ASSUMING THE WORST

by Steve Brown

Having just completed a swing through OR, WA and CA, we are now on our way to the East Coast to see how credit quality and banks are doing in MD, VA, SC, NC, GA and FL. From our talks, one thing that stands out is how bankers are still thinking about the housing-related downturn and planning for a bounce back in the economy by early next year.

We are hoping that we are dead wrong on this point, but the evidence is mounting and the probability of a prolonged economic slump is rising. When we run planning scenarios to test ALM and budget assumptions, a deep and lengthy recession garners a 35% probability. A rebound in 4Q, 2008 or 1Q, 2009 is fine as a base case, but it is worth spending a couple of hours in a strategic planning retreat to talk through a plan for what your bank would do if conditions got markedly worse.

From 1920 to 1938 the average length of a recession was 20 months. The average length of a recession from 1948 to 1991 was 11 months. The longest was the Great Depression, which lasted 43 months. If you look at the underlying economy, we are closer to the latter. Remember in the early 90's, corporations cut back spending, causing a mild (8 month) recession. Corporate spending has about a 12% impact on the economy. The consumer, on the other hand, comprises close to 70%. We have just come off a 7Y period of unprecedented growth and cheap capital. Unemployment is rising sharply and the consumer remains over-leveraged, with the lowest savings rate in history.

The rise of the dollar last week was a deadly sign. The dollar rose due to the deterioration of economic conditions in the world economy. While many international players will remain strong, many more will weaken considerably. Given that we have just come off of the greatest global fiscal party ever, the likelihood that this will be one of the greatest hangovers on record is high. In other words, this recession may neither be short nor shallow.

For community banks, what is particularly disconcerting is the deterioration of commercial real estate. Back in April, we reported on the harbinger of issues related to falling debt service coverage on cash flowing retail properties. As vacancy rates have continued to rise, particularly in "B" class retail centers (a favorite of community banks), we are now starting to see outright defaults. Worse, we are starting to see debt service coverage fall in industrial, self-storage, municipal and particularly, office.

Our July numbers point to the 4th consecutive drop in nationwide CRE property prices, off 4% for the year and 9% from their 2007 high. Vacancy rates have ticked up in a majority of U.S. markets in almost every sector but multifamily. In similar fashion, absorption is off sharply. The retail sector continues to be our greatest concern for banks, as nowhere in recorded history have we seen the amount of lease cancellations/non-renewals than we have seen in the last 4 months. Starbucks, Macy's, Gap, Home Depot, Sharper Image, jewelry, furniture, electronic, nail salons and the like have canceled over 8k locations (millions of square feet), more than 1k more stores than the previous record in 2001.

For planning purposes, banks should consider whether they can handle increasing loan loss reserves to 2.5% and risk-based capital to 15%? Could your bank manage the increased load on the loan workout group? Could it handle higher overhead expenses? Is it worth extending out the maturities of liabilities to insure liquidity?

Taking more reserves, capital and ensuring greater liquidity will surely hurt 2009 performance, but that is our point. While we are optimistic that we will be looking for a quick recovery in 2009, the odds are quickly mounting against it. As such, giving up earnings now to ensure survival later may be a strategy worth considering.

BANK NEWS

Hurting Housing

In a move that will negatively impact liquidity in the mortgage market and increase costs, FNMA said it will no longer purchase so-called Alt-A (between Prime and Subprime categories) loans. The loans accounted for about 11% of FNMA's loans during the past few years, but accounted for 50% of losses in the 2Q. FNMA also said it would increase the fees it charges based on borrowers' credit scores and the amount of their down payments.

Auction Rate Reimbursement

As part of a legal settlement with the NY Attorney General, UBS, Citigroup and Merrill Lynch said they would buy back Auction Rate Securities purchased by certain retail investors at par. The settlement covers $11B in securities purchased by 80k clients at UBS, $7B purchased by 40k investors at Citigroup and $12B purchased by 30k investors at Merrill.

S-Corp

The IRS released new guidance on how S-corps can reduce its tax attributes in years where there has been cancellation of debt that is excluded from grow income. A ruling will be held in Dec. to solidify this timely clarification.