PUTTING GAMBLING IN YOUR LOAN POLICIES

by Steve Brown

"Â…alright, enough debate. Mr. Chairman, I would like to make a motion to take $2mm of shareholder capital, give it to our CFO, have him go to Vegas and place it all on black for one spin. It should be noted for regulatory purposes that the Board is doing this as it is currently our best investment alternative. All in favorÂ…"

Sound crazy? More banks should consider spinning the wheel instead of some current practices. Before you think we have eaten too many mad cow-squirrels, consider the math. Users of our Loan Pricing Model have been watching probability of default rates rapidly increase for construction projects over the last several months. When users look at the new October data on Monday, they are qoing to see a significant jump. What was a 5% probability of default is now be a 12% default rate in some areas.

Our model uses forward-looking default data, as opposed to empirical or historical rate-based, so there is a large difference when compared to other models that use a 5Y historical average. This forward-looking view includes general economic conditions by state (soon to be zip code); supply vs. absorption by property type; demographic information and net effective rents. Every quarter, the model is correlated and validated to historical rates and adjusted accordingly.

One shortcoming of the model is that it assumes all loans are performing at the time of origination. However, if lenders attempt to price a construction loan that is being extended, the default picture gets decidedly worse. Once a loan starts having problems, our data unfortunately shows that 49% of loans will experience losses. Note that our data is within 8% of the new Fitch Loan Default Study released in July of this year.

When banks extend a construction loan for a 2nd time, the probability of default increases to approximately 65%. That means by the time you make that extension, the odds are high that you are going to lose money. While you may have thought our roulette analogy above was ludicrous, consider the odds of losing money by choosing "black" is significantly lower at 53%.

As one banker that we interviewed for this article commented, "CCOs are basically manipulating their balance sheets by extending these construction loans with little more than hope as a repayment source. These guys should be lucky they don't have to answer to 404 [SOX]." The point is well taken.

While we don't think CCOs are intentionally extending these loans based on hope, we are of the opinion that lenders should be more aggressive with their assessment of probability of repayment. Giving an already troubled developer more time and capital often amounts to throwing good money after bad. Having lived through the 80s and 90s, our recommendation is for banks to consider folding early, move to secure collateral, go after the borrower (if you are in a double action state where you can do both) and quickly get into an offensive position. This places the bank in a better strategic position to take advantage of other opportunities (such as the increase in spreads for long-term lending). Continuing to extend principal, capitalizing interest and spending resources on management of a troubled loan is often worse than closing ones eyes and spinning the wheel.

BANK NEWS

No more AAA

Moody's and Fitch are reportedly examining bond insurance companies MBIA, AMBAC and 5 others for potential downgrade. Banks will already see a decrease in relative value for this month and are expected to suffer even more when lower ratings are affirmed.

Hired

Merrill Lynch said it has hired NYSE Euronext CEO John Thain to replace Stanley O'Neal. Thain will become the new chairman and CEO.

Bank Investing

Berkshire Hathaway disclosed additional investments in U.S. Bank and Wells Fargo, becoming the single largest shareholder in both. The announcement brought a small bid to many bank stocks.

No Merger

Randolph Bank & Trust ($277mm, NC) and Bank of the Carolinas ($456mm, NC) have called off their proposed merger following a sharp drop in Bank of the Carolina's stock (since the original announcement in April).

Reverse Mortgages

BofA is expanding its consumer reverse mortgage business to the Southeast US. Accordingly, its Senior Equity Reverse Mortgage suite of products will be available to customers in GA, NC, SC, and FL.

Another CA Bank

Capital Bancorp ($4.7B, MI) announced the opening of The Bank of Feather River in Yuba City, CA. This is its 8th bank in CA and 57th nationwide.