LEMMING LOAN PRODUCTION

by Steve Brown

Contrary to popular belief, lemmings do not blindly follow each other off the cliff to their death. Particularly in the case of Norway lemmings, large migrating groups will reach a cliff overlooking the ocean. They will then stop until a biological urge to reach the ocean causes them to jump off the cliff and start swimming, sometimes to exhaustion and death. Those that don't jump are often pushed into the ocean by the crowd of lemmings coming from behind. Regardless of their reason for jumping, one thing is for sure - all lemmings wished they hadn't priced loans to their competition instead of to risk. Ok, we made that part up, but our analogy is apt, considering what has transpired in recent lending markets.

The FDIC issued a letter to banks on 3/17 (Managing Commercial Real Estate Concentrations in a Challenging Environment) that highlighted the importance of keeping up on current changing economic conditions. The FDIC reiterated that banks should not be tempted by the relentless push to grow, leaving sound judgment behind. From their letter: "A strong credit review and risk rating system that identifies deteriorating credit trends early should be enhanced or implemented." The FDIC asserts: "Competition among financial institutions for growth, profitability, and community influence sometimes results in the compromise of sound credit principles and acquisition of unsound loans. The ultimate cost of unsound loans outweighs temporary gains in growth, income and influence."

Three years ago, spreads in the subprime market ground relentlessly tighter, risk-based pricing fell by the wayside and investors and originators willingly priced assets without regard to true risk. Many banks pointed to low historic delinquency rates over the previous 5Ys as proof that the business cycle had ceased and the industry had fundamentally better underwriting By December of 2006, the market started to see defaults revert to the mean. By mid-2007, the market understood that financial institutions weren't prepared to handle "average" credit quality when viewed from a 1995 to 2005 historic default perspective. The last 12 months has firmly reinforced the notion that if you ignore risk-based pricing, you do so at your own peril.

At the end of the 1Q 2008, we unfortunately have multiple examples of banks that have mispriced risk across the broad spectrum of categories. The reasoning is largely the same - the competition was doing it, so we had to. Those words are a blow to the strategic planning process and disrespect the leadership of both the board and management. A bank always has choices - it can alter its business methods, get out of a line of business or stay disciplined and live with lower volume. Additionally, a bank can also choose to take the risk. Smart banks that choose this path will attempt to quantify the risk and educate the board and management so all parties are on the same page.

If you have not done so already, now is the time to institute a good pricing and credit model that periodically updates probabilities of default, by lending class and by region. It's not just about the borrower anymore - it is now about survival. In the last several months defaults on retail, multifamily, senior housing and owner occupied industrial have all moved in material amounts. In some cases credit has improved, in others it has deteriorated. For those categories where it has improved, the data gives banks a quantitative reason to tighten pricing. In categories where defaults and recoveries have deteriorated, banks need a higher return to compensate for the added risk. Banks that ignore the current changes in risk or take their cue from the competition should watch out for the lemming in front.

BANK NEWS

Massive Regulatory Overhaul

In the broadest overhaul of financial oversight since the Great Depression, Treasury Secretary Paulson is set to unveil a plan that would have far reaching impact to bankers. Under the proposal the FRB would have authority to look at the financial status of any institution that could affect market stability; the SEC would merge with the CFTC; and bank supervision would be consolidated into one regulator (OCC would absorb the OTS).

Risk Restructure

In a move designed to diversify geographic concentrations of its banks, Capitol Bancorp said it will sell 4 community banks in MI for $52mm. Banks sold included Grand Haven Bank, Kent Commerce, Muskegon Commerce and Paragon Bank & Trust for a combined asset total of $420mm.

Sales Restructure

In an effort to capture more clients, Citibank said it will break its consumer group into two separate units of consumer banking and credit cards. The move is designed to "bring decision-making closer to clients" by allowing regional units of the bank to make decisions more autonomously.

Liar Loans

A study of stated income loans finds consumers that took them out tended to heavily exaggerate how much money they made. The study found 90% of such loans had overstated income by at least 5%, however 60% of borrowers exaggerated their income by at least 50%.