Time Bomb

by Steve Brown

Nearly everyone knows that Mount Vesuvius is a mountain near the Italian city of Naples and a short distance from the Mediterranean coastline. What you may not know is that the mountain tops out at an elevation of around 4200 feet, but its exact elevation is a little hard to determine because it is an active volcano. Vesuvius last erupted in 1944, though that instance was a relatively minor spurt of ash and rock. The better known eruption happened around AD 79 when the entire city of Pompeii was buried killing an estimated 16,000 people. Vesuvius is still of great interest to geologists and volcanologists because some 3mm people live nearby, making it the most densely populated active volcanic region of the world. Worries continue around this volcano as a major eruption would be very serious indeed. After all, Vesuvius historically hasn't just spewed ash and gas, but also liquid lava, flying boulders and other things that make the morning commute more than just inconvenient. As things stand, Vesuvius is considered one of the earth's major natural time bombs, a disaster waiting to happen.

Like Vesuvius but perhaps on a lesser scale, bankers might be interested to note there is new Interagency Guidance on home equity lines of credit (HELOCs). The way this guidance is written, it appears regulators are concerned about a similar volcanic level of danger with these types of loans. In fact, regulators are particularly concerned about HELOCs nearing their end-of-draw periods. As most readers are already aware, HELOCS commonly have interest-only payments during the period of the draw, though once the loan reaches the end of the draw, the principal must be repaid either in a balloon or amortized over the remaining term of the loan. Regulators are concerned because HELOC balances are high and large amounts of outstanding loans are nearing their end-of-draw periods so this may result in payment shock to the borrower and a potential increase in defaults.

Of particular concern, some of these loans have been on the books for awhile, so regulators worry borrowers may be in a significantly different financial situation than when the loan was originated. That is why they are warning banks and telling bankers that if they intend to extend or modify draw periods or amortization terms for existing balances, there must be a thorough evaluation of borrowers' ability to repay the loan. For bankers this rings of terminology used during the credit crisis, so care must be taken to follow the rules. For borrowers that are experiencing financial difficulties, regulators indicate banks must establish modification or workout programs that promote systematic repayment. Under the guidance, if modifications result in a loan outside the institution's current underwriting criteria, efforts should be made to move the loan into compliance, while keeping the terms sustainable for the borrower. The guidance also highlights that banks should report and disclose troubled debt restructures and ensure appropriate ALLL estimation takes place before HELOCs reach their end-of-draw periods. Finally, the guidance spells out that bank management should anticipate and clearly report end-of-draw exposure within the bank, identify higher risk segments of the portfolio and to identify factors that might change risk levels.

While the guidance does not specifically address Prime-based floating rate HELOCs, we know some banks that have them in the portfolio. Given that Prime has been unchanged for 5Ys, borrowers may have forgotten that the interest rate on their loan can increase. Our suggestion is to take a careful look at HELOC and other floating rate portfolios in order to assess borrower risk and to take remedial actions as warranted before rates rise. By proactively addressing problems borrowers may have in the future, your bank can protect itself from a variety of risks and address the concerns of regulators. Most HELOC and other loan sectors probably won't have a cataclysmic volcanic explosion, but smaller eruptions are a distinct possibility so care should be taken. After all, more modern eruptions of Vesuvius than Pompeii created plenty of difficulty, pretty much burying all of southern Europe in ash as recently as 1631.

BANK NEWS

M&A

SNL Financial reports First Bank & Trust Co. ($624mm, TX) will acquire Texas Savings Bank ($78mm, TX) for an undisclosed sum.

M&A

First Merchants Bank ($5.4B, IN) will acquire Community Bank ($272mm, IN) for $46mm in cash and stock.

M&A

CIT Group Inc. (NY) will acquire OneWest Bank ($22B, CA) for about $3.4B in cash (59%) and stock (41%). OneWest will be combined with CIT's banking subsidiary CIT Bank, creating a $67B asset sized bank.

M&A

Private ATM machine company Cardtronics (TX) will acquire Welch ATM (26,000 ATMs) for $160mm in cash. The move increases Cardtronics' ATM portfolio to 109,600 globally.

Discontinuing Business

Bank of Marin ($1.8B, CA) said it will discontinue the mortgage brokerage operation it acquired from Bank of Alameda (CA), after determining the activity was too commodity-based to make a reasonable return.

More Regulation

The latest update from Davis Polk & Wardwell LLP on the status of Dodd-Frank (4Ys after it was signed into law) finds the SEC has the most still to do at only 44% completed and including all regulatory agencies the percentage bumps up to just over 50%. Hang in there.