A BALANCED LOAN PLATE

by Steve Brown

Thanksgiving always gets us thinking about food, which is typically not far from our minds anyway. As holiday feasting continues over the next month or so, there are always some interesting choices. While we strive for proper meal diversification and control, we usually end up weighting our plates too heavily towards turkey and gravy. This always results in repeated tryptophan stupors, which are only broken up by the voice of John Madden announcing multiple football games playing in the background.

Conceptually, we prefer a balanced plate of food, however when the time comes, making the decisions needed to achieve balance is easier said than done. In this vein, banks must consider the importance of diversification within their loan portfolio. High concentrations of particular asset classes result in greater default risk in general. When considering different options for growing the loan portfolio, it is essential to evaluate the entire picture. In addition, it may even be necessary to make some outside-the-box decisions.

Through our consulting group, we review the balance sheets of many clients on an ongoing basis. Perhaps not surprising, we find many community banks have high levels of CRE in their loan portfolio. Most these days also have commercial real estate and construction exposures in excess of 3x and 1x capital. As we all know by now, such concentrations can also trigger increased regulatory scrutiny and require additional risk management processes and procedures to support.

One possible alternative to help diversify the loan plate is our C&I Loan Participation Program. This program gives community banks the opportunity to lower default risk correlation among assets. Not only do the default rates of these credits exhibit low correlation coefficients with regard to CRE, but they also maintain lower coefficients among themselves (as they encompass a variety of industries sensitive to different economic factors). The beauty of these loans is that banks can pick and choose from a variety of credits to find those that best compliment their current loan portfolio risk profile. For example, since most banks already have a high correlation to the real estate and financial services sectors, diversifying into heavy manufacturing, technology or agriculture can help. Perhaps a bank would rather increase gaming, retail or public utility exposures to round out their credit plate. While these loans are not without risk, they do allow banks to maintain margins while reducing enterprise wide credit risk through diversification.

In addition, these C&I credits generally have debt service coverage ratios of 1.75x or greater, are companies with a large market share and have diverse revenue sources from many different product lines. As an added benefit, participant banks can also track the risk profile of many of these credits through national agency ratings (such as Moody's and S&P), as well as readily available corporate financial statements and covenant compliance certificates. Combine all of these factors with the fact that these loans also pay upfront fees and you have the equivalent of putting whipped cream on your already-delicious pumpkin pie.

The next time your family of loan committee members gets together for an approval potluck, make sure everyone considers the value of diversity. We are standing by to show you examples of a variety of credits that are floating rate, have 2Ys to 5Ys final maturity and carry attractive risk-adjusted returns.

BANK NEWS

Black Friday

While deep discounts pulled in 147mm shoppers (a 4.8% increase from last year), spending averaged $347.44 (down 3.5% from last year).

More Competition

A number of major national brokerages, including Stifel Financial Corp, Scottrade Inc, AG Edwards, and Edward Jones, are opening retail bank branches. The brokerage firms are betting that their established customer base, significant capital reserves, and network of brokers will provide a competitive advantage in the retail banking business.

Mobile Future

A new study found that although less than 1% of households currently use mobile banking, 35% will do so 3Ys from now. According to the study, by 2010 56mm households will be doing most of their banking transactions online, and 17mm will be doing so from their cell phones.

CFC Update

Countrywide said its October loan origination fell 48% YOY, but credit quality has begun to stabilize (due to cutbacks in riskier ARM and subprime home loans). Additionally, the company said it cut 2,100 jobs during the month and will eliminate up to 12k employees by December.

Small SOX

A recent study by the U.S. Chamber of Commerce that small companies are disproportionably burdened by Section 404 of SOX. The study found that 52% of companies with less than $75mm in market value will spend 3% of earnings on compliance with greater increases in 2008 and 2009. Only half of those thought the compliance would do any good at mitigating fraud.