

AVOIDING A SKUNK'S SPRAY

by [Steve Brown](#)

Nothing is more menacing than a skunk with its tail in the air. A skunk's spray can reach 12 feet, so avoiding it is the best course of action. We all know that the housing sector stinks right now, but like the person who walks around a corner and gets blasted by the skunk, knowing what to do next can quickly reduce the lingering odor.

For community bankers heavy in single-family residential construction, times are tough, but that doesn't mean nothing can be done to improve the situation.

To begin, we all have to get real with our projections. Home sales are down 37% from this time last year and the overhang of unsold homes sits at 11 months. The silver lining is that slower home sales have also led to a corresponding slowdown in construction. In order to reduce the overhang, we needed to choke new supply down to a trickle, which has now happened.

As of the last month, construction of new single-family homes fell to its lowest level in 17Ys. We also have to realize that condominiums will remain a problem for even longer in some markets. Condos now account for 1 in 8 homes in the country and in some hard hit areas, unsold units are outnumbering sales (for the past 12 months) by a ratio of more than 4-to-1. In Miami alone, the overhang will likely take 5Ys to be fully absorbed. This problem has pushed foreclosures in some buildings to 50% of

units. Understanding there is no quick fix here and taking into account the strength of the future real estate market is critical. Next, we suggest bankers update appraisals on larger exposures (or those having difficulty). While no one likes to hear bad news, the sooner one can take action with a borrower, the sooner the bank's interests can be protected. As one banker recently said, "if your best customer isn't paying on their loan as agreed, they are a liar and have ceased to be the best customer." Third, even "pillars of the community" can have difficulty and stop paying on their loans. When they do, bankers should move quickly to take action. Rich people may have money, but they also utilize leverage, so the first bank in is usually the first (and perhaps only) one to collect. Waiting rarely helps the situation. Another thing bankers can do is to get proactive. Do not sit and wait until a loan stops performing to attack a growing problem. If you find an area or sector you are lending into has begun to soften, get out and visit even strong borrowers and be proactive. Understanding where risks are forming and taking immediate action will help protect shareholder value. By now, all bankers know that regulators want to see the ALLL needle pointing higher. Don't wait for an examiner to show up on the doorstep to tell you the reserve will have increase. Bankers should also be prepared to suspend dividends if things get rocky in order to replenish capital and reserves. FOMC Chair Bernanke has even warned bankers to remain proactive in capital-raising efforts. This is particularly true if your institution has high exposures or area/sector risks are increasing. Capital has become harder and harder to come by, but worrying about this now, getting a plan in place and being prepared is

advised.

Bankers should also work to improve overall risk management processes and reporting. Being able to identify, monitor and react quickly to exposures and weakening customers are critical at this juncture.

Incorporate liquidity-adjusted pricing ("LAP") on your construction exposures. LAP is used by regulators to calculate the expected price a seller would get if they were to sell a house immediately in a given area. While LAP can sometimes be close to recent market sale prices when conditions are calm, it is particularly useful in areas where conditions are weakening. As demand for housing falls, prices fall and time on market increases. The more this occurs, the more liquidity-adjusting the price of sale becomes important. In some markets, the difference between last sales price and LAP can be 8% to 12%.

Once a skunk sprays you, it can take some time to remove the smell. It may also require trying many different remedies to find the right solution. Trying different remedies in construction lending is also very important right now. As it appears the bottom of the cycle will not be reached until late 2009, bankers will have to work carefully to avoid getting sprayed.

BANK NEWS

Munis

Banks breathed a huge sigh of relief yesterday when the U.S. Supreme Court ruled that states can continue to offer a tax-exemption within their borders. Had the ruling gone the other way, disruption would have reigned in this \$2.6T market and banks would have had to take a huge impairment writedown on municipal securities holdings.

State of Economy

Money management icon George Soros was on the tape saying that the worst of the credit crisis is over, but that a recession in the U.S. and U.K. is inevitable (due to lingering effects and higher energy prices). Meanwhile, investment firm Oppenheimer & Co., released a report saying the worst is still to come (as the consumer has yet to feel the full impact). That burden is expected to increase, as banks

are forced to take more writedowns, attempt to preserve capital and further decrease credit availability to consumers.

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