LOAN DEFAULT REASONS AND TRACKING

by Steve Brown

When it comes to loan defaults, one area that banks may want to consider tracking more closely are the reasons for a default. While it is not likely there is any singular reason for a loan to default, understanding contributing factors can be instructive. For example, is the business missing its revenue/sales targets? Is occupancy lower than expected? Are rents lower or expenses higher? Is it a combination of reasons? Attempting to distill down the problems and coming up with a quantitative set of potential impact factors can help your bank better analyze why and how loan performance problems occur. Then, once the data is collected it can be analyzed in the hope of improving underwriting standards. One area we have assisted banks is simply tracking when a loan goes into default. When a loan goes into default at maturity and cannot be refinanced (a "refi default") it is flagged. So too are loans that go into default during their term (a "term default"). The difference between the two may seem small, but it can have a huge impact on how you resource and handle future loan underwriting when done properly. Refi defaults for example, should occur less frequently than term defaults, but they can account for a larger potential risk (because of the amount of loan balance and capital involved). Refi defaults usually occur at set times (in accordance with maturity) and are much more predictable (we can accurately forecast refi defaults 1 to 2Ys in advance). Refi defaults are also usually heavily correlated to borrower financial condition and property value. Since a refi default usually means the borrower is able to make the debt service payments, but not to refinance, these loans are usually in better shape and have a lower level of expected losses. Thus, on a risk-adjusted basis, while there is greater capital at risk, the actual losses are likely to be lower. Actual losses from refi defaults are estimated to account for about 15% of bank losses for 2009 and 2010 (thru March). Term defaults, on the other hand, are a function of cash flow. These are more evenly distributed as to time of default and are typically less predictable. These usually are more common (usually close to 70% of a bank's problem loans) and are driven by cash flow problems. Here, the borrower usually has fewer options and thus risk is higher on a comparative basis, as expected losses are usually greater. When looking at the factors for defaults, date of origination and geographical location can be very important when predicting refi defaults. Here, allocation decisions usually have the largest impact on bank loan losses. In contrast, while geography is important, management, sales and expense control can be more influential factors when quantifying term defaults. For these, underwriting decisions usually have the largest impact on defaults. In addition, certain property types, such as retail properties, are multiple times (by a factor of 5) more likely to suffer a term default than a refi default. Tracking ongoing debt service coverage and appraised value (and the specific date) in electronic form is now mandatory for loan management. However, given the value of the data, looking at a variety of other factors can also be extremely helpful. Starting to track how defaults occur, as you collect more data are some of the many factors that we recommend tracking on a go forward basis.

BANK NEWS

Global Stimulus

As expected, the ECB lowered its rates to record lows, citing "downside risks to the euro-area economic outlook have materialized." In a surprise move, China lowered its key rate for the second time in a month.

More on Barclays

As the fall out from the Libor price fixing scandal continues, a third executive at the bank has stepped down and Moody's and S&P have lowered the bank's outlooks to negative.

Dollar Reserves

The latest IMF data reported by Bloomberg finds worried global central banks have pushed the dollar's share of global reserves to 62.1% (as of Dec.), a percentage that is likely to grow this year despite ongoing U.S. problems (because European issues are much larger).

Net Worth Drops

The Census Bureau reports median household net worth fell 35% between 2005 and 2010 to $66,740 (from $102,844 in constant dollars).

Mobile Competition

Intuit announced its 17th app for the iPhone recently, as it seeks to build a portfolio of options for customers. Intuit has apps focused on taxes (7), payments (2), small business (5) and consumer (3).

FreeMonee

US Bank partners with FreeMonee in an application that generates digital gifts and cash incentives from popular national merchants that are customized for Bank customers using their credit or debit card.

Tablet Banking

CNN reports 28% of tablet owners are over age 50 and 208mm tablets will be sold in 2Ys.

Housing

Census data indicates 33% of people aged 65+ have a mortgage today vs. only 20% 20Ys ago.

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