web to search for a home to purchase, while more than 50% of those aged 30Y or less have done so. Experts predict it is only a matter of a few years before significant numbers of people feel comfortable enough to purchase a home or get a small business loan over the internet.

Debt Load

Studies show more than 115mm people in the U.S. carry monthly credit card debt of an average $9k.

Businesses

A survey of CEOs from across the country found 69% expect sales to rise over the next 6 months, 39% plan on increasing capital spending and 37% said they expected to hire additional workers.

Defined Pensions

The FFIEC announced that FAS 158 that deals with the accounting for employers' defined benefit pension plans is under review and will not affect regulatory capital in the interim. While under-funded or over-funded pension positions to single-employer plans will have to be recognized this year, financial institutions should exclude this amount from the regulatory capital calculation.

BSA Fines

Foster Bank of Chicago ($461mm, IL) was assessed $2mm in BSA penalties for improper testing of BSA and failure to file SARs on 12 occasions.

Competition

National City Bank reported that it will sell its non-prime loan business to Merrill Lynch. The bank will take an associated $120mm hit in loan loss & insurance costs.

Copyright 2021 PCBB. Information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. Customers should rely on their own outside counsel or accounting firm to address specific circumstances. This document cannot be reproduced or redistributed outside of your institution without the written consent of PCBB.