QUARKS AND LOANS

by Steve Brown

Please enjoy this BID this month because it may be the last. It is not that we are discontinuing the publication, it is just that in the next couple of weeks you could be sucked into a giant man-made black hole. Today, deep underground in Switzerland, the largest particle accelerator, called the Large Hadron Collider, went full power and successfully moved particles around clockwise. In a couple of weeks, they will test the opposite direction and then do both together - ramming matter together at the speed of light. Since we do not know exactly what will happen on this subatomic level, the world is nervous. Either we will gain insight into the origins of the universe and have a better understanding of physics, or the whole world will be collapsed into the size of a hockey puck by Columbus Day.

This experiment brings up a similar one that we conducted 1Y ago this month, when we officially started sales of national C&I loan participations to community banks. Back in 2006, the industry needed to decrease its credit correlation to the economy, while keeping overhead costs in line. One solution was to acquire funded C&I loans from multinational banks in several different industries to add diversification. The program improves geographic and sector concentration, decreases covariance of the entire loan portfolio and reduces maintenance costs. All of these factors have contributed to increased earnings in a difficult market environment.

It has been more than a year since the credit crisis began and while both the construction and CRE sectors have deteriorated, credit in general on national C&I loans has improved. More than 40 banks have joined this participation program so far. It is little wonder if you consider that the average debt service of this group of loans has gone from 2.85x back in 3/07 to 3.46x as of 6/08. Debt, as a multiple of cash flow, has decreased during that same time frame and is now 17% lower. For these C&I loans, the probability of forward default has also fallen slightly, to approximately 1.45%, compared to 2.04% for community bank CRE loans. While industrial, retail and office default rates are increasing, national C&I probabilities of default and loss given default are holding steady.

The ability to add non-real estate correlated assets is attractive enough, but these assets also fit nicely into a bank pricing and risk profile. With a risk-adjusted ROE north of 30%, pricing around 3-month Libor + 3.50% (currently 6.32% or Prime + 1.32%) and 25bp in upfront fees, pricing is attractive. In addition, given the threat of inflation, the yield on these loans are expected to trend up towards 7.00% as rates rise. The floating rate structure fits with most bank asset-liability profile, while credit ratings and loan underwriting packages also accelerate/simplify the approval process.

If you are looking to add loan totals and diversify credit exposures, there is a wide choice of loans available. The track record over the past year has been solid and the prediction for 2009 is even stronger when compared to the rest of the community bank loan market.

If you would like to take a look at a sample credit, just send us an e-mail. In the meantime, we will keep monitoring the goings on with the particle acceleration inside the 17-mile, circular Hadron Collider and keep our fingers crossed. Since we are uncomfortable crammed into the economy class of airlines, we are not looking forward to being condensed to the size of a hockey puck. However, if that is how things turn out, please know that we sincerely appreciate your readership.

PREFERRED EQUITY

Banks reported trouble in raising preferred equity because of the Fannie and Freddie preferred equity performance. The GSE shares fell another 11% yesterday and banks that were in the midst of raising equity report more trouble garnering capital and at higher costs.

BANK NEWS

No End In Sight

A record 1.2mm homes were in foreclosure in the 2Q and new foreclosures increased 9% from the prior quarter. A record 2.9mm people are now behind on their loan payments and delinquencies have jumped 25% over last year.

SBA Pool Speeds

For banks working on their next year budget, SBA loan prepayment speeds are running at 15% CPR at the end of August, down 28% from 2007. For 2009, speeds are projected to slow slight to 13% CPR due to higher rates, lower debt service coverage and lower asset prices.

No More

A subsidiary of Berkshire Hathaway, Kansas Bankers Surety, said it will no longer offer excess insurance for bank deposits. The company, which used to cover insurance on deposits that exceeded FDIC limits up to $20mm per bank, will notify about 1,500 financial institutions in 30 states that it is out of the business. KBS is reportedly taking the action because it could no longer find reinsurance for the product.

Odd Merge

Kennebec Savings ($652mm, ME) will merge with KV Federal Credit Union ($50mm, ME) for undisclosed terms. Should the merger occur, it will be one of the first among cross species.