C&I vs. CRE REVISITED

by Steve Brown

A few days ago we wrote about the basis of comparing risk of default for C&I versus CRE loans using cash flow and leverage ratios. We also went on to underscore the inordinate amount of leverage that some banks have been willing to accept on CRE loans based on the false assumption of stability of collateral value. Finally, we offered a simple calculator to allow users to compare leverage ratios (debt divided by the cash flow available to service that debt) between CRE and C&I loans. We received hundreds of requests for a copy of this calculator and questions about our analysis, so we resurrect the topic here.

Many bankers questioned our proposition that more emphasis on C&I loan underwriting leads to more profitable community banks. The reasoning was as follows: if more community banks start competing for C&I loans, the margins will erode, structure will suffer and community banks will be back to sub-market returns. However, this publication is aimed at community banks. Of the 8,200 banks in the country, the largest 200 hold 83% of the C&I loans. We gear our message to the other 8,000 banks and state that this is not a zero sum game. We can all win. Remember, C&I loans may not have the best nominal margins, but they are a sector that has a strong risk-adjusted return.

A number of bankers also indicated that liquidating real estate collateral was easier in the event of default than taking over a business or selling inventory and equipment. There is no question this is the case. However, properly structured C&I loans have covenants that must be periodically supplied to the lender, creating an opportunity to intervene in the borrower's business before asset values deteriorate (to the point of jeopardizing the secondary form of repayment). If a CRE loan had the same covenant reporting requirements, than we agree that the real estate collateral is easier to manage and liquidate. Unfortunately, we have seen little evidence of robust covenant reporting in middle-market CRE loans. The problem is that when the borrower's cashflow fails to meet debt service, the value of the collateral has likely depreciated to the point of some impairment of the loan.

Still other bankers complained that most C&I opportunities they see are unfunded lines of credit that earn little interest income and carry heavy administrative overhead. We agree that this type of business is unprofitable, unless accompanied by material deposit balances. There is currently a healthy supply of fully-funded term loans in the market. If your bank is not seeing these opportunities, we suggest you try broadening your geographic search or refocusing business development officers.

Finally, quite a number of bankers pointed out to us that their banks aim to serve the community in which they operate. If the borrowers of that community demand CRE loans, then the bank must reflect that demand in its loan portfolio. If this is your thought, consider that if the prevailing demand in the community requires a bank to book assets that may threaten its long-term survival, then the bank may not be properly serving its local community (because it is undermining it own viability). If banks must supplement their local loan demand with outsourced opportunities, then as long as those opportunities are profitable to the bank, they are also long-term beneficial to the community.

We appreciate all the comments and questions that were sent as the result of these last few articles and we will continue to work to help make community banks more competitive.

CUSTOMER RETENTION

Why go after new customers if you are not taking care of the ones you have? Retaining customers is vital for banks that wish to improve profitability. Join us online tomorrow for a free session that looks at some best practices in improving retention and implementing a successful customer retention program: Register: https://bigevents.webex.com/bigevents/onstage/g.php?t=a&d=855716156

BANK NEWS

Bank Closures (124 YTD)

On Friday, the FDIC closed: [1] Commerce Bank of Southwest Florida ($79.7mm, FL) and sold it to Central Bank ($431mm, MN). Central Bank will assume all deposits for no premium and purchase essentially all assets, with $61mm under a loss-share transaction.

SBA Help For Banks

While a long-shot, the ABA is diligently pushing a plan that would provide an equity matching program for well-capitalized banks under $5B that submitted a request and capital restoration plan to their primary regulator. The program is being proposed under the current Small Business Lending Initiative.

Interchange Fees

A GAO study confirms that while reducing card interchange fees would reduce costs for merchants, it would not necessarily reduce the cost to the consumer and may actually hinder credit availability. The theory goes that networks may have to slow payments, reduce fraud protection or limit guarantees in order to compensate for lower revenue.

Jobless

Unemployment climbed higher in 29 states in Oct., up from 23 in Sept. MI ranks highest in unemployment, at 15.1%, followed by NV at 13.0%, RI at 12.9%, CA at 12.5% and SC at 12.1%.

Hiring

JPMorgan will hire 300 loan officers before the end of this year and 900 over 2010. Planning to expand small business lending, the bank will hire also 325 small-business bankers.