PSYCHOLOGY AND BANKING

by Steve Brown

When traumatic events happen, such as the Great Recession or banking industry stress currently underway, people tend to think in extremes. Such thought is officially called "cognitive distortion" by psychologists, which manifests itself as negative thinking. Cognitive distortion occurs when people under significant stress lose long-term perspective, focus on immediate issues and see only the negative. People in this situation tend to discount positive events and replace them with overgeneralization, as they dwell on the negative. It is easy to find oneself in this situation in today's banking industry, but as we analyze the economy this morning we'll try not to fall into that trap.

Housing: The inventory of unsold homes in most battered markets is somewhere around 9 to 10 months or about double the normal rate. While still an elevated level, this overhang is falling in step with lower home prices, which has been the leading driver for increased sales. There is more work to do here despite the fact that prices have declined about 35% from the high water mark to about 2003 levels, but signs are positive.

Equity: As home prices have fallen in many markets, negative equity has increased. It is projected that by the end of this year, in fact, 30% of all US households will have negative equity in their homes. As home prices fall, more households are put into a negative equity situation, creating an incentive for the borrower to walk away from the property. Compounding the issue, lower home prices and increased losses have pushed legions of banks to tighten credit standards and cut home equity lines, reducing options for cash-strapped homeowners. All of these issues feed the downward spiral, so successful foreclosure mitigation programs will be those that attack both negative equity and unaffordable payments.

Modifications: We have all seen or heard about the analysis done on re-default risk in mortgage modifications. After 8 months, loans that had been modified re-defaulted at a rate of roughly 58%. This probably isn't all that surprising when you consider that only 2.5% of loans modified between the 4Q of 2008 and 1Q of 2009 involved a principal reduction of any sort. Of greater interest, perhaps, research finds that 30% of seriously delinquent borrowers ended up paying off their loans without a modification of any sort and cured themselves on their own. We don't know why that is the case, but it does show some sector resilience one could argue.

Jobs: if one is going to talk about a housing recovery, the employment situation must enter the picture. Consider that during the last 30Ys, people who lost their job took an average of about 16 weeks to find a new one. As of 2Q, however, it was taking almost 25 weeks, the longest since record keeping began in 1948. Meanwhile, those people who had permanently lost their jobs (vs. temporary layoffs) had soared to a record 54%. Unemployment lags economic recovery, but records like these have us heading for the psychiatrist's couch.

Savings: We have all heard lots of news lately about how much more Americans have been saving. In fact, we have gone from a low rate one year ago of 0.1% of disposable income to a 14Y high (as of May) of 5%. That is great progress and it shows consumers are working to repair their household balance sheets. This is a good step, but when taken in context with unemployment, studies find 38%

of those who lose their jobs have no savings and another 32% can only last between 1 to 3 months before savings are exhausted. Progress is being made, but it is a race against time.

It is anticipated that the economy will grow about 1.5% in the 2nd half of this year, as the jobless rate reaches a high of 11% to 12% before things begin to completely turn around. Whether you find yourself cognitively distorted or not, finding a nice comfy couch to lie down now and again can't be all bad.

BANK NEWS

Bank #53 Closed

Regulators shut down Bank of Wyoming ($70mm, WY) on Friday and Central Bank & Trust ($96mm, WY) assumed all non-brokered deposits and $55mm in assets.

Multifamily Sector Stress

In the 2Q, vacancies rose to 7.5%, a 22Y high, and rents dropped to 0.9% according to Reis.

Retail Sector Stress

Reis is reporting that vacancies at US retail properties jumped in the 2Q to the highest level in a decade, as shopping center vacancies climbed to 10% (from 8.1% in 2Q 2008) and mall vacancies rose to 8.4%(from 6.3%).

Hotel Sector Stress

US hotel occupancy is down 53% through May month-end, marking the largest single decline in occupancy since Smith Travel began tracking 22Ys ago.

Office Sector Stress

Real estate firm CB Richard Ellis reports office vacancies reached 15.5% in the 1Q, up from 13.3% at the same time last year or about a 17% increase.

Home Equity Stress

The ABA is reporting that delinquencies on home equity loans have climbed to a record level of 3.52% of all accounts, as job losses take a toll on performance.

IOUs

The larger banks in CA will not accept the state's IOUs beyond the 7/10 deadline. Over 60 CU's have decided otherwise. For community banks, IOUs are posing a troubling dilemma - extend a loan to CA or upset depositors/customers. Complicating the situation, the SEC has ruled these are securities. What will you decide?