THE FUTURE OF BANK DELINQUENCIES

by Steve Brown

As banks plan ahead, one thing to keep in mind is the fact that loan delinquencies do not move in linear fashion with property valuations. The relationship between property performance and delinquencies is an interesting one and holds some important lessons for the future.

If you look at how the frequency of delinquencies occur in a downturn (depth in the left graph represents history, while the horizontal axis is duration of the downturn and the vertical axis is delinquency rates), banks experience a small rash of non-performing loans at the start of the downturn (usually within the first 6 months), a slowdown in delinquencies between months 6 and 12 and then a huge upturn in loan problems around the 18th month mark (the spike in the 3D surface plot above), before they begin to moderate. If the pattern from the 80's and 90's hold, banks should continue to prepare for even greater real estate related losses in the second half of 2008.

Banks remain highly correlated to property values due to concentrations in CRE, construction loans and geography. In fact, as of the end of the year, the correlation at most community banks approximates 0.71. That means, that 70% of an average community bank's credit performance can be explained as a result of real estate values in its service area. While underwriting and loan management are important, loan portfolio allocations are the single largest factors to explain bank delinquencies and losses. In terms of risk management, many banks strive for a correlation of less than 40%.

Another aspect of this delinquency profile is that if you graph property values and community bank loan delinquencies, one finds that the shape of the delinquency curve is concaved. That is, as property values decrease, delinquencies rise at a slow rate to start, moderate and then speed up. This non-linear or asymmetric behavior of loan performance is captured in the fundamental fact that property owners experience greater pain once values dip below 10% than they do when values fall 2%. Because of this sensitivity relationship, delinquencies at banks should increase at a faster rate than we have experienced to date. Long-term leases, backlogs of tenants (that eventually get exhausted) and the percentage of variable expenses to fixed costs (in that many properties can reduce expense quickly, as vacancies increase, but this can occur for only so long) all play a part in this behavior.

At present, while bank performance is poor for 1Q, our Credit Stress Model shows that things are about to get geometrically worse, as commercial real estate values fall more than 5%.

To mitigate some of this delinquency/property value behavior, banks should utilize analysis similar to our credit stress model to help set loan loss allowances. In addition, as we have written about extensively, increasing monitoring of the loan portfolio, selling CRE exposure (if concentrated) and immediately move to a more diversified portfolio are all solutions with impact. In upcoming strategic planning sessions, banks should strive to architect themselves to figure out how to expand their lending area and lending type in order to become less correlated to real estate values.

Our C&I program is designed for this very reason and allows banks to gain performing loans that are not correlated to the local real estate market. In this program, banks can book these loans quickly and efficiently.

Since we are a bank of banks, our very livelihood is tied to your success. If we can help provide data, products or services to help you thrive in the market, do not hesitate to contact us for more information.

BANK NEWS

Bank Liquidity

Bank demand has increased in the Fed's Term Auction Facility recently. As a result, funding levels have risen some 30+bp in the last month (similar to the recent rise in Libor). Look for the Fed to add more liquidity soon.

Interest On Reserves

In an effort to provide more liquidity to the banking system, the FOMC will reportedly discuss paying interest on commercial bank reserves held at the FRB. Congress had previously granted the FRB permission to pay interest on reserves starting on 10/31/2011 and any such changes would require its approval.

Competition

Using proprietary software and analysis, Wells Fargo boasts it can predict transaction volumes at more than 3,000 branches with close to 95% accuracy.

Housing Sale Detail

While lenders aren't formally required to report short sales, a recent study shows short sales account for 20% of closed home sales over the past quarter.

Competitive Threat

Community banks that haven't yet added internet-only banks to their competitive analysis shouldn't wait any longer. Consider that nearly 25% of consumers now say they have at least one account at an internet-only bank.