COMMUNITY BANK LOAN PERFORMANCE FOR DEC

by Steve Brown

For those of you using our Loan Pricing Model, you already have access to the latest December information. For everyone else, we provide an update on community bank loan performance. On average, default probabilities rose 6.5% for the month of December, one of the largest jumps for the year (a 78% annualized increase). To put this in perspective, banks will suffer about a 2% decrease in risk-adjusted return on equity, as a result of higher default rates. On the opposite side of the coin, to compensate for this risk, (given the average structure of loans for December) banks would have to increase pricing 26bp to maintain the same ROE (which incidentally was 14.3%). The riskiest loan a community bank could make in December - a 2nd TD HELOC (at a 3.81% probability of default).

Other notable changes include a 50% month-over-month jump in default expectations for hospitality lending and manufactured housing. Mixed use, multifamily, office, retail and self storage all rose 20% from last month. Office and retail continue to track each other and now show a 1% probability of default. The increases in defaults in these sectors are a result of a healthy amount of new supply coming on the market, combined with a decrease in demand. Our forward-looking model shows rents will decrease in about 75% of the 170 markets that we cover. Southern CA, southern FL, Las Vegas, Salt Lake City and San Bernardino/Riverside are all projected to have some of the largest deterioration of bank loan credit quality as a result of lower resets (exacerbated by lease terms that have shortened on community bank collateral over 2007). Nationwide, the retail vacancy rate hit 7.5%, its highest level since June of 1996.

The bright spot at this point is loans on agriculture farm land, which dropped 33% from last month. As we have been saying for years, while agricultural loans have higher default rates, they are counter-cyclical and can offset construction risk nicely. Another bright spot is loans on senior housing. After some higher probabilities of default over the last several months, December saw lower risk (as it looks like many properties lowered rates and increased occupancy, resulting in better DSCRs). Construction risk abated slightly, due to lower cost of construction inputs (causing less reported price overruns on projects). In addition, lower employment has caused many firms to increase manpower on projects. The combination of more available workers and lower construction inputs (wood, steel, gypsum, concrete, etc.) has overwhelmed the risk from slower lease up times. As a result, for the short-term at least, the probabilities of default on both residential and commercial construction have been reduced an average of 8% for the month.

On a statewide basis, some significant changes last month include default probabilities going down 4% in PA and 6% in RI. Meanwhile, probabilities went up 6% in NH and 5% in MN. The worst states for loan performance for community banks include: TX, OK, TN, MI and VT.

BANK NEWS

Weak Earnings

SunTrust followed other large banks in reporting 4Q net profit fell sharply (down 98%). The Bank was hammered by housing and after being forced to prop up two of its money-market funds. SunTrust set aside $357mm for credit losses, more than double the 3Q level.

FHLB Flood

New research comparing the 2Q vs. 3Q of 2007 finds the FHLB system saw Advances jump 28% over that period. Market uncertainty, credit pressure and less expensive borrowing than the CD market all contributed to the heavy increase in bank borrowing. The increase was nearly 5x larger than any prior quarter.

FHLB Exposure

Did you know that as of the 3Q of 2007, the following banks represented 40% of total FHLB borrowing exposure to the system: Citibank (12%), Countrywide (6.2%), Washington Mutual (5.3%), World Savings (5.0%), Bank of America (4.2%), RBS Citizens (2.7%), Sovereign (2.6%) and US Bank (2.0%). The number represents 5.3% of GDP, roughly a 400% increase over the average of the past decade. Experts say the FRB expanded its discount window operations through the Term Auction Facility (TAF) as a result of this extreme shift in pressure on the FHLB.

Recession Perception

A new Fortune Magazine poll found that 3 out of 4 Americans believed the US economy is already in a recession, or will be sometime in 2008. Additionally, almost half of those surveyed say they've cut back their spending compared to last year.

M&A

Last year, there were 215 bank mergers, 12% fewer than 2006 and the lowest level in 5Ys. Meanwhile, the median acquisition price to book value was 2.08x and the most active markets for acquisitions were CA, PA, OH, NY and TX.

Denovo Activity

There were 117 initial offerings in banks and thrifts in 2007, 30% less than in 2006.