MANAGING LOAN REFINANCING RISK

by Steve Brown

One thing that all banks need to get a handle on is loan refinance planning because the clock is ticking. As we look at past origination volumes, using 2009 as a base, refinancing risk more than doubles next year and remains elevated in 2012. The reason for this is twofold; one is that due to origination demand, banks added a heavy amount of 5Y loans with 25Y amortizations back in 2005 and 2006. The 2nd reason is that credit and liquidity risk has brought on one of the highest risks that the commercial loan market has ever seen.

Let's recap the risk of balloon loans in general. Contrary to popular belief, most balloon loans contain more risk than longer, fully amortized loans. While maturities are shorter on loans with balloon structures, compared to loans with full amortization, the liquidity risk is higher on the former. It follows that pricing should be relatively higher (on a spread basis) when compared to longer loans. This is the exact opposite to how most banks price their balloon structured CRE loans.

For the sake of example, let's assume interest rate risk and repricing risk are identical in both of our example loans. Fundamentally, a balloon loan that needs to be refinanced must face a similar positive cash flow and valuation outlook as a fully amortizing loan. Thus, credit risk for a 5Y balloon with 25Y amortization is just slightly higher (by just a couple of percentage points) than a similar 25Y fully amortizing loan. However, the 5Y balloon loan has the added risk of liquidity. This balloon liquidity risk overwhelms any difference in credit risk between the two structures, thus creating more risk in balloons. Not only does credit need to have a positive outlook, but banks must be willing to lend to those economics. 2009 highlights the perfect storm to highlight this risk. While a property's economics may be positive, the lack of conduit alternatives and restrictions in bank lending have shot this liquidity risk through the roof. Statistically, a loan with a 75% LTV and 1.25% DSCR has about a 95% probability of getting refinanced under the same or more advantageous terms (if you look at the data from 1997 to 2007). In 2009, this probability (just based on the past 3 months), has dropped to less than 10%.

Since these loans are already on the books, the question is what to do about them? For starters, hopefully you have reports that chart not only the amount of loans coming due in the next 5Ys, but the distribution of those loans. For 2010, you should know the dispersion of cash flow coverage, guarantor quality and current loan to value. Next, assumptions need to be made on what these metrics will be 6 months before the maturity date. The remaining loans will be those loans susceptible to an elevated level of refinancing risk. Next, those loans that meet current lending parameters need to be tested to make sure they can handle the presumably higher pricing. The loans that are left over, should then be triaged as to severity and discussions should be had as early as possible with borrowers.

We pulled a sample group of 200 CRE loans that are on community bank books and do not currently qualify for refinancing (but were coming due next year). The good news is that these loans had an average debt service coverage of 1.76x with a project coverage rate in March of 2010 of 1.51x. A common loan was a $4.4mm loan that appraised at $6.6mm back in 2005 (for a 68% LTV). Currently, cap rates average 8.8% for combined properties and are projected to be 9.9%. This gives a value of about $4.5mm or about a 98% projected LTV. Currently, as projected for March, this loan would have to have a 60% LTV to have an 80% probability or better of being refinanced. To achieve that, the borrower would have to either pledge additional collateral or come up with $1.76mm in cash.

Given the large amount of risk currently embodied on community bank's balance sheets, wise banks are making sure they have an action plan, sufficient capital and resources to deal with the risk. In this market, getting borrowers to come up with additional capital may be problematic, so banks may need a back-up plan. The upside is that the sooner a bank and borrower start planning for refinancing risk, the greater the odds of a successful resolution.

BANK NEWS

Bank Closure #21

Omni National Bank ($956mm, GA) was closed on Friday and depositors were given 30 days to transfer funds to other banks or close their account and receive a check. At the time of closing, there was approximately $2.0mm in uninsured deposits. Other information on Omni: it had been in business for 32Ys, had 7 offices, had a noncurrent loan to equity ratio of 230% and used wholesale funding to support 56% of assets.

M&A

Southern Bancorp ($200mm, AR) acquired Timberland Bank ($139mm, AR) for about $6mm or 48% of book.

M&A

Merchants Nat'l Bank ($418mm, OH) will acquire CB Bancorp ($110mm, OH) for $10.8mm or 1x book.

Enforcements

The FDIC issued 45 orders in Feb., of which 21 were C&D orders, 7 were removals and prohibitions and 10 were civil money penalties. On a more pleasant note, 3 previous C&D orders were terminated.