PLEASE PUT ON THE GOGGLES

by Steve Brown

The rise of home theater systems has caused motion picture studios to push for 3D innovation in order to fill seats. Avatar, shot in 3D, is on its way to becoming one of the highest grossing movies ever. Customers are paying large sums to watch a human live in an artificial body. Before the movie came out, people had to travel to CA to see that.

The immersive effects of the new "motion capture" technology allows viewers to focus not only on what is in the foreground, but have a better awareness of what is going on in the background. The analogy is apt, as bankers will be in need of 3D glasses to better understand how CRE will impact their performance for 2010. Before you dismiss as another "doom and gloom" article on CRE, wait, because it is the opposite. In true 3D form, if you look past the headlines of what is happening with existing risk, we now have some quantitative signs of improvement.

Last month marked the first signs of a possible turn around. The average probability of default dropped 5.36% from the prior month to 4.88%, for the average CRE loan originated by community banks. This drop followed a 16 month continuous rise, so this is good news indeed. Meanwhile, industrial and "Other CRE" probabilities of default dropped over 20%, with the majority of categories experiencing declines. Our latest research also shows falling loss given defaults, resulting in additional reductions in expected losses.

What is happening here? The answer lies on how our Loan Pricing Model is constructed. Our model is forward looking, so Dec. marked the first time projected cash flow streams of a loan were positively impacted by forward looking factors, such as expected rents, supply/demand, absorption and other factors. These projected factors are better than where they are today, discounted for time. In other words, while Dec. doesn't mark the bottom of the CRE cycle, banks looking at a 5Y loan or longer should understand the sum of the risk profile is better due to improvement in the later years. Lower property values and less cash flow from lower rents are bad for existing loans, but great for future loans (as it means that the downside risk is dramatically less for banks originating new CRE exposure). On top of that, pricing is still at some of the widest levels ever recorded, particularly for 7Y and longer fixed-rate transactions.

The practical application is such that should this economic recovery hold, probabilities of default will be falling and it will happen fast. Add in higher pricing and banks will be facing a very interesting dilemma - while regulators will be pushing banks to lower CRE concentrations, the risk-adjusted reward profile will be such that banks may find the best way to reduce risk to the overall portfolio is to add new CRE origination (in order to offset existing portfolio risk). Even more perplexing to risk managers will be the fact that the better risk-adjusted reward profile could also be great enough to offset added concentration risk.

The potential dynamic on the horizon is Avatar-like mind blowing, as the industry may be pushed into actually diversifying into higher risk categories, resulting in an increased risk to the overall portfolio at the bank. While diversification is important for the long-run, it is the formation of capital through earnings that has a much, much greater positive impact on risk.

It is important to note that not all CRE sectors are performing the same, nor are all geographies. This is why banks that use our risk-adjusted loan pricing model at the zip code level will have a huge advantage over banks that don't.

We also note that not all probabilities of defaults are dropping. Agriculture, mixed use, multifamily and self storage probabilities of default are still on the rise in about 80% of the zip codes. However, by utilizing our Loan Pricing Model, banks can have a basis for judging relative risk, both now and in the future - an effect that is much closer to a 3D view.

BANK NEWS

IRR Warning

Federal regulators issued an advisory on interest rate risk (preparing everyone for eventual rate hikes) to banks to establish and maintain sound "risk measuring and monitoring systems" and processes. Regulators reminded bankers to be wary of funding longer-term assets with short-term liabilities; indicated strong IRR processes are particularly important for banks experiencing lower earnings & capital due to lower credit quality; and said effective IRR must include actions to control risk (not just measure and identify it) including raising more capital or mitigating exposures.

Consumer Stress

The ABA is reporting delinquencies on home equity loans climbed 7% from the 2Q to the 3Q to a record 4.3% level and home equity lines of credit jumped 10% to a record of 2.12%.

Better CRE

The WSJ is reporting that a group of analysts at Morgan Stanley indicate CRE property values bottomed out in 2009 and that the sector is "only a moderate headwind for the economy."