EFFICIENT DIVERSIFICATION AWAY FROM CRE

by Steve Brown

Many concepts are better understood when studied in detail and inspected up close. For example, take The Statue of Liberty - impressive from a distance but even more awe inspiring up close. We recently learned that at the foot of the statue lie broken shackles of oppression and tyranny. There are seven rays on her crown, one for each of the seven continents. Lady Liberty takes a smoking break every day at 3pm. All right,

that last bit we made up, but she is an interesting woman. Over the course of the last few years we have discussed the benefits of diversification in community bank loan portfolios. In the past, we have noted how C&I loans provide good diversification for real estate-centric community banks. For example, electronics manufacturing is generally negatively correlated (R2 of -0.15) to real estate. We have even communicated with many banks that are sold on the concept of loan diversification. However, upon closer examination, some of these banks have found it difficult to apply the concept in practice. Most banks around the country are seeking out C&I loan opportunities. Issues can arise, however, as many of these available C&I loans demonstrate hurdles including: 1) the loans are exceedingly small (under $200,000), 2) the loans are standby lines (translating to minimal revenue and full credit exposure), and 3) borrower strength is suspect. All of this translates to an enigma for community banks - where to find profitable C&I loans. Dealing in the more concrete and practical end of things, we have been discussing our National C&I loan program that allows banks to participate in larger loans originated by national companies. These credits are available in larger loan sizes (from $1 million or higher), all loans in the program are fully funded, and the obligors are well-rated credits with abundant publically

available information for community bankers to access. One example of a loan from the program is Flextronics International. This loan adds diversification, provides loan growth and is rated one notch below investment grade (BB+ by S&P). Given probabilities of default and loss given default levels, that is probably better than the average bank rating on the majority of loans in the average community bank's portfolio. This credit pays a monthly coupon of LIBOR + 2.25% and banks in our program have also received the benefit of a floor. The floor gives community banks a higher coupon payment when rates are lower in the initial loan periods (helping NIM) and a floating rate coupon down the road when the economy bounces back (6 to 30 months from now). This added feature also helps banks offset loan loss

reserve costs when these loans are initially booked. Other factors banks have liked about this particular credit include: Flextronics is the largest and one of the lowest cost providers in the electronic manufacturing industry (making a wide variety of electronic components for most cell phones, computers, GPS units, etc.). With 14k employees, manufacturing has continued to grow in this recession. The Company's size, position and broad service offerings provide non-correlative credit risk that community banks find hard to duplicate in their local market.

This credit may not be for all banks, but we strongly believe C&I loans are a good solution for many community banks seeking diversification, increased profitability and enhanced risk management. Such loans offer banks an opportunity to originate a more balanced loan portfolio and increase profitability.

Our National C&I program has also been offered to community banking with great success for the past 3Ys. In so doing, we have tried to give community bank clients yet another option to create a more stable balance sheet and profitable income stream, while allowing banks to focus on their core customers.

BANK NEWS

Muni Insurance

FGIC, one of the largest bond insurers to community banks, filed for Chapter 11. This has minimal impact on banks since, most of the bank issues were reinsured by Nat'l Public Finance Guarantee (NPFG). That said, since NPFG was the old MBIA, banks are in the process of understanding their consolidated exposure.

Bankrupt

The American Bankruptcy Institute notes personal filings jumped 9% MoM and YoY in June to 138k. YTD, 802k filings have been made or nearly 1 in every 125 households.

Buyback

FRBNY is considering a required bank buyback of bad loans from the takeover of Bear Sterns and AIG.

Foreclosures

RealtyTrac indicates more than 1mm people will face foreclosure in 2010, following 900k who lost their homes in 2009. Of note, foreclosures in a typical year are usually around 100k.

FDIC Agenda

The regulator released their agenda for next week's Board meeting. On it, the FDIC will consider proposed templates for safe, low-cost transactional and basic savings accounts. In addition, the Board should also finalize the details on guidance around the role of public credit ratings in regulatory capital guidelines.

What's In A Name

1297 banks in the US carry the word "First" in their name, while 154 have "Peoples" and 55 have "Heritage." If you need to name your bank, The First First Bank is still up for grabs.