

MAY LOAN PERFORMANCE AND CREDIT SENSITIVITY

by [Steve Brown](#)

There is a lot of useless information floating around. In college, you spend about 5 hours learning things you need for the real world and 2,250 hours learning things that aren't very relevant. We had a biology professor that made us memorize "don't ask us why" - major species of fish. This is a problem to this day, particularly when we are trying to remember something important - like whether the wife told us to get tuna packed in oil or in water. All we can think about is Thunnus albacares - right there on aisle 5. It's a horrible waste of limited brain power. Some facts, on the other hand, can come in quite handy. Take loan defaults for example. Knowing the actual risk of an underlying loan is central to running a profitable bank. When you get down to it, credit is the main output for a bank. As we update our Loan Pricing Model for the month, we wanted to share some important community loan performance facts. Users of this model not only know the latest changes in credit quality, but, they also have the ability to better structure loans and understand the trade-off between risk and value. By state, CRE loans in MN, WA, MD, AZ, and VT have materially improved since the end of 1Q (improvements averaged 10bp) and now warrant lower pricing or higher margins. Loans in LA, MA, KS, UT and CA, on the other hand, have deteriorated (by an average of 4bp), so pricing in those states should be widening. By sector, construction deteriorated further (8bp) from the 1Q and remained the most negatively volatile lending sector in 2007. Most reported credit problems stem from land development loans and residential / condo construction. Of significant note, May marks the first time that office lending has seen an increased in probability of default (8bp) after 11 straight months of tightening. Meanwhile, defaults for loans to senior housing facilities slipped by 10bp, as did office construction (by 5bp). In terms of improvement, the mixed use and industrial loan sector picked up from 1Q. Almost all other sectors and states remained steady for the month. For all community bank loans, probabilities of default increased by 3bp. The other research update culled from the data is the sensitivity of lending sectors. Using our Credit Stress Analyzer model, we have shocked more than 1mm loans and observed the sensitivity on a loan by loan basis. One class that stands out is hospitality. Sector performance has been outstanding, as probabilities of default have dropped from 300bp in 2005 to close to 50bp in May. Despite some of the best total return performance for independent banks, hospitality remains one of the most volatile sectors. If you take hospitality loans and shock them 1 standard deviation (something akin to going back to "average" 10Y performance), hospitality loans suffer almost 250bp of defaults - the most sensitive of any major lending category. Another interesting sector is multifamily. Prior to 2003, this was one of the least volatile areas for any community bank. Now, with lower demand (due to more households qualifying for home loans) and a huge supply of condo conversions (both taking supply out of the market and now, putting it back in), this segment has become highly sensitive to interest rate shocks. Of further note, office lending tends to be the least sensitive to real estate downturns, followed by retail and then industrial. We realize not all these facts are helpful. However, since knowledge is power, we think the data is a whole lot more interesting than *Lutjanus buccanella* (which is snapper by the way, if you are going to the market).

BANK NEWS

M&A

Pacific Capital (\$7.4B, CA) will sell its equipment leasing and financing division to LEAF Financial for \$280mm (for a \$20mm gain) and the sale of its indirect auto business to Wells Fargo for \$222mm (no gain). The sales better align the bank's core competencies with its strategic focus.

Wal-Mart Expansion

Wal-Mart said it would expand its in-store "MoneyCenters" (which offer check cashing, money orders and money transfers) to about 1k locations by 2008. The company also said it would begin selling prepaid Visa debit cards that don't require a credit check or bank account and can be reloaded at any Wal-Mart store.

Competition

Bank of America announced a program enabling clients to apply for up to \$150k in term life insurance through the bank's web site. The product, called "Simplified Life," offers level premiums, immediate enrollment, no medical exam and coverage for amounts between \$25k and \$150k.

Enhanced ATMs

While it would not disclose savings or revenues, Bank of America said daily deposits at new ATM machines installed in the past 2Ys have increased 50% over the past year. The bank said the new machines save money by eliminating courier, paper and administrative costs.

Online Security

A new survey of computer security finds 33% of people write down their password or leave it on their computer. In addition, 67% never change it and 20% use the same one for both banking and non-banking websites.

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