PREVENTING A PANTSLESS FINISH

by Steve Brown

While 2009 isn't going to turn out so hot compared to budget for most banks, the question is how to improve next year. Building cheap deposits will be one key to success. In addition, over the next 2Ys we anticipate that many community banks will face challenges in new loan generation. The vast majority of loan growth for community banks in the past decade has come from construction, land development, CRE and C&I loan categories. In the next year, earning market returns on new loans will not be easy.

Based on absorption rates for retail, warehouse, office and apartment categories; demand for construction lending will be soft through 2011. Construction facilities under $20mm have historically been a large growth engine for community banks. That engine will not start again in the short term. Land development loans will take even longer to recover and may not be in favor with banks (and regulators) for a long time to come.

CRE loan demand will revive in the short-term, however, with defaults at all-time highs and still rising; next year will be challenging for almost all real estate classes. Bank generated C&I and CRE loans have averaged annual returns of almost 8% between 1988 and 2008. On a risk adjusted basis, these loans have outperformed REITS, high-yield CMBS, and real estate equity. However, increasing capitalization rates in primary and secondary markets and increasing probabilities of default, will cause many banks to forgo all but the strongest CRE loans for 2010. Unfortunately there will also be sufficient competition for the plum CRE loans to keep community banks challenged to keep their share of this asset class.

We forecast that over the next year the average probability of default for community bank-generated CRE loans will be 4.64% (almost a 300% increase over historical average). The per annum probability of default for community bank-generated construction loans will be 9.21% - a remarkably unattractive loan class given prevailing pricing and lack of cross-sell opportunities.

C&I loan performance will stand out as a bright spot for many community banks. On a relationship basis, these loans bring deposit and other cross-sell opportunities for banks. In addition, business formation and earnings growth is expected to be in positive territory in 2010. We forecast that over the next year the average probability of default for community bank-generated C&I loans will be 1.42% (substantially lower than CRE default rate). The biggest hurdle for community banks is sourcing these C&I credits in a cost effective manner. First, national banks are still competitive in this loan category and we continue to see loans priced at LIBOR + 2.00% (some are self-funded with deposits; others generate substantial fee income). Second, many C&I credits are simply too small to be profitable for all but the most efficient banks. We do not believe that many community banks can earn positive contribution to overhead for facilities under $250k in average loan balances.

For banks that would like to book C&I credits but are currently challenged in their local market, we have developed a C&I loan purchase program. These C&I loans are fully funded and can be purchased in sizes ranging from $750k to $10mm. All loans are made to borrowers that are the top 3 competitors in their industry and exhibit at least a 1.5X interest coverage ratio. In order to prevent getting caught with the proverbial pants down when it comes to asset generation, banks that are looking to supplement local loan demand with lower risk credit will benefit from this program.

BANK NEWS

M&A

FirstMerit Bank ($10.7B, OH) will purchase $1.2B of deposits and 24 branches for $42mm from First Bank ($10.3B, MO) as it moves to enter the Chicago market. First Merit will acquire all asset-based loans from an affiliate of First Bank.

M&A

Citizens Bank and Trust in St. Paul ($54mm, NE) will acquire Central Bank ($21mm, NE) for an undisclosed sum.

Assessment

The FDIC Board meets this morning and is expected to approve the final rule requiring banks to prepay deposit insurance assessments.

Bank Failures

In her most recent speech, FDIC Chair Bair indicated "a lot more banks (that) will close this year and next," but that the peak of failures would be "next year and then subside."

FRB Survey

The latest survey of bank loan officers finds 67% say they have nearly 10% of their CRE loans in foreclosure.

Muni Stress

Research by the Pew Center finds the 10 states facing the most fiscal stress (based on factors including falling tax revenue, rising unemployment, foreclosure rates, the size of budget gaps, etc.) in order are CA, AZ, FI, MI, NV, OR, FL, NJ, IL and WI. Community banks with bank qualified municipal bond holdings in those states should review underling risk.

CRE Pressure

The chairman of the Fisher Center for Real Estate and Urban Economics at the University of California, Berkeley said he expects commercial real estate conditions will be "awful" in 2010 and "bad" in 2011, before things get better. Earlier this week, billionaire investor Wilbur Ross said he believes the US is going to see a "huge crash in commercial real estate."