COMMUNITY BANK LOAN PERFORMANCE FOR 2Q

by Steve Brown

We just updated our probabilities of default for August and published our CRE Lending Index for 2Q, so we thought we would share some highlights of community bank lending by sector.

Retail - Forward looking probabilities of defaults remained constant from 1Q to 2Q and came in at 6.57%. However, due to 1.5% lower rents and a 6% to 10% rise in vacancies, the future volatility of retail loan performance has increased. As a result, our retail loan index fell to 65.99, down 16% from 1Q.

Industrial - Probabilities of default kicked up 21% to a 7.30% rate. This dropped the index down 20% to 55.84. Lower production and more manufacturing co. bankruptcies have limited the need for warehouse space. The one bright spot is construction in this sector was down 50%, so the forward view shows stabilization towards the end of the year and then a reduction of risk in 2Q 2010.

Multifamily - Probabilities of default ticked up 10% to 3.62%. This dropped the index down 8% to 84.39. Most of the credit problems in this sector stem in outlying suburban areas as people relocate to same priced product closer to their workplaces or have failed to find employment and have moved out. 60% of markets showed an increase in vacancies and 80% showed a rent decline quarter over quarter.

Office - Probabilities of default for this sector moved up 8% to 3.65%. Higher default probabilities along with the 6th consecutive negative absorption quarter moved our lending index down 5% to 78.73. Vacancies now hover around 10% and average rents have dropped 3% since the start of the year. One thing for community banks to note, suburban areas now exhibit a higher dispersion, thus indicating greater risk in the future. Choosing the rate project to lend becomes more important than ever.

Self storage - This was the eye opener of the quarter as demand dramatically dropped causing more price concessions in the market. Probabilities of default increased 31% to 2.06%. While still low, look for the default rate to move dramatically up.

Residential/HELOCS - Much of the risk has already been taken out of the sector so the probabilities of defaults are slowing and only rose 3% (to around 3.25% and 4.10%, respectively). Look for reversal as soon as employment improves. Mixed use properties with a residential component increased 14% (due to the retail side) to a probability of default rate of 3.24%.

Agriculture - The probability of default on production loans increased 4% to 1.25%, while land loans increased 10% to 2.06%. Lower demand and softer commodity prices were drivers.

Construction - The increases in the probabilities of default are starting to slow. Construction, as a whole, increased probabilities of default by 7% to an average of 9.25%. Residential construction fared the worst (now over 10% probability of default), while commercial did the best at 6.59%.

Best/Worst - For the trivia buffs: Q: What is the lowest risk CRE loan you can make and in what area? A: Houston multifamily. What is the most risky and in what areas? A: An industrial loan in Los Angeles or Tampa.

In short, banks need to take into account the most updated probabilities of default when originating loans in order to get the structure and pricing correct. Further, it is recommended that banks utilize a credit stress and ALLL model to help manage risk of existing loans. Since we are a bank of banks, we have both a risk-adjusted loan pricing model and a credit stress model to help banks better manage loans and profitability. If you are not taking into account the latest probabilities of defaults, contact us today to get more information on both products.

BANK NEWS

Stabilizing

The Fed suggested yesterday that "economic activity is leveling out," the committee's most forward statement to date that the recession's end is close. The fed also noted plans to slow the pace of Treasury purchases and continue through the end of October.

FHLB

The banks reported an overall net income of $1.1B, a 56% rise from the year prior, largely resulting from a $979mm net gain in rising rates on derivatives and hedges. The quarter did not go on without losses; the banks took on $437mm in mbs writedowns.

CRE Past Due

Half of all bank past due loans are attributed to construction and land development loans. While the dollar amount in loans 60+ days past due have increased, loans 30 to 60 days past due dropped reflecting some easing in new delinquencies.

Muni's & S-Corp

A ruling last month is creating a stir for about 1,500 S-corp banks that could owe up to 3Ys back taxes for the TEFRA disallowance that they took, but shouldn't have. It is estimated that if upheld (the ruling is being appealed) payments could exceed $100k+ for many banks.

Jobs Still Slow

A survey by the National Association of Business Economics finds only 6% of businesses added jobs in the most recent quarter, a 30Y low.