LIVING BETTER BY UNDERSTANDING DEATH

by Steve Brown

When we travel, we have an odd habit of occasionally visiting historical cemeteries to get a feel for the past. Our fascination with death doesn't end there, as we are probably also one of the few that read the newspaper obituaries. While on the surface both activities seem macabre, we believe every death tells a story and some are quite interesting. How people died, and more importantly, how they lived, add texture to our mortality.

In a similar vein, we are fascinated as we visit the graves of non-performing CRE loan transactions from failed banks. These credit write ups are essentially the loan's tombstone and they can impart important lessons. After recently reading more than 3 dozen from a variety of such banks, it became obvious that these banks placed a greater emphasis on asset value over cash flow.

For some reason, these bankers (and many in the industry back in the high flying days of yore) thought it was just fine to let a group of doctors with no prior experience speculate on a housing development. Many thought is was OK to put a 10Y loan on a retail center with 1Y leases and some felt it was acceptable to include a reserve fund as a source of primary repayment. When things were running hot, everyone wanted to believe the borrower's projections and many took them at face value. LTV became the lynchpin of the argument and if anything looked odd, the guarantor's outsized net worth was relied upon. Few ever stopped to look at the quality of that equity or how much it might be leveraged on other deals. While we have no quantifiable evidence of this next statement, we are confident that if you were to ever analyze the number of pages in a loan write up compared to actual performance, the two would likely be inversely related. As for the group of problem loans reviewed, the write ups tended to be short on quantitative analysis and drone on about other factoids that had little if anything to do with credit quality. We have seen over the years that good credits often tell their own story through the numbers and allow for short conclusions, while not so good credits require more verbose prose to support.

In most of the problem loans we reviewed, cash flow projections by the bank were either brief or rarely done and downside scenarios were almost never presented. Ongoing rent roll information and updated financial information was often not collected, and when it was, it rarely was turned into analysis.

While a post-mortem on failed bank loans is interesting, the lessons learned will continue to haunt the industry like crows on a wire. We now sit at a time of record low rates and yet we are still faced with a record CRE refinance wave set to peak in 2012 and again in 2016 (5Y and 10Y loans). As an industry, we can either choose to ignore this or we can get proactive. Running updated projections, stress testing and taking action now can help protect us in the future.

For example, our Bankers' Loan Processing (BLP) product has helped many banks take a portion of such loans off of their floors, fix the rate for the borrower (the bank still gets floating), extend maturities and increase debt service coverage. If done in conjunction with scenario cash flow projections, while short-term margins may decrease, risk-adjusted return rises (because of a reduction in the probability of default and the larger stream of cash flows). We are not talking about doing this on every loan, but bankers should look closely at those that are projected to run into trouble on cash flow coverage (due to effective rents that are substantially lower than when the project was financed). By dealing with this problem now, banks increase options available and stand a greater chance of successfully dodging this bullet.

Dead men and dead loans do tell tales. Learning the lessons from the past and applying those to the future helps ensure those dead loans did not perish in vain.

BANK NEWS

New FDIC Rules

Under rules proposed yesterday, the FDIC will require banks hold at least 5% of any security created under a securitization effective 1/1/2011; low-interest consumer checking accounts and Interest on Lawyer Trust Accounts (IOLTAs) will no longer be eligible for an unlimited FDIC guarantee effective 1/1/2011; TAG will expire at the end of 2010 and be replaced by unlimited insurance for all depositors on all noninterest-bearing transaction accounts beginning 12/31/2010 through 12/31/2012.

JP & WAMU

JP Morgan has reportedly submitted $6B in Washington Mutual related lawsuits to the FDIC and requested it be paid under the agreement signed at the time of acquisition (agreement reportedly states FDIC will cover "liabilities of the failed bank" when "written notice" is provided). The number is well above the total $1.88B JP paid in total to acquire Wamu.

Opt-In

A Moeb Services' survey of 2,300 banks finds 60% to 80% of people who overdraft 10x or more per year have opted in to overdraft protection. If this trend holds across the nation, such fees will total $35.4B this year, down just $2B from '09.

Tax Increase

The WSJ is reporting that states have increased taxes this year by the most in 30Ys, as they seek to stay afloat.