EVEN HE COULDN'T FIGURE OUT LOAN LOSS RESERVES

by Steve Brown

Back in 1895 at a teacher-parent meeting, a teacher said to a father "It doesn't matter what he does, he will never amount to anything." We found that quite funny, since the student the teacher was talking about was Albert Einstein. We are sure at the time Einstein's father was probably worried, as he wondered what he could do as a parent to change that - obviously, he did not need to worry. As bankers struggle to figure out what else they can be doing in this crazy environment, we focus in on loan grading.

For regulators, loan grading begins with a review of assets (loans in this case) that are initially assigned either a "pass" rating or a "classified" one. Loans assigned a pass rating are deemed by regulators to have a reasonable prospect for the return of P&I according to contractual terms. Loans assigned a classified rating are further analyzed and placed into one of three buckets - Substandard, Doubtful or Loss. While bankers know most of this already, perhaps, it may not be as obvious that each of these categories has all of the characteristics of the previous one and then layers in additional factors.

For instance, loans classified as Substandard are deemed to have a well-defined weakness that could jeopardize collection of P&I. This does not mean that Substandard loans will have losses, rather, these loans have been identified to have weaknesses that are likely to sustain some loss if not corrected. Typical weaknesses can include inadequate net worth, borrower paying capacity or the value of any underlying collateral.

Loans classified as Doubtful on the other hand, have all the weaknesses of Substandard loans, plus a few more. Doubtful loans have additional characteristics that would indicate collection in full is highly questionable (on the basis of currently existing facts, conditions and values) and that some loss in the loan is likely. While the amount is unknown at the time of regulatory review, loans flagged as Doubtful are typically valued to the collateral and any remainder is immediately charged off.

That takes us to loans identified by regulators as Loss. These loans are deemed to be beyond Doubtful and are considered uncollectible. It is important to note this does not mean from a regulatory viewpoint that the loan has absolutely no recovery or salvage value. Rather, regulators have found the loan to have so little underlying value that it is not feasible to defer writing it off. Here, regulators would expect the bank to have charged off such loans and collect any potential future payment as a recovery.

Before we go to the bank side of this issue, understand that regulators have a defined process that begins by assigning loans a grade from not reviewed; to Satisfactory (an acceptable business credit); Special Mention (the loan is missing documentation); Substandard (some loss is probable unless corrective actions are taken); Doubtful (full repayment is questionable); and finally Loss (a complete write-off). That process hasn't changed since 1938 believe it or not and it doesn't look like it will do so anytime soon.

Switching to the bank side of things, most banks utilize a 10 to 15 point loan grading scale that ends with the last 3 numbers as the classified grades and uses the rest of the scale to slice and dice varying grades of pass credits. We will spend more time on this another day given space constraints, but suffice it to say regulators do not require banks to adopt identical classification definitions. Rather, banks only need to have a grading scale/classification structure that can be easily reconciled with the regulatory version.

We don't know if even Einstein could figure out the banking industry these days, given the stresses and massive changes, but if anyone could it would have been him. We also wonder if the comments from Einstein's teacher provided a spark that in some way drove him to succeed. After all, sometimes it is the smallest things that can make a big difference.

BANK NEWS

CRE Overblown

JPMorgan indicates fiscal stimulus and stronger CMBS refinancing point towards a faster than expected recovery in the commercial real estate market.

Fed

The FRB said it will continue purchasing Fannie and Freddie debt and MBS through 1Q 2010.

Almost Over

JP Morgan estimates banks are 72% through the cycle of financial losses and writedowns.

Going Mobile

New research finds Bank of America is the #1 provider of mobile banking services with 2mm customers (about 35% of the market). They are followed by JP Morgan (12%), Wells (9%) and Citigroup (5%).

Trust Accounts

The FDIC clarified that it will consider information in a bank's system (like a numerical code) when looking at trust account titling in relation to maintaining insurance. This means that even if the signature card is incorrect, as long as such accounts are recorded as revocable trusts on the system, insurance coverage should apply.

Mortgages

The Mortgage Banks Association finds 3.89% of commercial MBS were 30 days or more past due in the 2Q, up from 2.04% in the quarter prior. Loans 60 days past due rose 0.3% to 0.15%. Multifamily loans 90 days past due held by FDIC insured institutions jumped 0.64% to 2.92% over the 2Q.

Home Sales

Analysis finds 33% of all home buyers in the past 3 months used the $8k home buyer tax credit.

Housing Update

It is interesting to note that only 5% of Americans are not current on their mortgage, 5% aren't current on their mortgage, 33% rent and 20% have no mortgage at all.