HOLDING THE LINE ON LOAN TO VALUE

by Steve Brown

In the military, soldiers will yell to "hold the line" when an enemy is attacking; in business, CEOs will often try to hold the line on hiring or spending when things get tough; in government, politicians say they want to hold the line on expenditures (even though they really don't); and in banking, it is important to hold the line on loan to value (LTV) when it comes to lending. While regulatory supervisory limits allow for an 85% maximum LTV for improved commercial real estate (CRE) properties, that does not mean regulators are comfortable when bankers go to that limit. As with most things in life, nothing is as easy as simply setting a limit and letting things run along. One reason things aren't that easy in lending is that when you set an LTV limit many other factors must also be considered to maintain credit quality over the longer term. Among others, these include the size and type of the property; debt service coverage (DSC); borrower net worth; geographic location of the property and bank-specific issues or existing loan concentrations. In short, the greater the risk of any one of these parameters, the more another one should offset to maintain credit quality. For example, an 85% LTV on a given CRE loan might be ok, as long as DSC is 2.0x. However, it might need to drop back to 75% or even 70% when the DSC is 1.5x or 1.1x, respectively. Meanwhile, DSC can potentially give (both up and down) if borrower guarantees are stronger or weaker, based on loan structure and many other factors too numerous to mention here. When it comes to CRE in particular, some issues are at play right now that should make bankers think twice (or even three times) before originating a loan with an 85% LTV (all things equal). Here are just three key points to consider. Point #1 - Property values are down 40% from their peak levels on average according to Fed research. That means many borrowers have little equity on loans originated 4Ys to 6Ys ago and the LTV could be high on these when they come up for renewal or rollover. Point #2 - The OCC warned as recently as June that up to 50% of all outstanding CRE loans will need to be rolled over by 2014. They also noted that many of these loans were originally set up as interest-only or with minimal amortization. That too will add stress to the system as these loans look to extend. Point #3 - Ongoing economic weakness has led to higher overall levels of vacancy and leases signed during better times are rolling over during a period of significant economic weakness. That means these leases are being renewed at lower levels, weighing on property operating income. These factors will all combine to reduce the capacity to service debt. The good news in the CRE sector is that things are slowly improving, but the bad news is that a weakened state is likely to continue for the next 1Y to 3Ys. As such, bankers should be careful and holding LTV at 75% is as good a place to start. Given so many community banks have CRE concentrations and exposures, when it comes to LTV at least, consider taking these two steps. First, as our introductory paragraph indicates - hold the line on maximum LTV at 75%, no matter what. Now is not the time to stretch to 85%, so push borrowers seeking a loan renewal to roll over by putting in extra cash or paying down the loan amount to get things right-sized. Second, do not allow borrowers to take cash out right now. There are exceptions, but here again; things may get choppy down the road, so borrowers that have multiple loans should be discouraged from seeking to take cash out. Ask them to hold the line until the economy recovers and then come back for a discussion at that point. We know it isn't easy to hold the line when competition is so strong and borrower capacity to put in more cash is limited, which is why it is so important right now. Maintaining a maximum LTV of 75% and not straying toward supervisory limits of 85% is critical. As the data shows, just over the horizon there could be new and possibly increasing risks on the loans already in your portfolio, so being careful and diligent now is just being prudent.

BANK NEWS

M&A

Spirit of Texas Bank SSB ($305mm, TX) will buy Oasis Bank ($84mm, TX) for an undisclosed sum.

M&A

BOK Financial (OK) announced it will buy Denver, CO based The Milestone Group Inc., a wealth management company with about 250 high net worth clients and about $1.3B in assets under management.

GSEs

The Treasury reaffirmed its long-term commitment to both FNMA and FHLMC, by removing capital concerns in the future. GSEs will now pay all profits earned to Treasury (vs. 10% prior) and have to shrink their portfolios at a faster rate.

Flat Mortgage Fee

In another surprise move, the CFPB reversed itself and said it will allow lenders to offer discounted fee mortgages (instead of a flat fee) so that borrowers can continue to "buy down" their interest rate. The CFPB's original proposed rule in May would have done away with this practice.

Muni Risk

Moody's issued a warning on the precarious state of CA municipal credit and said that it will review all large issuers for their ability to repay.

Virtual Wallet

PNC announced that it surpassed 1mm account holders on its online and mobile application tool.

Payments

In what could be a big boost for digital payments, NY's Metro Transit Authority (MTA) is rolling out a beta program to allow riders to pay fares with their smartphones.

Dour Outlook

The latest quarterly survey by the Philadelphia Fed finds professional forecasters have cut 3Q GDP growth estimates by 36% from just 3 months earlier. They now estimate it will grow at 1.6% this quarter, down from 2.5% prior.