Thoughts on the Credit Crisis and Community Banking

Timothy W. Koch, President
Graduate School of Banking at Colorado

Introduction

Most community banks have largely avoided the problems in subprime loans, loans to large firms involved in leveraged buyouts, credit default swaps, and speculative real estate loans faced by the largest institutions across the globe. They have not had to take large asset write-downs and sharply reduce dividends paid to shareholders. Still, they face potential problems in commercial real estate and other types of lending in the event of a deep economic slowdown. The U.S. government has reacted to the ongoing problems by injecting enormous amounts of liquidity into the banking system, lowering the targeted federal funds rate, and buying stock in banks. Sheila Bair, FDIC Chair, is aggressively promoting mortgage loan modifications to keep individuals in their homes and is getting an increasingly positive response from Congress and the public.

What is best for the U.S. economy, the banking system and U.S. consumers? Should policy makers allow more banks and large non-financial firms to fail? Are their recent efforts to address the credit crisis and problem institutions the appropriate ones?

Where Are We Today?

The credit crisis is front-page news. Is it real or media hype? How serious are the problems faced by businesses and individuals currently and how bad will it get? Government actions in the U.S. and globally clearly signal that regulators and politicians believe the crisis is real. Consider the following:

During the past two months, the U.S. government

- put Fannie Mae and Freddie Mac into conservatorship
- loaned AIG over $120 billion effectively taking ownership of the insurance company
- insured/guaranteed money market mutual funds
- approved Goldman Sachs and Morgan Stanley as bank holding companies
- bought commercial paper directly from issuers
- increased FDIC deposit insurance coverage
- encouraged Citigroup to acquire key assets of Wachovia, then approved Wells Fargo's acquisition of Wachovia
- passed the Troubled Assets Relief Program (TARP)
- announced the purchase of $125 billion of preferred stock in nine large banks and made another $125 billion available for other institutions, and
- continued to lend large amounts to large U.S. financial institutions through the discount window and via other liquidity facilities.

What explains these actions? Large institutions are generally less willing to participate in unsecured lending to other institutions not knowing which ones are really solvent. Many institutions have stopped new commercial and consumer lending and tightened terms on renewals. Lower interest rates don't solve the problems. Governments around the world are pumping liquidity into the system, 'helicopter money' as Milton Friedman called it, to try and stimulate lending and spending but this hasn't freed up credit. Governments are taking stocks (buying stock) in large banks to shore up their capital. In short, credit markets are not functioning normally. Some pundits are even discussing the possibility of deflation and almost everyone believes that the U.S. and many other countries are in recession.

Clearly, the banking system relies on confidence which has eroded with recent events. Two things must happen for confidence to return and for large institutions to start lending. First, the largest banks must clean up their balance sheets. This is one of the objectives behind governments' buying stock in banks. Hopefully, these equity injections will induce banks to lend. At worse, these banks will simply write-down more problem assets and offset the newly raised capital with charge-offs. What we will likely see is banks using TARP proceeds to acquire weaker firms and/or pieces of their operations, such as branches and key subsidiaries. Second, we must find a floor for housing values. Exhibit 1 documents the one-year drop in average house prices through July 2008 for several large metropolitan areas across the U.S. While most communities in middle-America have seen house prices fall modestly, declines in Las Vegas, Miami, and Phoenix approach 30%. Not surprisingly, foreclosures in markets that experienced a sharp run-up in house prices followed by the sharp declines have reached historically high levels. One of the objectives of the FDIC's foreclosure forbearance at IndyMac is to slow the drop in housing values. Bank of America's recent agreement to settle litigation by paying $8.7 billion to roughly 400,000 borrowers regarding predatory lending at Countrywide will presumably keep people in homes across the 11 states affected. Any drop in foreclosures brings the supply of housing closer to demand.

However, problems in housing are again largely an inventory problem in select markets. Most communities in middle-America and similar geographic markets did not see the run-up in house prices and thus have not seen the large proportionate declines recently. While some institutions have seen problem loans and loan charge-offs increase sharply, most community banks that operate in these markets have not reported significant loan losses and earnings are reasonably strong.

What Is the Impact on Community Banks?

What do these recent events mean for community banks who have largely avoided the credit problems facing the largest banks? Even the best managed banks with strong capital and asset quality have seen frightened customers withdraw deposits due to a lack of confidence in the overall banking industry. Fortunately, the combination of increased FDIC deposit insurance and problems at the largest banks seems to have brought deposit customers back to community banks. More importantly, well-run community banks have taken the opportunity to promote their emphasis on relationship banking. They have

affirmed credit availability to qualified borrowers thereby reinforcing strong deposit and credit ties to customers. Their futures appear bright if they proactively seek out strong business and consumer customers because there are great opportunities to expand their franchises.

How Might Managers Best Position the Bank?

Because the economy is fragile, bankers should be proactive in positioning their banks for future strength and growth. Fears concerning the decline in housing values, the slowdown in commercial real estate, and a collapse in commodity prices with the corresponding difficulties for agriculture are real.

I offer several recommendations. In order to best position the bank going forward, management should consider the following strategies and policies:

- Verify that the bank has adequate liquidity across different environments and extraordinary events; do this on a cashflow basis and not by reviewing static liquidity ratios
- Establish a contingency funding plan and test it periodically; consider both short-term needs/plans (less than 90 days) and longer-term needs/plans
- Get as much external capital as possible
- Identify credit concentrations and key exposures in detail
- Review mortgage exposures and modify loans as appropriate
- Conduct detailed strategic planning including forecasts of future performance under numerous scenarios incorporating 1) significant deposit outflows, 2) above average loan charge-offs, and 3) declining margins; what is the outcome if these occur simultaneously?

Some of these suggestions are controversial and some bankers may argue that they are unnecessary. Perhaps. So, let me offer several specific suggestions to clarify some opportunities and possible impacts.

1. Community banks should carefully consider participating in the Treasury's TARP Capital Purchase Program: Banks rated 1 or 2 can largely avoid regulatory supervision and obtain up to 3% of risk-weighted assets in senior preferred stock (non-voting) which qualifies as Tier 1 capital. The opportunities for banks rated 3 are less obvious and banks rated 4 and 5 are not eligible. The dividend rate is 5% for the first five years, then increases to 9% and the Treasury gets warrants to purchase the bank's common stock up to 15% of the TARP proceeds. Issuing banks must accept restrictions on executive compensation, but these do not appear to be onerous.

   The biggest negative in participating is having government ownership. Observing the past few months of actions demonstrates that government officials can and will change their minds with some frequency. Who wants government oversight especially with uncertain guidelines? Still, there are many reasons to get

TARP funds. In financial terms, the funds are relatively cheap capital. For banks with growth options, this type of capital is an inexpensive way to increase loans, acquire other institutions, buy branches, and expand into new product lines. Importantly, how will customers react when they hear that some banks in the community get TARP funds and others don't? They will likely know that high risk (problem) institutions do not qualify. If your bank does not participate, you will need to have a program in place to communicate why without explicitly stating that you are rated a 1 or 2.

2. If you have not done so or do not have plans to do so, you should get in front of the mortgage forbearance freight train. Mandatory mortgage forbearance may come sooner than you think given economic conditions, rising foreclosures, and the upcoming elections. Specifically, community banks should modify mortgage loans where appropriate and actively promote their programs to do so. Banks should continue to foreclose on borrowers with non-performing loans who have abandoned a property or who do not have the capacity to service a modified loan. Banks should maintain agreements for borrowers with performing loans. Importantly, however, banks should restructure loans for borrowers with non-performing loans who can meet acceptable debt service requirements. The obvious issue is to determine what is acceptable? Where possible, the loan should be modified by converting it to interest only for a maximum period of time and/or extending the final maturity.[1] Such modifications may successfully involve no principal reductions. Borrowers will have the opportunity to stay in their homes as long as they stay current on the loans.

Potential Benefits

Over the next 3-5 years, well-run banks will have the opportunity to grow at the expense of lesser competitors either organically or through mergers and acquisitions. As Warren Buffet has demonstrated with his investments in Goldman Sachs and GE, in today's markets capital (cash)-rich investors can extract premiums for having liquidity. Given market conditions, investors will organize – private equity in particular – to acquire healthy and failing banks and branches at extremely attractive prices. For those with cash, it is a great time to put together a regional conglomeration of community banks positioned for growth when the economy improves. Similarly, while mortgage loan restructuring in unappealing on the surface, it may keep borrowers in their homes thereby reducing future charge-offs and the associated reductions in capital. Private restructuring may well benefit the overall economy by reducing the number and magnitude of foreclosures and thus help stabilize housing values. It has the further benefit of keeping the government out of the business of dictating loan modifications as the FDIC is doing at IndyMac.

[1] FinPro, a consulting company for community banks, is recommending restructuring loans incorporating interest only payments under a defeasance program through the U.S. government.

Conclusion

While the U.S. and many global economies are in the midst of a credit crisis and many market participants have lost confidence in financial institutions and markets, every community bank should carefully assess its current operating profile and strategic opportunities. At a minimum, managers must continually evaluate their access to liquidity, credit concentrations and likely loss experience, and capital adequacy. Well-run banks will have opportunities to grow their franchises and improve long-run operating performance. Managers should act now to take advantage of these opportunities.

Exhibit 1: Decline in Average Existing House Prices Across Selected Metropolitan Areas: August 2007 – July 2008*

Metropolitan Area	One-Year Decline
Phoenix	- 29.3%
Los Angeles	- 26.2%
San Diego	- 25.0%
San Francisco	- 24.8%
Denver	- 4.7%
Washington, D.C.	- 15.8%
Miami	- 28.2%
Tampa	- 19.4%
Atlanta	- 8.2%
Chicago	- 10.0%
Boston	- 5.4%
Detroit	- 16.7%
Minneapolis	- 13.1%
Charlotte	- 1.8%
Las Vegas	- 29.9%
New York City	- 7.4%
Cleveland	- 7.9%
Portland	- 6.6%
Dallas	- 2.5%
Seattle	- 8.2%
20 City Composite	- 16.3%

* Source: S&P Case-Shiller Index