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the riley report: - Winter 2009 Edition
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the riley report Winter 2009
Common Sense Banking for the 21st Century

Welcome to the Winter Newsletter - Ideas and Strategies to Improve Your Bank's Performance

Having lived in Virginia for many years, residents know there are fewer places that are more colorful than the Commonwealth in the Spring. Winter, however, is filled with gloomy grey weather. Our Winter edition reflects the tough side of banking: cleaning up the balance sheets, distressed homeowners and new regulatory warnings. The good news is Spring is just a few months away.

- ***Joe Bartolotta: New Year, New Defaults - If you thought 2009 was scary, wait for the sequel - opening 2Q 2010 at a portfolio near you!***
- ***RileyREO.com: Getting bank OREO properties in front of every possible buyer***
- ***First Penn and the FDIC - It's not deja vu all over again, but here's the warning***
- ***Another Fearless Prediction and this Time, It's Political: Let's scrap the current homeowners assistance programs and start all over***
- ***The OREO Tables - not a pretty sight***

As always, we appreciate your comments and suggestions.
Mark

New Year, New Defaults: If You Thought 2009 Was Scary, Wait for the Sequel - Opening 2Q 2010 at a Portfolio Near You!

Among the lessons to be learned from the current financial cycle are that real estate doesn't always increase in value and credit scores are not always a reliable predictor of a consumer's likelihood of repaying a debt. Lenders need a tool that allows them to see into the future -- and most importantly, to take specific actions on that information.

Lenders holding residential mortgages in their loan portfolio and investors holding mortgage-backed securities know full well how the events of the last two years have caused these assets to lose a substantial amount of their value. But are these market valuations accurate? Do they truly reflect the revenue-producing value of these assets?

The answer is yes -- *on average*. But consider the man standing in a bucket of ice water, with his hair on fire: on average, he's comfortable. But to get a true assessment of his comfort,you need to consider all the extremities. And so it is with a loan or MBS portfolio: the true value can only be determined by a loan-level valuation.

"Can Repay" vs. "Will Repay"

At the heart of this valuation is the borrower's likelihood to repay the loan. Traditionally, a consumer's *ability* to repay the debt was the primary consideration: this is how most loans were underwritten, and, using a credit score as a proxy for repayment ability, this is how most loans are evaluated today.

Many lenders, and some investors, utilize models to predict the likelihood of a borrower defaulting on his loan. While the model techniques vary, they all share the common trait of being backwards-looking, and therefore, reactive to trends. That is, the models look at patterns which known defaulters have already shown, and then examine current loans for the same patterns. All else equal, a borrower who exhibits these traits is considered more likely to default than someone who doesn't.

This approach worked well when repayments were largely driven by ability to pay. Consumers who were overextended typically began to exhibit fairly consistent characteristics that were quickly picked up by credit bureau scoring models, resulting in a lowering of their credit score. Borrowers with decaying credit scores were placed on 'watch lists', and to this day many lenders consider that technique a key part of their loss-mitigation efforts.

However, this type of backward-looking approach relies on these recurring traits to be displayed before identifying a consumer as high risk. Moreover, its basic assumption is that a customer stops repaying his debt when he's no longer able. But in today's environment, many consumers become delinquent on a loan who actually have the resources to make their payment -- but they have made a conscious decision not to.

Collateral Damage

This latest phenomenon can occur with an auto loan when external factors such as poor fuel economy during a time of rising fuel costs make the model unattractive, lower its resale value and thus place the borrower in an upside-down situation where his loan balance is greater than the car's value.

Nowhere is this issue more pronounced than in the residential mortgage market, where declining home value can easily turn a loan upside-down -- and a borrower with little or no equity originally in the home can find himself owing far more than the home is likely to be worth in the near term. A 'perfect storm' of sorts occurs when the borrower is a non-occupying owner. A vacant investment property -- providing no rental income to the borrower -- that is worth less than the unpaid principal balance, and in which the borrower has little or none of his own money invested - provides a great incentive for that borrower to forego his monthly payment.

What's the worst that can happen?

Aiding in this conscious decision to forego making a payment is the knowledge that many consumers are gaining about the foreclosure process -- how long it takes, the protection afforded consumers by most state laws, and frequent statements from the Federal government regarding various homeowner assistance efforts currently in place and in development.

Even the specter of a damaged credit report has lost much of its power over consumer behavior, as many have come to believe that in a vibrant lending market there will always be a lender who will provide financing -- albeit at less favorable terms -- and the current gain from abandoning the mortgage debt is far greater than the penalty pricing on a future loan. So, a consumer with a seemingly high credit score and a clean payment history can suddenly stop remitting payments -- and the lender or an investor holding a security backed by that loan realizes an unexpected loss.

An active approach is needed

With a default-prediction mechanism that's forward-looking -- and uses information about the consumer that goes beyond simply the credit bureau score to include factors such as the macroeconomic environment he's living in -- many of these 'surprise' defaults scan actually be predicted 60 to 90 days in advance of the first delinquent payment.

At one level, this type of tool allows for more accurate loan loss reserves. But its real power lies in the ability to protect the lender or investor from the loss, or at least minimizing the severity of the loss.

Once the 'default threat loans have been identified, the same loan-level examination can be used to determine what program(s) the borrower may qualify for, and/or what types of contribution' would be needed in order to make the loan meet established Agency guidelines -- and thus able to be re-originated and sold. The contribution can come in the form of a rate subsidy (if prevailing rates are greater than the existing note rate) or a principal reduction (in order to achieve an acceptable debt-to-income ratio and/or to correct for a decline in the collateral value).

Spend to save

Does paying a consumer to restructure his mortgage (or his auto loan, or even a credit card balance) sound expensive? Consider the alternative: wait until that same credit begins showing signs of delinquency. Attempts to re-originate a mortgage for sale will be futile, as consumers with several 30-day mortgage delinquencies (or a 60- or 90-day delinquency) will be disqualified from virtually all Agency loan products. The value of the collateral will have further decreased, so a principal reduction will be more costly, as will be disposition costs if the property is eventually foreclosed.

A loan-level default prediction tool can also drive hold/sell decisions on an entire loan portfolio, and, used prospectively, can offer a competitive advantage when bidding on portfolio acquisitions and when examining the loans of a potential bank acquisition target. The concept of recognizing a small, controlled loss now to avoid a larger loss later is the stumbling block for some lenders and investors. Much of their training and experience runs contrary to the notion of incurring an expense on what appears to be a current, performing loan.

Instead of the traditional backward-looking approach to risk management, look forward to what's in store for 2010: existing home value is not likely to increase, and may continue decreasing in some markets. Unemployment may continue to increase for the next several quarters, or at the very least remain at its current levels. Perhaps the largest driver, the Treasury will stop its purchase of Agency MBS, with the very likely result of an increase in consumer mortgage rates -- making a restructuring of an existing loan that much more costly by mid-year.

Use the start of the new year as a reason to adopt a more powerful default-predictor model -- and the preemptive value-maximizing approach that it powers. It's a testable event: in a classic 'champion versus challenger' set-up you can run both methods side-by-side and calculate the actual cost of the proactive measures versus existing loss-mitigation efforts -- and take an active role in increasing your company's profitability in 2010.

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RileyREO.com: Getting Your OREO Properties in Front of Every Possible Buyer - *Our FREE Offer*

The OREO Tables at the end of this newsletter report show that community banks up to $10 billion in assets *have over $20 billion in OREO properties as of 09/30/09*.That's a $7.6 billion increase from 12/31/08. This doesn't include the $17 billion in OREOs held by the nation's largest 112 FIs.

Current forecasts suggest that there will be more OREOs in 2010 -- that means more properties for sale to a finite group of buyers. Feedback from bankers has been that OREO properties are taking between six and nine months to sell. Some institutions have kept OREO properties on the books for over a year.

As we know, every month an OREO stays on the books, there are hard dollar expenses (taxes, maintenance, other fees) as well as soft dollar expenses, such as lost opportunity income. The current traditional methods of disposing of OREO properties do not bring all potential buyers to see your properties. You're probably already doing the following:

1. Marketing the properties to your customers by direct contact;
2. Putting an OREO page on your website and hope buyers will go to your website;
3. Running a few ads in local media, but the buyers are limited to its recipients;
4. Signing up with a realtor on a commission basis. That expands the potential buyers to those who want to work through realtors.

The questions are: How successful have these methods been? Are you reaching every available buyer?

The answer is: Post your properties on RileyREO.com to leverage the internet and attract every possible buyer. RileyREO.com was created by bankers to benefit bankers first. Our fees range from$50-$100 per month per property slot for 90 day period.More importantly, our approach supports the bank's current marketing efforts:RileyREO.com directly markets to institutional buyers such as REITs,insurance companies, hedge and private equity firms. In addition, we'll use state of the art marketing, through Google search capabilities,so buyers are

First Penn and the FDIC - It's Not Deja Vu All Over Again, But Here's the Warning

In 1980, First Pennsylvania Bank, N.A. (First Penn) set the standard for incompetent interest risk rate management. First Penn is an $8 billion financial institution (FI) and successor the to the first U.S. private bank (established in 1782).

According to the FDIC-Managing History Report, in 1976, First Penn began using short term deposits to fund the purchase of long term securities. By early 1980, the bank was paying 15.5% on short term deposits to fund $1.2 billion of fixed rate securities that earned 8.7%. *First Penn failed shortly thereafter and will forever be remembered as the poster child for poor interest rate risk management.*

Fast forward 30 years and the FDIC Supervisory Insight Winter 2009 article: "Nowhere to Go But Up : Managing Interest Rate Risk in a Low Rate Environment" has an excellent article that strongly encourages FIs to review and tighten up their Interest Rate Risk Models. No one is expecting another First Penn, but effective Interest Risk Rate management is a positive reflection of a bank's Board and Staff committed to getting it right. At FIRSINC, we can assist your bank in reviewing the bank's policies, modeling assumptions and establish corrective strategies, ensuring that your bank does get it right.

The OREO Tables

FDIC 09/30/09 Quarterly Banking Profile, Table V-A Loan Performance

Asset Size Distribution	< than $100 Million	$100 Million to $1 Billion	$1 Billion to $10 Billion	Totals		$10 Billion +	Combined totals to foot to FDIC
Number of FDIC Insured Institutions	2,912	4,496	579	7,987		112	8,099
Memo: Other Real Estate Owned (in millions)	$Millions	$Millions	$Millions	$Millions	% of totals		
All other real estate owned	949.4	10,394.3	8,746.1	20,089.8	100%	17,074.8	37,164.6
Construction and development	328.1	5,305.7	4,689.3	10,323.1	51%	4,543.0	14,866.1
Nonfarm nonresidential	259.4	2,137.2	1,612.0	4,008.6	20%	1,829.7	5,838.3
Multifamily residential real estate	26.2	335.7	448.9	810.8	4%	631.0	1,441.8
Other 1-4 family residential	315	2,481.6	1,837.9	4,634.5	23%	7,794.3	12,428.8
Farmland	20.3	127.6	61.1	209.0	1%	16.7	225.7
GNMA properties	0.5	8.5	97.5	106.5	1%	2,217.1	2,323.6

FDIC 12/31/08 Quarterly Banking Profile, Table V-A Loan Performance

Asset Size Distribution	< than $100 Million	$100 Million to $1 Billion	$1 Billion to $10 Billion	Totals		$10 Billion +	Combined totals to foot to FDIC
Number of FDIC Insured Institutions	3,131	4,499	561	8,191		114	8,305
Memo: Other Real Estate Owned (in millions)	$Millions	$Millions	$Millions	$Millions	% of totals		
All other real estate owned	663.7	6,512.4	5,247.0	12,423.1	100%	14,195.2	26,618.3
Construction and development	201.5	3,358.2	2,677.4	6,237.1	50%	2,501.0	8,738.1
Nonfarm nonresidential	177.9	1,162.6	686.8	2,027.3	16%	1,344.3	3,371.6
Multifamily residential real estate	17.2	231.5	567.3	816.0	7%	386.4	1,202.4
Other 1-4 family residential	249	1,692.6	1,293.3	3,234.9	26%	8,244.9	11,479.8
Farmland	15.6	66.5	12.5	94.6	1%	8.5	103.1
GNMA properties	2.7	2.2	16.5	21.4	0%	1,610.8	1,632.2

Variance FDIC 09/30/09 to 12/31/08 Quarterly Banking Profile, Table V-A Loan Performance

Asset Size Distribution	< than $100 Million	$100 Million to $1 Billion	$1 Billion to $10 Billion	Totals		$10 Billion +	Combined totals to foot to FDIC
Number of FDIC Insured Institutions	(219)	(3)	18	(204)		(2)	(206)
Memo: Other Real Estate Owned (in millions)	$Millions	$Millions	$Millions	$Millions	% of totals		
All other real estate owned	285.7	3,881.9	3,499.1	7,666.7	100%	2,879.6	10,546.3
Construction and development	126.6	1,947.5	2,011.9	4,086.0	53%	2,042.0	6,128.0
Nonfarm nonresidential	81.5	974.6	925.2	1,981.3	48%	485.4	2,466.7
Multifamily residential real estate	9.0	104.2	(118.4)	(5.2)	0%	244.6	239.4
Other 1-4 family residential	66.0	789.0	544.6	1,399.6	18%	(450.6)	949.0
Farmland	4.7	61.1	48.6	114.4	8%	8.2	122.6
GNMA properties	(2.2)	6.3	81.0	85.1	74%	606.3	691.4

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attracted to our site. Best of all - there's absolutely no cost to the buyer to see your properties. RileyREO.com is in the final stages of beta testing and will launch soon. We invite you to be one of the first to take advantage of this unique opportunity and in doing so, we will waive all RileyREO.com listing costs through 03/31/2010. There's no downside to you or your FI. *Our offer is simple.*We know this is a new way to market OREO properties so we've made it risk free to you. For more information, please emailinfo@rileyreo.com.We look forward to being a part of your success!

Let's Scrap the Current Homeowners Assistance Plans and Start Over - My 2010 Fearless Prediction

In an insightful article in the December 29, 2009 *New York Times*, Billions to FightForeclosure, but Few New Loans, reporter Michael Powell noted "[t] enmonths ago President Obama announced a $75 billion program to keep as many asfour million Americans in their homes by persuading banks to renegotiate theirmortgages. Lenders have accepted more than one million applications and cutthree month trial deals with 759,000, but they have converted just 31,000 ofthose to permanent new mortgages that are the plan's goals." Moreover, thesearing article reported delays, obtuse responses, and more onerous terms thancurrently existed more often than imagined; after months of this arduousprocess, which included borrowers attempting to keep up their payments, theseborrowers were told they didn't qualify for the modifications.

In a nation of 300 million Americans, 31,000 completedmodifications is an atrocious record and clearly reflects a failure. Theprogram is fundamentally flawed in that mortgage servicers are the path thatborrowers must take and there is no incentive for mortgage services to modifyloans. An MSNBC article, Here's Why It's So Hard to Modify a Mortgage:MSNBC: The Mortgage Modification Mess, reprinted in the rileyreport (02.2009) succinctly outlined the challenges. Since founding Bank Resources & Solutions, we have advocatedcreating programs that will give credit worthy homeowners some breathing roomduring this Great Recession. The emphasis is on providing breathing room, notbailouts. We discussed, in Mr. Bartolotti's article in this newsletter, we areentering a period where qualified borrowers may say 'enough is enough. Hereare the keys to my house." Proactive action to ameliorate thisattitude by the federal government is critical.

Here's my2010 Fearless Prediction. The national political party that understandsthe frustration and fears of hardworking Americans who have played by the rules,need some breathing room and can translate that into a viable solution, willwin big in

the mid-term elections.
This great country was built on a spirit of fairness and willingnessto help one another in times of trouble. For a party to be perceived as cowtowing to Wall Street and the behemoth mortgage servicers does so at its ownrisk. Surely, we can do better than help only 31,000 borrowers a year.

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