LENDING REVIEW, RISK AND OPPORTUNITY

by Steve Brown

We were talking to a loan review team recently and asked them what they were seeing in community banks they reviewed and whether they could share any observations. We were focused on what they thought could be areas of future risk, but might not be that obvious. We picked up some good information from them and then reached out to other sources to see what else surfaced. Here, we have compiled a few areas we see as some to monitor as you continually improve risk management. Our first area for discussion is around exposure to non-profits and how to quantify risk around them. One problem that may not be totally obvious can occur even though borrowers are paying current. This type of borrower may even have decent cash flow currently, but as the economy has deteriorated (or municipal finances have softened), issues could be on the horizon. To get a better handle on things, consider stratifying borrowers into more granular buckets. Break them down by funding source (such as county, state, federal, private, etc.). Next, get your teams out talking directly to borrowers. Work to capture updated financials, ask questions about the non-profit's own expectations for the future and probe to find out what they are seeing and how strong funding streams really are. Non-profit borrowers can only support their loans if they get support from donations (or municipal funding), so right now given that such donations are declining, issues could soon follow. It is crucial to get to your customers to fully understand the picture as you protect your interests in this tough environment. Once you have more granular data, you may also want to break down the portfolio even further, by identifying areas of funding probability. Here, look at whether the borrower's program is considered "mission critical" or could be subject to funding cuts. Then, assign a weighting to each one based on that probability. When you are done, simply sum them up in a spreadsheet and sort to start managing the risk by categorizing it into "high", "medium" or "low" buckets vs. the overall portfolio. Then, focus your resources on looking closer at those marked "high" to get moving faster. Another area of potential risk is in rolling over existing CRE loans. Property values have declined in some cases by 40%, so loans that mature in the next 2Ys may need additional support to get the LTV to work. To get ahead of this issue, do a cut of your portfolio on all of these loans. Then, sort them by origination year and apply a discount percentage to the loan amount to calculate the amount of decline for each year that will need to be recaptured in a new loan or appraisal. For example, a loan originated at the peak in 2007 that matures this year might be assigned a 40% reduction in value, while one originated a year later might be assigned a 30% reduction. Once you do the math to account for the deterioration in price vs. when they were originated, you can get a good handle on what additional money will be needed from each borrower to get the LTV on any new loan to an acceptable level. Then, encourage borrowers that have a gap to fill to come out of pocket (after all, cash is earning nothing, so why not pay down the loan to right-size the LTV) right away, before a competitor does this on another loan. Finally, keep an eye on loan loss reserves. The OCC recently warned banks not to get too crazy when reversing out reserves, as more storm clouds are on the horizon. Be sure you have a process that is grounded in sensible mathematics and you will have a good foundation upon which to determine what additional reserves you might need. Then, periodically double-check your reserves to loans vs. expectations (as well against other banks in your market to see how you stack up). This isn't perfect, but it at least will make sure you are directionally correct. The lending business remains tough, but community bankers are seeing some traction here and there. As we all await better economic conditions and more robust lending opportunities, an ounce of prevention is worth a pound of cure.

BANK NEWS

M&A

Prudential Financial Inc. will buy The Hartford's individual life insurance business for $615mm in cash.

Branch Purchase

Heritage Oaks Bank ($1.0B, CA) will buy a branch from Coast Bancorp ($134mm, CA) for a 2.2% premium (deal includes $30mm in deposits and no loans).

Consumer Fines

Banking agencies and the CFPB announced American Express will pay restitution (of about $85mm to 250k affected consumers) and civil money penalties (of $27mm) totaling $112mm to settle violations related to consumer protection laws. The CFPB alleged American Express charged unlawful late fees, used age discrimination in credit scoring for new customers, failed to report consumer disputes to credit bureaus and mislead customers in relation to debt collection.

CRE Lending

Bloomberg reports Reis analysis finds U.S. office vacancies have fallen to 17.1% nationwide, their lowest level in about 3Ys and down from 17.4% 1Y ago. Low new building construction activity and high demand from energy and technology companies have been strong drivers.

Auto Lending

Bloomberg reports auto loan rates have hit the lowest levels since data was collected in 1971, adding support to industry sales.

Deliquent Loans

Bank of America is offering to write off 150,000 delinquent second liens for certain "in need" borrowers, as part of its national settlement agreement.

Good News

Home prices nationally have risen at about an 8% seasonally adjusted annual rate over the past 6 months. That looks likely to continue, as this past week, 30Y fixed rate mortgage loans fell to a new all-time low of 3.40%.