LOAN SIZE AND DEFAULTS

by Steve Brown

Recent asset quality problems have, unfortunately, given us a tremendous amount of data to enhance loan performance. It is the one bright spot in the downturn. While there are many areas that we need to enhance as an industry, one area that community banks have it right is underwriting for size. In the past, we have looked at how profitability is multiple times greater for a larger loan over $2mm than it is for the average $450k loan. Today, however, we just focus on credit. Specifically, we looked at a representative sample of some 200 balloon loans originated in the last 5Ys in the main commercial real estate segments of retail, office, multi-family, industrial and hospitality. We looked at loans between $200k and $25mm that have matured since the start of 2009 but cannot be repaid or refinanced subject to the underwriting standards of the originating bank. We stratified by original size and asked the question if the defaults have any correlation to size?

The answer, given our data to this point, and to the credit of many bankers, is - not really. While larger loans may pose greater risk because they have a larger impact on capital, our analysis indicates that they do not negatively affect bank capital. In fact, while it is too early in the cycle to tell, our initial findings are that larger loans carry slightly lower risk. While this answer is comforting, the details may be instructive for community bankers to help in future underwriting.

For starters, loan underwriting standards at most community banks don't vary too much according to loan size (although some banks do have higher underwriting standards for loans of larger size). However, banks seem to be operating on an informal, non-codified set of underwriting standards in that bankers often require higher debt service coverage, higher quality of collateral, more collateral or more guarantees for larger loans. This seems to be working, as the one major anomaly in the data shows that loans above $10mm have actual defaults of 68% less than the defaults for smaller loans under $10mm. While the evidence is inconclusive, it does appear that loans above $10mm were informally underwritten to higher standards. For example, larger hotel properties in addition to better underwriting metrics, tend to have a national sponsor, tend to be in larger metro areas and tend to be to owners with generally more financial wherewithal. As a result, matured loans that were in technical default were more likely to be cured by the borrower or refinanced by another bank (with or without additional borrower support).

Conversely, loans below $1mm have a slightly higher default rate compared to loans in the $1mm to $5mm group. Smaller borrowers tend to have a more limited ability to pay down the loan or refinance. Loans below $1mm tend to be in smaller markets and more exceptions to policy tend to occur. If there is one bit of advice that we can draw from the data it is that banks should consider increasing pricing on smaller loans to compensate for the risk (in addition to relatively higher overhead costs), and/or raise underwriting standards to bring defaults in line with the rest of the portfolio.

Finally, loans between $1mm and $5mm exhibited almost identical defaults during the last 18 months. There is slightly better performance in the $1mm to $2mm range, but it is within the margin of error, so we will call it a dead heat.

Given these statistics, it appears the bank credit officers instinctively know that large loans present more risk to the institution relative to capital and tend to informally adjust. If they can do the same for loans under $1mm, banks will find that they can improve performance.

BANK NEWS

AgBank of China

The Bank completed its first leg of its IPO raising $19B. Orders will still be taken that may boost this bank to a new world record for any IPO currently set at $21.9B (by the Commercial Bank of China). AgBank was founded in 1979, has 320mm retail customers, 2.7mm commercial clients, 24k branches and $1T in deposits.

Past Due

Data from LPS Applied Analytics shows mortgage delinquencies increased in June from May, following months of declines. Mortgages 90 days or more delinquent rose 20bp to 9.2% month-over-month with foreclosures steady at 3.18%. In NV and FL, 1 out of 5 loans is at least 30 days delinquent.

M&A Potentials List

Following a 2Y pause, KBW Inc. recommenced posting its Bank Takeover List, of which includes 38 prospective buyers, 26 potential sellers and a group of probable buyers who become likely sellers.

Summer Travel

A survey by the National Foundation for Credit Counseling finds 64% of people are staying at home this summer due to the lack of discretionary income.

Higher Bankruptcy

The American Bankruptcy Institute reports consumer bankruptcies in the first 6 months of this year are 14% higher than the same period last year. Hard to find jobs, high levels of existing debt and low savings rates are catching up to consumers according to analysts.