LOAN DEFAULT REASONS AND TRACKING

by Steve Brown

When it comes to loan defaults, one area that banks may want to consider more closely tracking are the reasons for that default. While it is not likely there is any one reason, understanding the main contributing factors can be instructive. For example, is the business not meeting its revenue/sales targets? Is occupancy lower than expected? Are rents lower, expenses higher? Or is it a combination of reasons? Making an attempt to distill the problems and coming up with a quantitative set of potential impact factors will help banks better analyze why and how loan performance problems occur in hopes of improving underwriting standards.

For example, one area that we have been working with banks is simply tracking when a loan goes into default. Does the loan go into default at maturity when it cannot be refinanced (a "refi default") or does the loan go into default during its term (a "term default"). This seemingly small data point, can have a huge impact on how you resource and how you handle future loan underwriting.

Refi defaults occur less frequently than term defaults but account for the larger potential risk because of the amount of loan balance and capital involved. Refi defaults occur at set times (in accordance with maturity) and are much more predictable (we can accurately forecast refi defaults 1 to 2 years in advance). Refi defaults are heavily correlated to borrower financial condition and property value. Since a refi default usually means the borrower is able to make the debt service payments, but not refinance, these loans are in better shape and usually have a lower level of expected losses. Thus, on a risk-adjusted basis, while there is greater capital at risk, the actual losses are lower. Here, actual losses from refi defaults account for only about 15% of banks' losses for 2009 and 2010 (thru March).

Term defaults, on the other hand, are a function of cash flow, are more evenly distributed as to time of default and are less predictable. These are more common defaults (usually close to 70% of a bank's problem loans) and are driven by cash flow. Here, the borrower usually has less options and thus risk is higher comparatively as expected losses are greater.

When looking at the factors for defaults, the date of origination and geographical location are highly important when predicting refi defaults. Here, allocation decisions have the largest impact on bank loan losses. In contrast, while geography is important, management, sales and expense control are also more influential factors when working with quantifying term defaults. For these, underwriting decisions have the largest impact on defaults. In addition, certain property types, such as retail properties, are multiple times (by a factor of 5) more likely to suffer a term default than a refi default.

Tracking ongoing debt service coverage and appraised value (and the specific date) in electronic form is now mandatory for loan management. However, given the value of the data, looking at a variety of other factors can prove extremely helpful. How defaults occur are just some of the many factors that we highly recommend tracking on a go forward basis.

BANK NEWS

OCC

The Comptroller of the Currency, John Dugan, announced he will leave at the end of his term on Aug. 14.

Social Media

As mentioned previously, banks should assign someone to monitor social media for risk management. This fact was driven home last week when 2 people attempted to destabilize Venezuela's banking sector by putting out false rumors on Twitter. There are simple applications that look for key words that cannot only give you competitive feedback, but give you an early alert system to watch for problems.

Still Delinquent

In the 1Q, $23.9B in nonresidential loans were restructured, of which nearly 45% were already 30 days or more past due by quarter end. Not surprisingly, in the 1Q more than 9% of all CRE loans were past due. Currently, Foresight Analytics estimates 2/3 of all CRE loans maturing in 4 years or less are underwater with $176B worth delinquent.

CMBS

According to Fitch, the volume of US CMBS loans in special servicing is at a record high and is expected to continue rising across all property types. Fitch's annual US CMBS Loss Study also found that cumulative average loss rates totaled 37% by the end of last year. For 2009, loss rates reached 57%, up from 43% in 2008, and resolution periods averaged 19 months. Annual losses for industrial, hotel, multifamily, office and retail properties are expected to hit 49%, 82%, 58%, 57% and 48%, respectively. Methods of recovery with losses well over the average were REO settlements, discounted payoffs and note sales.

Stock Buybacks

Due to excess corporate cash, the rate of buybacks in the US is running at highest levels since the start of the year. 27 new buy-back programs occurred last week totaling $18.5bn. So far in 2010 there have been 343 new authorizations for $178bn in buy-backs; buyback pace is still running below '07 peak.