

WHAT IS THE VALUE OF BORROWER RECOURSE

by [Steve Brown](#)

As bankers, we were taught to always require recourse when it comes to commercial lending. Having a guarantor clearly lowers credit risk. However, the question you have to ask yourself is not as obvious. Is lowering credit risk really the goal? This seems like a ludicrous question because lowering credit risk is always one of the goals of every lender. The question is not so straight forward as it might seem, as we highlight the distinction between lowering credit risk and lowering risk. In lending, there are many ways to lower risk. One way is to simply raise pricing. Here is a quiz: Which would you rather have, a 5Y loan on a commercial retail center with recourse at Prime, or without recourse at Prime + 15bp? This quiz at a recent banking conference resulted in 90% of the participants choosing Prime. Yet, if a lower risk profile really is the goal, then the Prime + 15bp loan presents less risk. To break this down, for the average commercial real estate loan, the value of recourse is worth about 7bp in probability of default per annum, or in similar terms, about 9bp of additional yield. By pricing the loan 15bp higher, bankers are more than compensated for the additional risk and can achieve enhanced earnings. Greater earnings obviously results in lower risk for the institution and its shareholders. Put another way, a bank could make a non-recourse loan, increase reserves by 7bp, mitigate 100% of the difference in risk and still have an additional 8bp in earnings. Fundamentally, while recourse is important, it is only a secondary risk mitigator. This is because a loan would have to go into default and the guarantor would have to be willing, able and legally allowed to extinguish all or part of the obligation. Successfully exercising borrower recourse is a low probability event. Booking an additional 8bp of earnings, however, is an extremely high probability event. Because of these differences in probabilities, recourse is not as valuable as many believe. Of course, the value of recourse varies as to structure and terms, so don't use 7bp as a "rule of thumb." In general, the value of recourse increases the longer the maturity, the stronger the prepayment penalty protection, the higher the LTV, the higher the quality of recourse or the lower the debt service coverage. Conversely, the opposite is true for each of the afore-mentioned factors. While we would never turn down recourse (all things being equal), given the choice between recourse and non-recourse for a higher credit spread, the answer may be the latter. Further, bank loan policies that mandate recourse may be reducing bank opportunities thereby increasing risk. Bank lending is getting more complex, so bankers need to adapt. In order to attract customers, banks should review lending practices to ensure they accomplish intended goals. This goes for risk management, profitability and adding value to quality customers.

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BANK NEWS

M&A

The HC for Greene County Bank (\$1.7B, TN) will acquire the HC of Cumberland Bank (\$944mm, TN) for \$163.7mm, or about 3.1x book.

Housing

Final 2006 housing data just released indicates sales of existing homes fell at the fastest rate in 17Y. Sales fell 8.4% for the year.

Competition

Both Wells Fargo and PNC Financial have announced plans to increase the number of ATM machines that can accept checks without envelopes, in an effort to boost imaging customers. Wells has reportedly already rolled out 400 of such machines.

Competition

The Chairman of JPMorgan said the bank will continue to grow organically in the U.S., but would "not miss an opportunity" to acquire a bank, possibly in the southeast or west.

Extension

The FDIC is reportedly planning to recommend that the ILC moratorium be extended for another 12 months to give Congress time to draft legislation. Reportedly, more than 100 lawmakers had pressured the agency to make the extension.

Customers

Studies show online banking adoption rates from small businesses reached 40% at the end of 2006.

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