POT SMOKING AND ENVIRONMENTAL LENDING

by Steve Brown

The other day at a lending conference, a banker and a lawyer teamed up for an insightful presentation on environmental lending. The team opened up with a couple of jokes about the incessant Katy Perry Song Last Friday Night and how tree hugging, pot smoking environmentalists normally don't mix well with bankers, they might have surfaced an exception. The conclusion of the presentation implored banks to lend on environmentally friendly, LEED- certified buildings. Overall, the presentation was professional, graphically appealing and chock-full of facts (such as a graph showing how LEED CRE lending had lower delinquency than other types of real estate). The conclusion was that loans on LEED buildings are a better risk than non-environmentally friendly loans. The problem is - we believe it to be wrong. At the urging of the above mentioned dynamic duo, we did some research on banking and the market for "ganja," which can be seen above. The top picture is the street price for marijuana, with the dark green areas an indication of a lower price and the lighter green areas an indication of a higher price. The bottom picture is a map of non-accruing loans at banks that shows roughly the same thing. Running the regression on the underlying data, we find that the value of loans and marijuana prices are a statistically significant 46% correlated. While we know many of our astute readers have already made this leap, the conclusion that could be drawn is that cheaper marijuana prices lead to more borrowers just forgetting to make loan payments. That seems to make some sense. Or, the case could be made that more loan and economic problems lead borrowers to switch demand away from marijuana to something harder and more addictive, like say, Katy Perry. Whatever the case, it is hard to draw a supportable conclusion from the fact that the price of marijuana and loans are positively correlated. Let us quickly state that we are all for environmentally sound lending and we don't condone pot smoking. Let us also say that over time, environmental lending may be a safe bet, however as of now, the facts do not support the conclusion it is safer than any other lending. The two examples are based on a common problem we see in banking - drawing the wrong conclusion from the data. Most likely your first statistics class taught you that "correlation does not imply causation." That is, just because something is correlated to something else does not mean the two factors are linked. A classic example is that video games cause violence. Yes, the two are correlated, but it just so happens that under experimentation; more violent people are drawn to video games. To prove a casualty between two factors, the best way to prove it is through a controlled study. When it comes to environmental lending, not only do we think that it may not be a safer bet, it may even be a worse one. A quick review of a group of 56 environmental loans, in fact, finds they exhibit below average risk-adjusted return. While the sample size is small and may not be valid, we point out that we know of no environmentally-focused bank that has produced consistent above average returns. After some additional work on CRE with LEED buildings, we do find that vacancy rates are in fact lower for this property type. However, since LEED buildings tend to be newer, a high percentage of them are considered Class A space. We point out that Class A space has a lower vacancy rate than the rest of the market (which contains Class B and C buildings). To further our point, if you compare LEED buildings to non-LEED Class A space, there is no significant difference we could find. In other words, that fact that LEED buildings are Class A space is likely a better reason for their lower delinquency rate than the fact that they are kind to the environment. Being a Friday before a long holiday, we urge readers to be careful with statistical conclusions - particularly those that involve environmental lending, pot smoking or Katy Perry.

BANK NEWS

Mortgage Mess

The Fed ordered Goldman Sachs to hire an outside consultant to review mortgage loans serviced by a subsidiary where borrowers were wrongly foreclosed upon. The Fed also said a monetary penalty will be needed.

Refi Boomlet

Bloomberg is reporting the sharp drop in interest rates has overloaded lenders, who have cut back staff and are now trying to handle a surge in borrower refinancing activity. Lenders indicate the time needed to close a loan has doubled to 60 days and refinancing applications are up 83% from this yearÃ¢Â€Â™s low in February.

Virtual Cards

Discover discontinued its "Secure Online Account Numbers" service that allowed customers to generate temporary, per transaction card numbers in order to prevent left in addition to guaranteeing 0% loss on credit card transactions. While it was unclear why Discover discontinued the service, we speculate that it was either due to the lack of usage, cost to administer or combination of both.