A BAD HABIT

by Steve Brown

This one is for the banking history books. It seems some banks in Greece lent a group of nuns' money to open 25 knitting shops across the country. Before opening the shops, the nuns took some of the money and used it to travel to fashion shows in other countries, in an effort to find out the latest designs. Unfortunately, when all was said and done, every one of the knitting shops failed and the bankers involved sent foreclosure notices. The crazy twist on this story is that upon receipt of the foreclosure notices, the entire order of 55 nuns involved skipped town. This left the lending banks scratching their heads and looking to the property pledged by the convent as a way to collect on the debt. To do so, it appears the banks would have to sell the convent. The problem with this is that apparently some townspeople are now getting involved, asking the bankers to forgive and forget. Sitting on uncollected debt obligations, the bankers now find themselves wondering whether the townspeople would view the sale of the convent as a battle between good (the poor nuns) and evil (the bankers). It just goes to show you not only how tough it is to be a banker, but also how difficult it can be to predict the performance of any credit. These bankers relied too much on appraised value of the properties involved and not enough on reviewing the viability of knitting shops and examining the business plan more closely. Content to rely on LTV alone, these bankers now find themselves in a pickle. If the lenders had done just a bit more research (this took us 7 minutes to collect), they would have found: 1) knitting shop startup costs are higher, on average, than many other businesses; 2) such businesses have lower profit margins, on average, than many other businesses; 3) knitting shops belong to an industry sector with growth that has been falling over the past 5Y; 4) this sector has high competition; 5) even a properly run knitting shop is estimated to have an expense to revenue ratio of 89%. We even found that a quick check of knitting shops currently for sale (comparables) seem to only be able to muster a net profit of $25k to $40k Â– even after 10 or more years in business. Finally, knitting yarn sales overall have been flat for some time and home sewing sales have been falling for many years. In short, with inexpensive goods from China and Wal-Mart flooding the country, people interested in sewing have decreased. Clearly, with a little more scenario running and market research, these banks may have been able to steer the nuns into a more profitable business line. While bankers cannot tell exactly which loan is going to stop performing at any given time, expanding the analysis to include realistic cashflow projections, liquidation valuation, probabilities of default, loss given default and other key factors, the risk can be reduced to an acceptable level. At the very least, doing so protects bankers from having to step to the front of bankruptcy court and have their knuckles rapped with a ruler.

BANK NEWS

ILC Action

As expected, the FDIC extended the moratorium for 1Y, basically giving Congress more time to assess the situation and complete legislation.

SOX

President Bush yesterday called for changes in Sarbanes-Oxley Act enforcement and acknowledged that it is a compliance burden.

Tax Refunds

A recent survey reveals that 59% of people who get a refund will deposit it into a long-term savings account or investment. What programs or promotions do you have in place to capture that money?

Loan Fair Value

Going against staff recommendations, FASB has decided not to require fair value accounting for loans.

Online Banks

There is a lot of hype around online banks; particularly given the fact that studies show some 33% of households did some online banking in 2006. Large banks are enticing customers to open online checking accounts as a way to get new deposits and relationships. Banks may find it interesting that from 2004 to 2Q of 2006, assets in online savings accounts doubled to $113B.