THE IMPACT OF LOAN WORKOUT EXPENSES

by Steve Brown

If you have not run across your loan workout people lately, you are lucky. They are in a foul mood, similar to the look one gets when a rabid shrew is in one's shorts. We can't blame them, as they are doing some of the most important work in the bank these days, are under tremendous pressure and

are being confronted by people that really don't want to work with them or are impatient with the process. The job is taxing. Within these dark corners of banking, there is the little known concept of managing severity of loss when dealing with both loan pricing and loan workouts. The market is starting to get a true understanding of the role that both expenses and principal losses play when it comes to loan workouts.

Remember that some of the factors of loan pricing are probability of default and the potential loss given default net of recoveries (as users of our Loan Pricing Model can attest to). Included in the loss given default calculation are expenses associated with fixing any property in trouble, which include legal fees, workout staff resources, property maintenance, selling expenses and foregone interest to name a few. This total can be significant, so today we discuss ways bankers may want to consider incorporating this to improve pricing of loans and get a better handle on total costs when loans go into workout mode.

If you are a user of our BIG Profit profitability model to price loans, then we have you covered, as we automatically pull updated expense data to help. If you are not a user, here are some things you may want to think about to give you a better working knowledge when making decisions.

First, expenses as a percentage of loan size vary. For example, the average for community bank loans pulled from our BIG Profit data is 9% for loans under $10mm, 12% for loans under $5mm and up to 25% for loans under $1mm. Keep in mind that these expenses are irrespective of any decline in principal value. This makes sense when you think about it, as workout expenses are largely fixed and have little to do with loan size. As can be seen in a loan pricing model, this is also yet another reason why smaller loans should be priced higher to compensate.

Another factor driving non-principal loss is the time it takes to work the property out - the longer the time, the greater the loss. As such, a property's liquidity and the loan's complexity impact workout expenses. Here, as the data from our BIG Profit model shows, large loans above $25mm and small loans under $300k tend to take longer to work out and as such, tend to have relatively higher expenses.

Yet another factor driving up expenses is the loan type. Here once again, data from our BIG Profit model shows hospitality loans for example, take the longest to work out of any major asset class and so they also have the highest workout expense. The data also shows a distant 2nd is retail, followed closely by office, industrial and multifamily.

Finally, time or "vintage" also matters somewhat. The data shows loans originated in 2004 tend to have more collateral coverage and are sold faster, thereby resulting in fewer expenses. In the same vein, loans with more participants tend to cost more to manage, which increases legal and workout costs, which the data from this analysis shows can be 3% to 5% higher than loans where the bank is only dealing with itself.

As we wrap up, there are a couple of other factors this analysis reveals. Interest rates play a role in loss severity because the higher the rate the more expensive the "carry" and the larger the loss can be. Also, since time in workout is such a big factor, banks that can sell properties in pools gain economies of scale and generally do better than when selling properties individually.

The good news is that since liquidity is prevalent right now, the data from BIG Profit shows workout expenses are lower in 2010 than they were in 2009. This is because the time in OREO or for note sales is shorter.

The next time you price a loan or try to figure out profitability, don't forget to capture all of the expenses in the calculation. Knowing your costs ahead of time won't make it any better, but at least you won't be surprised by that rabid shrew feeling.

BANK NEWS

2Q Quarterly Banking Profile

The final report from the FDIC finds: loan balances slipped 1.3% during the quarter as banks continued to shrink to preserve capital; the "Problem" bank list climbed 7% to 829; earnings climbed 16% (the best performance in 3Ys), but this data was skewed by FAS 166/167 items and lower provisions at large banks; annualized NIM was 3.81%; provisions fell to lowest level in 2Ys; loan loss reserves to loans fell to 3.40%; net charge offs and noncurrent loans both fell; and the share of assets funded by FHLB advances fell from 4.8% to 3.4% (are down nearly 30% over the prior 12 months). Meanwhile, here are some averages for community banks ($1B or < in assets) of selected key ratios: ROA = 0.42%; ROE = 3.73; Efficiency = 73.75%; Allowance/loans = 1.73%; Leverage Capital = 10.58%; Tier 1 Capital = 15.76%; Total Risk Based Capital = 16.92%; Loan to deposit ratio = 76.23% and Loans to assets ratio = 63.15%.

Better Times Ahead

S&P said the worst is over for the US banking industry, although the company reiterated that the industry won't enjoy a quick rebound.