KICKING THE CRE LOAN MODIFICATION CAN

by Steve Brown

The analogy of "kicking the can down the road" is beginning to become one of the most overused analogies in financial reporting. Since we haven't used the term in quit a while, we wanted to do our part in helping to wear the phrase out. Given all the talk about modified residential mortgages, we were curious as to how CRE loans (non-construction) were faring, so we chose this time to take a kick at the expression.

To answer the question of where lenders were going in CRE loan modifications, we took a look at about 500 restructured loans at banks, asset managers and private investors. It is no surprise that the first thing that jumped out of the data was that loans originated near the top of the market in 2005 and 2006, were more likely to run into trouble. Also obvious was the fact that the closer a loan was to maturity; the more likely it was to be restructured. While this seems straightforward, from a risk perspective it should be the other way around. Once cash flows are jeopardized, the theoretical risk to the remaining cash flow is the same, regardless of whether the balance is due in 6 months or 2Ys. Having a longer road to maturity gives lenders more time to work with borrowers and thus presents more options.

To better understand this point, let's look at the breakdown of how lenders modify loans. In about 40% of the cases we reviewed, maturities were extended. In about 20% of the cases, documents/covenants or other terms (like capitalization of interest or additional collateral) were changed to bring the loan back into compliance. We point out that in about 60% of cases the main objective of reducing the probability of default wasn't actually achieved. While extending maturity buys time, the expected loss doesn't change unless the bank has knowledge that future expected losses will be lower. While we all hope for the economy to improve, the future is uncertain and "kicking the can down the road" may not be the best way to solve the problem.

The same goes for loosening covenants. While this eliminates a compliance issue, it doesn't reduce risk. Additionally, requiring more collateral helps improve loss given default numbers, but it does little to prevent the loan going back into default, as the probability of default remains the same. If early data from the residential sector is any indication, loan modifications from just maturity extension or term changes are just as likely to go back into default as not. While sometimes a maturity extension or relaxation of terms is all that can be done, it is likely far better to restructure CRE loans in such a way that the overall probability of default is improved as this definitively reduces risk now.

In 30% of the cases we reviewed, lenders restructured both amortization and maturity. This provided the loan with greater cash flow coverage and improved the expected loss. In 10% of the cases, principal reduction, rate reduction or payment modifications were made. This not only increased cash flow coverage, but it also gave an economic incentive to the borrower to keep the loan current. By reducing the incentive that the borrower will walk away, banks further decrease their probability of default. Similar to residential loans, we would expect CRE loans modified to improve cash flow and some type of principal/interest reduction to show the most improvement in the borrower's ability to remain current.

Since most modified CRE loans have been performing for less than a year, it is still too early to have any definitive clarity on what loan modification or combination of methods will ultimately be best. As such, we will take another look at this topic in the middle of the year, as we kick the analytical can down the road.

BANK NEWS

TAG Extension

To the joy and happiness of community bankers everywhere, the FDIC extended the Transaction Account Guarantee (TAG) component of the Temporary Liquidity Guarantee Program (TLGP) for 6 months, through Dec 31, 2010, with the possibility of extending the program an additional 12 months without further rulemaking. Banks that wish to opt out of the TAG extension must submit their request to opt out on or before Apr 30, 2010. Assessment rates will remain the same during the 6 month extension. Beginning Sep 30, 2010, for Call Report purposes, banks must report the total dollar amount of TAG-qualifying accounts and the total number of accounts must be reported as an average daily balance. The maximum interest rate limit for NOW accounts guaranteed under the TAG program will be 0.25% effective Jul 1, 2010.

JPMorgan:

The Bank reported stronger than expected 1Q profit of $3.3B (up 57% from 4Q), driven by investment banking (up 53% from 4Q), fixed-income (up 12% YOY) and a lower provision for credit losses (down 27% from 4Q), as nonperforming loans fell 39% from the 4Q. CEO Jamie Dimon said the economy is showing "clear and broad-based improvements" and that the company planned to hire 9,000 new employees in the US.