COMMERCIAL LOAN DEFAULTS

by Steve Brown

You have to make sure everything is tightened down if you are going to take risks. Since banking is all about taking risk, bankers should consider tightening loan default monitoring and pricing. Banks using our loan pricing model, have been updated monthly on some of the recent increases in delinquencies for speculative land development and condo construction. In contrast, most long-term CRE lending sectors (office, industrial, multifamily, etc.) have continued to improve. This latter fact explains why CRE loan pricing has tighten for April/May. Starting with our next release of the loan pricing model (set for July), we will be including a C&I component that breaks down probabilities of default and loss given default on more than 180 industries, -right down to a 6-digit NAICS code. As we derive loan performance histories from almost 100 independent banks (using our Credit Stress model) we backtest our model and are confident in the results. The C&I default output has also been highly educational. While it is no surprise that credit among industries are different, it is interesting to note the extent of which they differ and the impact on banks for both pricing and risk. While the data is focused on unsecured commercial lending, it also has implications for real estate lending to the extent that major tenants are identified and provide a property's cash flow. For example, a 5Y loan for a multi-tenant office building in Chicago has an average of 0.35% of default risk per year. If it were a single tenant property, the default risk vaults to 1.12%. However, if that single tenant is a veterinarian, the default risk drops to 1.05%. Compare this to a single tenant new car dealer at 1.72%. For comparison, if you remove the real estate component here are some of the latest probabilities of default for popular bank commercial lending lines (unsecured): Dentists 1.36%; Doctor Groups 1.40%; Lawyers 0.92%; Real Estate Developers 2.84% (up 23% for 1Q); Trade associated with residential housing 3.16% (up 21% for 1Q); Furniture Stores 2.91% (Up 14% for 1Q); General Manufacturing 1.57% (we also track 28 different subgroups here); Dry Cleaners 1.24%; Restaurants 1.39%; Bars 1.11% (all cash + people drink in good and bad economic cycles); Wineries 3.75%; Breweries 3.40%; Religious Organizations 0.99%; Non-religious Non-Profits 1.08%; Trade Associations 0.82% (includes labor unions); and, Advertising Agencies 1.36%. For practical application, this data indicates that a loan to a group of doctors is more likely to run into trouble than a loan to a law firm. Using an average 5Y loan structure, this would mean that given a loan at Prime + 75bp, risk-adjusted ROE would be 23% for lawyers versus an average of 20% for doctors. Another way to look at this is that a bank could offer the lawyers a loan priced at Prime + 20bp and still achieve the 20% ROE. As can be seen, to stay competitive and better manage risk, banks need to increase granularity in their credit analysis and become more adaptive in their pricing. By doing so, banks can win a higher percentage of loan business, raise profitability and better manage credit risk within the organization.

HIGH PERFORMANCE WORKSHOP

Are you looking for guidance on loan pricing and underwriting strategies? Come to our next Workshop on June 7th in New Orleans where we will be focusing on not only the liability side of the balance sheet, but asset pricing and management as well. Don't miss our complete list of 1Q data for all C&I probabilities of default for more than 180 popular bank industries. Enhance your knowledge as we examine how risk and profitability intersect. For more information, e-mail for a brochure.

BANK NEWS

M&A

The HC of Southside Bank($1.8B, TX) will acquire the HC of Fort Worth National Bank ($131mm, TX) for $36.5mm, or roughly 2.7x book.

M&A

CapitalSource Inc. will acquire the HC of TierOne Bank ($3.4B, NE) for about $652mm or roughly 1.7x book. CapitalSource is a commercial lending, investment and asset management company with an $18.3B loan portfolio targeting small business customers.

Possible M&A

Bank of America is considering "strategic alternatives" for its commercial insurance brokerage business, which provides brokerage and consulting services for property and casualty insurance and employee benefits.

Regulation

A new study finds that U.S. financial services regulators levied $5.2B in fines over a recent 2Y period.

E-Banking

This week's conference entitled "Competitive Forces Shaping the Payments Environment" sponsored by the Fed focused on the replacement of checks by images, contactless/cell phone payment systems and the global remittances business. Due to items pricing and higher transportation costs associated with the closing of many check processing centers, the rise of check imaging will get even faster than its current 500% increase over last year.