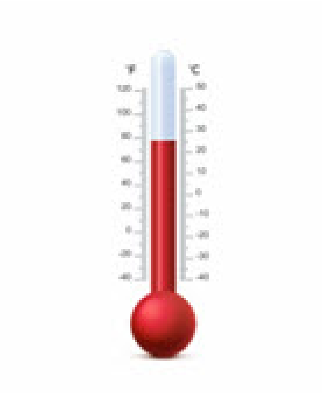

Measuring Your Loan Portfolio Temperature

by Steve Brown

Fahrenheit is the US unit for measuring temperature. The system was developed in the early 1700s by a German scientist named Daniel Fahrenheit at a time when there was no consistent measurement for temperature. Fahrenheit made two thermometers that gave the same reading at the same time and this was a ground-breaking achievement. In developing his system, he set zero at the lowest temperature that could be reached using a salt and water mixture and the other static point was human body temperature close to 100. Shortly thereafter, Anders Celsius in Sweden developed an alternative measure based on a scale where water freezes at 0 degrees and boils at 100 degrees. The Celsius scale was adopted into the metric system and into worldwide use, but the US hangs onto Fahrenheit as efforts to convert to the metric system in the 1970s and 80s ultimately did not pan out.

Understanding measurement is important in assessing risk and opportunity on bank balance sheets too. Regulators have been making note of the increase in concentrations of CRE and other real estate-based loans on bank balance sheets. This has been particularly true in community banks.

There are numerous reasons for community banks to concentrate on local real estate in their lending activity. It is generally an area of expertise given local familiarity, critical when underwriting CRE and it is also a traditional business focus. An additional regulatory concern around CRE is that borrower preference and competitive pressures have driven significant extension of maturities and reset periods for most banks. Many of these credits are structured with fixed rates which could lead to difficulties when the Fed raises rates.

It is easy to say - banks need to diversify their loan portfolios when risks become unbalanced, but in the end it is often not that simple. One area bankers have been working to expand is C&I.

C&I loans can be an attractive sector that offers diversification, generally they also come with floating rate structures and cash flow is not based on occupancy. The problem with C&I for most banks is that these loans can be tricky to underwrite. Many community banks say it is difficult to shift staff trained in real estate over to C&I without a great deal of time and effort. Many banks also don't have the time or the systems needed to keep up with required ongoing monitoring.

One alternative is to purchase C&I loans from PCBB. These loans are floating rate, have a short maturity (usually 3 to 5Ys) and can be purchased in amounts from $1mm to $50mm (so loan portfolio balances can be quickly built up if needed). A number of elements in this sector have also moved in a positive direction recently, including market response to regulatory measures. Many attractive loans are being generated with lower leverage levels than the benchmark 6x total debt to EBITDA. This means there is more quality inventory to choose from and more opportunity to diversify. As rates are poised to rise, having floating rate credits in your portfolio should generate more income and protect your bank from contracting NIM in the future.

However you measure risk and opportunity, take a look at nationally recognized, publically rated C&I loans. They take less time and expense to board than originating loans directly in most cases and can both augment and diversify your existing portfolio quickly. If your bank needs loans that can put on the books by the end of the quarter and your pipeline has gone cold, this could be an attractive alternative - whether you measure it by Fahrenheit or Celsius. Contact us to receive a current inventory.

BANK NEWS

Risk Officers

A Deloitte survey of global risk managers finds: 92% have a chief risk officer (CRO) position or equivalent and 68% said the CRO reports to the CEO (46% report to the board).

Retirement

USA Today reports a study by Voya Financial finds about 60% of retired Americans said they had to retire sooner than planned. Unexpected health issues, layoffs and having to care for another family member were cited as primary reasons.

Regulatory Liquidity

The Fed has proposed a rule that would allow general obligation (GO) municipal securities to qualify as high quality liquid assets (HQLA) under Basel III liquidity requirements for the largest institutions. To qualify, the securities would not only have to be GOs (no revenue obligations) but also: be investment grade (determined by the bank based on issuer capacity); be issued by an entity with a proven track record of liquidity during periods of significant stress; have lower price volatility (specific rule here); not be obligations of a consolidated subsidiary of a financial sector entity (no bonds issued by regulated financial companies, investment companies, non-regulated funds, pension funds, investment advisers, etc); cannot rely on an insurance wrap; cannot be > 25% of the total amount of outstanding securities with the same CUSIP number; and cannot be > 5% of the total HQLA amount. Look for more liquid and larger municipal issuers to once again have large banks as buyers with this change.

Households

A Fed report on household economics finds 65% of people say they feel their family is doing OK or living comfortably financially vs. 62% who said so in 2013. Meanwhile, 29% expect their income to be higher this year vs. 2014. Further, 23% said they have some form of education debt and 31% of non-retirees said they have no retirement savings or pension.

Speaking

Entrepreneur magazine reports the founder of Expect Labs projects up to 40% of apps launched for mobile devices will come with voice recognition by the end of 2015 and by 2018 it will be the primary user interface we all use to communicate with our devices. It sure beats texting on small keys and should super accelerate wearable devices.

Outlook

A Fitch Ratings survey finds 84% of US investors surveyed expect GDP to be above 2.0% over the next 12 months. Meanwhile, 53% expect the Fed to raise rates 25bp by Oct.