MAY THE LOAN ODDS BE EVER IN YOUR FAVOR

by Steve Brown

In The Hunger Games, 24 citizens between the ages of 12 and 18 are pitted against each other to the death in the name of entertainment. Prior to the competition, contestants train and compete in order to better their odds in an effort to attract more sponsors. Sponsors are important, as once the contest starts, they can purchase needed provisions to help contestants stay alive and improve their odds of winning. The film's heroine, Katniss, for example, starts at a long shot 20-1 and then moves steadily up to a 6 -1 near-favorite. Having better odds implies you have more money behind you and thus have a wider sponsor base to draw from to give you the competitive advantage. Different from other games, the competition in Hunger Games is distinct and occupies a separate branch of game theory in the fact that you can influence the outcome during the game (by inputting new resources) and shift the odds in your favor depending on performance. To optimize , a player's best strategy is to expend the bulk of their resources during the game, as those resources have an incrementally greater influence on the outcome. If all this seems off topic to banking, let us bring it home. The competition for sponsors is similar to attracting bank capital. In the current environment, loans are the best way to impact your outcome because of leverage. Specifically, protecting current capital in existing loans should far outweigh your demand for resources versus new loan production, due to the amount and probability of the capital at risk. Thus, similar to The Hunger Games, bankers need to do all they can to improve their odds in order to attract future bank capital. As we mentioned yesterday, creating our suggested loan reports, helps banks focus resources, as it can lead to forecasting the future. For example, chances are your CRE loans originated in 2004 are barely registering losses, while your 2007 loans compose most of your losses. If you ran our Credit Stress Model (CSA) back in 2008, you would have had a fair understanding of what was to come as our expected delinquency rates and capital requirements were in the right ballpark (the model is independently validated). We agree that hindsight is nearly worthless; however our CSA model points to the fact that due to the cash flow, seasoning, maturity structure and LTV, almost 85% of the losses from 2004 have already been realized in the form of losses or delinquencies. Unfortunately, this is not the same for loans originated in 2007, as only just a little more than half the loss has been realized. That statement has far reaching consequences, as it may signal when your bank expands, merges or goes to attract capital, not to mention how much capital will be required. In fact, looking into the future, we predict that losses and delinquencies on 2007 CRE production will reach a cumulative 10.5% versus a current realized 5.7% now. This figure includes a little more than 20% of your past TDRs going back into default that is the projected average probability of default for a loan once it has been restructured. If all this sounds like a black box, it isn't as we know 2 major variables with some certainty - current cash flow/LTV and the future of rates. For many of these loans, LTV is projected to be over 85% at balloon maturity. Unless you know the borrower has wherewithal to make that equity down payment to assist in the refinance, chances are a near majority of those at-risk loans will have problems. Add to this equation slowing corporate earnings in many NASICs codes for owner occupied buildings and rising expenses, and our credit model shows a material amount of problems ahead for community banks. This brings us back to the Hunger Games strategy. Bankers, have the ability to improve their future odds mid-game. If you know what loans are likely to go bad at maturity, the best proven strategy is to negotiate an A/B loan structure, where the A loan has the best chance of performing, while you will probably have to write off B. However unpalatable that is, the track record for A/B structures have been dramatically better than other alternatives such as immediate liquidation, interest reductions alone and hope. In addition, once principal is reduced on the A loan, it pays to utilize our BLP Program in order to lock in a fixed rate for the customer, while you maintain a floating rate note. While it is hard to write off part of a performing loan early, many banks now have the ability to control when this occurs which is a critical factor in performance management. By utilizing the strategy of targeting problem loans as early as possible and restructuring them, your bank can literally put the odds in your favor.

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AmericanWest Bank ($2.3B, WA) will buy Security Business Bank of San Diego ($233mm, CA) for $26mm in cash, or about 1.07x tangible book.

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FNB Bancorp ($716mm, CA) will buy Oceanic Bank Holding ($169mm, CA) for $27.75mm in cash, or about 1.16x tangible book.

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Capital Bank Financial ($6.5B, FL) will acquire Southern Community Financial ($1.5B, NC) for $48.4mm in cash and stock, or about 35% of book. Capital was formerly known as North American Financial Holdings and was funded 2Ys ago by private equity firms with $900mm in capital to absorb distressed banks in the Southeast.

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Montise PLC will acquire Clairmail for $173mm as it expands its mobile banking services in North America.