CRE LOAN PREPAYMENTS

by Steve Brown

As of March, we have observed more than 750k loans in our Credit Stress and Loan Pricing Models. As such, we see prepayment characteristics of independent bank commercial real estate loans. Up until last year, we treated our prepayment model on an aggregate basis. That is, we lumped together yield maintenance, prepayment penalties and unprotected loans into a single bucket. This analysis derived that while the 20Y trend for prepayments is about 14% CPR (that is 14% of CRE loans prepay per year), since 2000, this speed has averaged 24% (and has hit 35% in several quarters). This is fast. Lately, we have had enough data to take the analysis even further and research loans by penalty and by sector. This analysis has been eye opening, as loans without penalties have prepaid at rates that are 3 to 5 times faster than loans with some sort of prepay penalty. For example, a 5Y loan made on a seasoned retail center (that has debt service in excess of 1.3x and LTV better than 70%) has a 25% probability of prepaying in 2007 (if it has a prepayment penalty) and a 73% probability if it does not have any protection. A loan that is expected to stay on the books for 5Ys, is most likely really only going to be there 1Y. Banks not only miss out on the present value of 4Ys worth of risk-adjusted credit premia, but also have to amortize acquisition costs over a much shorter period. This data underscores the value of prepayment protection. Relatively low capitalization rates, looser underwriting standards and fierce competition have given borrowers (or prospective property buyers) all the catalyst they need to refinance. Other analysis shows that the greater the credit spread, the slower the prepayments. That means prepayment penalties are worth more on retail, office and mixed-use properties than they are for multifamily, hotel or senior housing (although these rates are beginning to converge due to improving credit quality on the later group). While prepayment rates are slowing slightly, our model projects speeds will accelerate as rates are predicted to fall in the future. That means prepay protection remains vitally important. To put this into perspective, prepayment risk can overwhelm credit risk, depending on the structure and credit quality. Loans with high debt service coverage, low LTV and in an appreciating market will exhibit the greatest prepayment risk (much more so than credit) and should be the bank's largest concern. Banks struggling to get prepayment protection on their loans, may want to try give incentives to lenders that negotiate protection. In addition, offering the borrower a lower rate, in return for prepayment protection (especially on your quality loans), should help. For our retail loan example above, the annualized value of prepayment protection is approximately 92bp (net of amortized costs). A bank that offers 5bp in additional incentives to lenders and a 20bp reduction in rate to the borrower is still well ahead if they can get prepayment protection.

BANK NEWS

Branch Sale

Heartland Financial USA ($3.1B, IA) said it will sell a branch in MT with deposits of $30mm for an undisclosed sum. The company said the sale was part of a strategic plan to divest branches of smaller size and greater distance from its primary banking markets.

Restructuring

The WSJ is reporting that Citigroup may cut 15k jobs and take a charge to earnings of $1B. The bank employs 327k people worldwide.

Rate Cuts

Chief economists from Merrill Lynch and Goldman Sachs are predicting the FOMC will cut interest rates at least 3x this year, according to recent surveys.

Foreclosures

A study by RealtyTrac finds the percentage of homeowners behind on their payments is projected to soar 33% over the prior year, if the pace of the first few months continues. Nationwide, proceedings jumped 12% in February compared to the same period last year, as one in every 884 households fell into foreclosure. States that were particularly hard hit by foreclosures when compared to the prior year included FL (+91%), CA (79%), NV (77%), AZ (+44%), IL (+45%), and NJ (+36%).

Electronic Taxes

The IRS is reporting that 73% of returns have been e-filed so far this year, compared to 70% last year. In addition, about 76% of filers had their tax refund automatically deposited to their bank account, compared to 71% last year.

Competition

Wells Fargo reports its average customer uses 5.2 different bank products, about 2x the industry average. In addition, the bank reports 20% of customers buy 8 products from the bank. The bank calculates the cost to sell a product to an existing customer is about 10% as much as selling the same product to a new customer.

SBA Lending

Legislation moving through Congress would reduce fees on some SBA loans. The bill would eliminate fees on loans made to veterans and cut fees by 50% on loans made to doctors and dentists in geographic areas with a shortage of medical professionals.