LIMITING VIBRATIONS WITH LEASE RISK MITIGATION

by Steve Brown

A recent survey by Baystate Medical Center (MA) found 68% of hospital staff was vexed by "phantom vibration syndrome" or the strange ailment that makes you think your cell phone is vibrating in your pocket even though it is not. By our anecdotal evidence, this also happens to about 85% of bankers. While there are many theories, the likely culprit is a stressed brain that jumps the gun and creates a false signal in response to other stimuli. In other words, a stressful day and a minor shift in your shirt may set off a false cell phone vibration in your pocket. If this happens to you, know that you are not alone. It also appears to happen more to credit officers than other bankers in general. One potential reason is the stress of lease expiration risk in the CRE portfolio. While in the past we have discussed looking forward and analyzing loan refinance risk, today we break down the subcomponents to determine properties that are at-risk for lease issues. The analysis is germane, as the ability to maintain a leased property at market rents or better is the number one driver of loan performance. Banks that understood their lease exposure to Blockbuster Video for example, had 9+ months of lead time to work with the property manager to mitigate the risk of store closures and problems. The same is now true for office buildings that have law firms, as probabilities of default for this subsector have increased in the last year, as cash flow has decreased. When it comes to best practices for lease monitoring, banks usually look at 2 items: the year of lease expiration (and the amount of time to expiration) and a measure of total leased value as a percentage of total value. The latter metric is analyzed in a variety of ways, but can be done by taking the total lease value under contract for each year (or maybe just the top 3 tenants) and dividing it by the total square footage available, multiplied by market rents. The key is to get a standard measure so that as leases run off or shorten, you can see the potential risk ahead and how it relates to refinancing. In addition, banks that are on top of their risk game also track market gross rents, market net effective rents (the difference between the first two are concessions which is also worth tracking), existing lease net effective rents and options for lease extension. By way of an example, we looked at a random sample of almost 9k CRE loans totaling over $15B. Of that amount, we found multifamily, lodging and other specialty properties with no long- term lease coverage composed almost 20% of the exposure. This is an important fact to know, as you now have a feel that if this was the composition of your bank, 20% of your exposure is highly correlated to economic conditions (and the most volatile in terms of valuations). Next, we looked at major tenant exposure and found that while retail is the single largest lease risk in terms of total loan dollars under contract, industrial properties have the highest concentration to single tenant leases (and thus could present the most potential volatility). This explains why the probabilities of default are greatest for these two categories and why pricing is the highest when compared to office (which usually has smaller leases for a longer term). We also point out that with lease terms and credit being equal, multi-tenant properties offer more diversification than single tenant properties and thus carry lower probabilities of default. As we look ahead, a record number of leases as a percentage of total value come due in 2012, keeping CRE risk elevated at many banks. This ratio continues to grow each year, until it peaks in 2015 and is the result of loans tied to 5, 7 and 10Y leases that were signed during the go-go years of 2004 thru 2007. Managing and monitoring lease risk can add an extra window into credit risk. As such, getting an intern to go through loan files and collect current property information is a worthy project for the summer. Creating a database of lease exposure to help you quickly ascertain what your exposure is to weakened tenants could also prove helpful. By looking at after-lease risk, you may reduce risk as you reduce phantom cell phone vibrations.

Related Links:
[PCBB 2012 Executive Management Conference]

BANK NEWS

New Construction

A report issued by NAIOP Research Foundation finds construction spending on commercial real estate totaled $92.3B in 2011, a 12% increase over 2010 and the first nationwide gain since 2007. By state: TX came in first with $7.9B in new development activity, followed by NY ($6.5B); W VA ($5.9B); CA ($4.5B) and AZ ($4.2B).

Mortgage Settlement

Bank of America said it has sent 200k letters to the first group of underwater homeowners at least 60 days behind on payments as of Jan. 31 offering to reduce loan principal. The offers are part of the $25B mortgage settlement and provide average monthly savings to borrowers of 30%.

FINCEN Switch

FINCEN is reminding banks to switch over to electronic filing for reporting no later than July 1.

Fortune 500

Fortune's annual ranking of the top 500 U.S. companies shows the top 5 in order for 2011 were Exxon Mobil; Wal-Mart; Chevron; ConocoPhillips; and General Motors. The best performance by a bank came from Bank of America at #13, followed by JPMorgan Chase (#15) and Citigroup (#20).

OD Fees

A Pew study found that almost 2Ys after the Fed started to require banks to obtain customers' consent before hitting them with a debit overdraft, many customers are surprised when OD charges hit. The study found that more than 50% of customers charged OD fees did not believe they had opted in (but they did). The results point to the fact that either opting in has limited value or banks need to do a better job at reminding customers.