LEAPING FROM RISK TO OPPORTUNITY

by Steve Brown

Given all the extra work that needs to be done, bankers seem generally pleased that this year is a leap year. For the curious in the crowd, note that a leap year occurs every 4Ys, primarily because Pope Gregory XIII liked to have order and at the time, the Julian calendar (we all now follow the Gregorian calendar) simply wasn't getting it done. In short, it takes about 365.25 days for the earth to rotate around the sun, which means about every 4Ys we need to have a catch-up or leap year to keep everything in synch. That extra catch-up day is today, which is why we take a moment to help busy community bankers get back in synch.

While everyone probably saw FNMA and FHLMC post whopping 4Q losses in the past few days, some may have missed the extra commentary that came along with it. FHLMC's CEO called the current housing situation "one of the most severe housing downturns in American history," as he projected credit losses would soar to $2.2B in 2008 and 30% more in 2009. FNMA's CEO called the slump the worst "in a generation." Meanwhile, Moody's said it might cut both GSEs financial strength ratings since the losses "represent a significant deterioration of surplus regulatory capital." The longer FNMA and FHLMC struggle, the less effective they will be in supporting an already struggling housing market. In credit rating agency speak, that means both GSEs will have to raise more capital.

We often still hear bankers saying their region isn't getting hit as bad as others. While that may be true in some cases, note that it was recently reported that home prices in 20 major markets had their biggest annual drop (down 9.1%) last year than in any of the prior 20Ys. Even worse, home prices fell 325% more than they did during the 1990-1991 recession. In like news, luxury home builder Toll Brothers reported the average price of its signed contracts in the prior quarter fell 13%. Bankers with single family residential construction loans on the books should stress loan values on these holdings by 10% to 50% when modeling the impact of this risk.

Bankers are grappling with economic weakness by increasing loan loss provisions and writing down goodwill from prior acquisitions as impaired in many cases. The 4Q data shows net income at institutions fell to a 16Y low, while ROA for the quarter tanked to 0.18%. Note that this was the lowest ROA since 1990, when it came in at a negative 0.19%. Provisions more than tripled compared to the same quarter in 2006, jumping by their biggest amount in 20Ys. Despite the increase, the coverage ratio fell to 0.93%, the first time since 1993 that noncurrent loans have exceeded reserves. For the quarter, noncurrent loans had their highest increase in 24Ys. The data shows bankers will likely see increased write-offs, higher loss provisions and have less time to chase new business (as most will be busy managing existing credit exposures).

Consumers have also been impacted recently by actions taken by the large national banks. A few days ago, Bank of America said it would no longer allow certain customers from drawing on home equity lines due to softness in the housing market. Their action followed a similar move by Countrywide and a few other large banks. Yesterday, Wells Fargo said it would tighten lending standards in 200 markets across the country that it called "severely distressed." While the impact of these events has yet to trickle through the economy, we wonder what people will do with a half-completed kitchen, a 10-month housing overhang and no where to go to get additional money. That problem, combined with already higher oil, tax and food costs, point to a protracted consumer spending (and therefore economic) slowdown.

As for us, we prefer to focus on the positive by reminding community bankers that out of disaster also comes opportunity. Banks that want to leap ahead will focus on improving risk management, do careful lending, shore up existing exposures and keep their eyes and ears open for opportunity.

BANK NEWS

Bernanke

Scaring bankers, our Fed Chair said that housing problems could cause some small banks to fail. Analysts put the number from 50 to 100. Bernanke went on to add that banks should continue to raise more capital to allow more of a credit buffer. While he didn't say it, we are sure he was thinking that banks should talk to us about a bank holding company loan, TRUPs, subordinated debt or preferred equity.

CRE Projection

Moody's projects commercial real estate property values will fall 15% to 20% over the next few years.

Foreclosure

Nationwide last month, the foreclosure rate reached 1 in every 534 homes. That compares to 1 in every 86 homes in the Cape Coral-Fort Myers area of FL, where foreclosure rates were the highest. Foreclosure rates soared 75% in 2007 to their highest since World War II.