INCEPTION - DREAMING ABOUT LOAN DEFAULTS

by Steve Brown

In the instant cult movie Inception, a specialized team goes into a dream, then into another dream and into a 3rd dream, in order to plant an idea deep within a person's subconscious. Its all very trippy, made even more interesting by the fact that you realize that while the plot line is science fiction, it is not too different from the shared experience of watching a movie (your dream) about making a movie (the directors dream) of a movie (the writer's dream); which some argue is what Inception is about. The movie also raises questions, such as, are emotions felt in a dream any less real than reality; and, if you experience something in a dream, can that information help you change reality for the positive?

We believe that dreaming emotions are real and that dream information can help process information in the present. Take loan performance as an example. We constantly have these unsettling dreams that we, as an industry, are not doing all we can to help our loan portfolio. Further, when we look ahead, the very real outcome of defaults in some sectors makes us want to take further action now to prevent that potential reality.

A large percentage of community bank floating rate CRE loans for example are at 1.25x debt service coverage or less. The problem with this reality is the two things working against it: 1) further deteriorating credit and 2) rising interest rates. On credit, things don't have to get worse from here, as just the passage of time will cause problems. For instance, taking a look at a rent roll of an average office or retail property, current market rents in many geographic areas are some 20% to 30% lower. As leases come due, rents could reset lower as either tenants get replaced or current renters negotiate lower terms. The net result for the bank with the loan is that cash flow coverage could be stressed even to non-performance.

In another version of this dream, we see a market where rents move higher, so that future cash flow presents debt service coverage where it is today. Here, the property is less sensitive to movement along the credit curve, but more sensitive to movement along the interest rate curve. That is, credit improves to the point of causing inflationary concerns, which drives interest rates higher. Given a 1.25x debt coverage on a floating arte loan (or one sitting at a floor), loans will become strained somewhere around 120bp of upward movement. In this scenario, despite a better credit environment in general, a number of properties will stop performing as higher interest expense eats into cash flow.

To prevent either or both of these states, we recommend banks conduct a credit stress test to better understand what could happen at the loan level when credit or interest rates rise. Once the size of the problem is understood, banks can then take steps to renegotiate loan terms by extending maturities or reducing rates, to name a few. Doing this now could not only help prevent a troubled debt restructuring down the road, but also protect against a material loss of principal. In this instance, banks can use our BLP program to fix the rate for customers to stabilize their debt service coverage and mitigate the majority of the interest rate risk. This can help prevent the property from negatively cash flowing due to rising rates.

Dreaming about the future of the loan portfolio and taking steps to offset the pain of rising rates now is important to ensure ongoing performance. As Cobb, the main character in Inception said, "negative emotions are trumped by positive emotions." By dreaming of these issues now and taking steps, you can change your future reality and protect bank performance.

BANK NEWS

Exam Appeal

The OCC sent out a notification yesterday to banks it supervises, reminding them of the appeals process that can be used to resolve differences when bank executives and directors disagree with examination results.

USDA

The Supplemental Appropriations Bill (H.R. 4899) that was signed into law includes the re-approval of $32mm in Agriculture Dept. Farm Service Agency guarantees and an additional $1B in FSA lending authority (that will ensure that the USDA's 502 housing program will continue).

Lower Fees, More Bouncing

The WSJ is reporting a survey by the National Foundation for Credit Counseling finds 74% of people will not use overdraft protection to make purchases or withdraw money when their checking balance gets low. Under the new regulation, beginning August 15, customers of banks must sign up for overdraft protection before a bank can charge a fee or allow an overdraft to go through.

No Muni Money

Moody's indicates the amount of debt US states are carrying jumped 10.3% last year to $460B. The good news is that the median state debt to gross state product is only 2%, so the risk of default remains low.

Lend a Hand

A survey by US Bancorp found 7 in 10 customers think they are not saving enough while 6 in 10 would like their bank to help them in this effort.

Chase Atlanta

JP Morgan announced that it will open 10 Chase branches in northern Atlanta this year and 35 next year.