

Problem loans: Art or science?

Banks are getting headaches dealing with problem loans

South Florida Business Journal - by Brian Bandell
December 18, 2009

While many customers are seeking loans, many banks are focused inward, examining their loan portfolios for weaknesses.

With problem loans at record-high levels, it takes a lot of work from bank staffs to monitor borrower performance and evaluate collateral assets. What they find often determines not only the profitability of the bank, but also what the bank will do with its problem loans.

Local banks are increasingly butting heads with regulators over whether they should classify loans as impaired and how much they should reserve to cover their losses.

In November, Federal Deposit Insurance Corp. examiners told Fort Lauderdale-based OptimumBank Holdings that its bank subsidiary must restate its level of impaired loans to \$41.8 million, from the originally reported \$7.3 million. That caused the bank to take charges to reserve for those problem loans.

During the second quarter, Boca Raton-based Sun American Bancorp said regulators told it during an examination that it must change the way it determines how much to reserve for its future loan losses. That accounting change cost its bank subsidiary \$6.2 million.

BankUnited Financial Corp. repeatedly revised its estimated fiscal 2008 losses as it dealt with federal regulators looking at how it recognized impaired loans and booked loan loss reserves. Its bank subsidiary was closed by regulators, who sold it to a consortium of private equity firms.

Dozens of Florida banks are under regulatory orders that address alleged deficiencies in how they monitored problem loans and reserved for their losses.

For the most part, Florida bankers do a good job identifying problem loans and properly reserving, said Linda Charity, director for the Division of Financial Institutions at the Florida Office of Financial Regulation (OFR).

"There are isolated incidents where we request additional reserves based on examination findings," she said.

Key issues for regulators

Of all the financial institutions the OFR regulates, including banks and credit unions, Charity said 39 percent are on the agency's watch list. Most of that is for financial problems, but

some of those are healthy institutions that were recently opened or changed ownership, she noted.

Florida law requires the OFR to examine state-chartered banks and credit unions once every 18 months. Because of the recession, the agency is now examining these institutions every six to 12 months, she said. It brought examiners out of retirement to handle the extra workload.

Many regulators don't have enough staff to give banks regular examinations, said Dennis Nason, CEO of Coral Gables-based financial services executive recruitment and staffing firm Nason and Nason. That means some banks - especially small community banks that haven't had any trouble in the past - could go 18 months in between exams.

But, when they arrive, regulators are increasingly taking an adversarial role, Nason said.

"A 28-year-old kid who has been doing this for two years tells the bank president, 'This is what it's going to be,'" Nason said.

One key issue regulators have mentioned in recent orders against local banks has been keeping updated information about the financial performance of commercial real estate borrowers. Even if a borrower is paying on time, a loan can be considered impaired if the borrower's financial standing has deteriorated or, in the case of a developer, the borrower hasn't met the building schedule, said William Garzozzi, executive VP of credit administration for Doral-based U.S. Century Bank.

However, just because a loan is worth more than the value of the collateral property doesn't make it an impaired loan that requires a reserve, Garzozzi said. As long as the borrower makes payments and doesn't violate the financial covenants of the loan, the bank can classify the loan in good standing, he added.

A common problem is when a loan reaches maturity and it is worth more than the collateral value of the property. Some banks demand full repayment, and then file a foreclosure lawsuit when they don't get it. That often requires that the bank write down the difference between the loan balance and the value of the collateral property, plus its legal and property management expenses.

Another way to treat a maturing underwater loan is a troubled debt restructuring arrangement. Garzozzi said this works best with income-producing properties. For instance, a borrower might have lost some tenants and can no longer afford an 8 percent interest rate. So, the bank might reduce the interest rate to 4 percent. The bank would probably write off the amount of the interest rate reduction from its future earnings, which can be cheaper than writing off the property's value, Garzozzi said.

"If we can document that with concessions we make to the borrower, this can become a performing loan again, and we don't want to foreclose," he said. "We want to work with these customers and work through the cycle."

Whether a borrower gets a restructuring or a foreclosure notice often depends on the philosophy of the bank and which outcome would cost the bank less, said attorney Derrick Gruner, who represents banks in foreclosure lawsuits for the Miami-based Pinkert Law Firm. Some banks prefer to avoid litigation and let developers discount condo sales or reduce rents, while other banks don't mind seizing properties.

Tactics against homeowners

Some banks are even offering delinquent homeowners cash to turn in the keys to their homes immediately, Gruner said. What the banks often don't tell them is that they haven't been released from the full balance of the mortgage, he noted.

Another frequent practice is banks winning a foreclosure judgment and then taking their time before seizing the home, he said.

"If I have a \$100,000 mortgage note, I could foreclose and sell it for 40 cents on the dollar," Gruner said. "But, if I get a \$100,000 judgment, I can keep that value. How do you say that's not worth \$100,000?"

A regular issue that surfaces between banks and regulators is whether the bank used the correct method when appraising the collateral property, said Frank Gonzalez a partner at the accounting firm of Morrison, Brown, Argiz & Farra in Miami. They could choose to look at the income generated by the property or its fair market value. Some banks use online sources of fair value that might not be accurate, Gonzalez said.

Regulators might also take issue with how often banks do appraisals on collateral property tied to problem loans, he said. With property values falling so quickly over the last year, getting updated appraisals is important to keep track of the value of a loan portfolio. However, Gonzalez said that it's difficult to order timely appraisals.

Charity said the lack of reliable appraisals has made it hard to measure the value of some problem loans.

"In a lot of cases, there are no comparables and there haven't been any sales," she said. "It is hard, in some cases, to get reasonable appraisal that can be relied upon. It started in homes, and we are seeing it in commercial real estate now."

Some banks would rather not take big write-offs now by disposing of properties, so they extend loans with lower interest rates for a year or two and take a smaller write off, said Joaquin Urquiola, a partner with the Coral Gables-based accounting firm Goldstein Schechter Koch and a board member of Miami-based Pacific National Bank. His firm has been helping banks and credit unions get ahead of the game by predicting the level of reserves they'll need to cover potential defaults in the coming year based on economic trends.

Subjective reserve questions

Determining the right amount of loan loss reserves can be tricky for banks that have a huge amount of residential real estate, since it's hard to individually appraise each home, Urquiola

said. GSK likes to look at residential depreciation by ZIP code. When dealing with commercial properties, he stresses that banks should visit them to make sure they still have tenants.

Just as appraisals can be subjective, so too can loan loss reserves, Nason said. Some banks might justify holding a higher appraised value for the property or point to a strong personal guarantee from the borrower, and then keep the loan in good status.

"It has been going on since I can remember that banks will have a different opinion on the capacity of a borrower to keep their loans current," Nason said.

In October, Miami-based Ocean Bank gave Sergio Pino and his Century Grand I a nine-month extension on their \$20.7 million mortgage covering a vacant development site. The following month, BankUnited filed a \$34.3 million lawsuit against Pino over that site and Wachovia Bank hit Pino and Century Grand I with a \$65.6 million foreclosure lawsuit.

Some banks reserve for loan losses using a different formula. Garzozi said the historical losses of a bank and its concentration in certain industries factor into how much it reserves for new problem loans.

"When you set up reserves, one of your starting points is how much losses have you absorbed recently to capture the downturn," he said. "So, banks that lost more recently must have higher reserves."

While some banks might not have reserved enough, Urquiola said some local banks have probably over-reserved for their future losses. When property values increase banks could add their excess reserves to their bottom lines in the form of profit, he added.