

## **A World in Transition**

Now is a great time to be a depositor in your local bank. The amount Americans save is so low, and alternate sources of funds are so scarce, banks are paying premiums to attract deposits. Given the scarcity of funds to lend, many banks are mandating the establishment of a depository relationship as a condition for securing a loan. Due to the turmoil in the industry, you would be well advised not to deposit more than \$95,000 in any one bank (so the principal and accrued interest are fully covered by FDIC insurance) – unless the bank is a Certificate of Deposit Account Registry Service (CDARS) participant or offers some form of collateral for amounts in excess of \$100,000. The CDARS service allows you to access up to \$50 million in FDIC protection on CD investments.

How else does the recent turmoil in the banking industry affect the depository and borrowing practices of the local church? In order to answer the question more fully, permit us first to set the stage by looking at how the industry got to this point.

Through much of the last decade, commercial banks, mortgage companies and other lenders greatly relaxed their standards for originating or underwriting real estate mortgages to homeowners. Formerly, home buyers needed 10% down and were held to fairly rigid income evaluation standards. More recently, homeowners have been able to purchase homes with nothing down by entering into a prime and a subordinated (home equity) loan agreement. In certain markets, lenders even loaned homeowners as much as 130% of the appraised value of the home, believing the value of the home would rise substantially after closing. Collectively, these highly leveraged loans were known as “sub-prime” loans. Many of the loans were ARMs, structured with a variable interest rate that reset periodically, but started with a “teaser” (below market) rate. Additionally, more liberal income analyses enabled borrowers to qualify for larger loans or even qualify when they previously would have not been able to do so. For many years, all was well.

All loans need a funding source. These sub-prime real estate loans were often sold to investment banks, which bundled the loans and created a variety of new investment vehicles. The new securities still had the income stream from the sub-prime loans as their underlying source of repayment; however, these investment vehicles were paying higher rates of return. As long as the monthly loan payments were being made, investors received substantial returns on their investments. Other loans were sold to Fannie Mae and Freddie Mac, which also bundled the mortgages and sold mortgage-backed securities.

As the real estate market weakened, unemployment climbed, and mortgage interest rates reset to a market rate or above, these leveraged instruments proved vulnerable to the softening economy. At the same time, the ability of leveraged homeowners to make monthly mortgage payments decreased

dramatically. Commercial and investment banks have lost billions of dollars lending to homeowners who entered into mortgages beyond their means, speculated on real estate values continuing to increase, or both. Many of these same homeowners are no longer able to make their monthly mortgage payments. The result has been an enormous increase in foreclosures with a ripple effect that has touched all sectors of our economy.

How does this impact the local parish or school seeking to borrow funds? We have observed less competition for loans and greater interest rate spreads between the high and low bidders when we have sought competitive bids. A request for proposal that a year ago would have garnered a dozen bids, today receives only two or three responses. Fewer loans are being automatically renewed (“rolled over”) as they mature. Lenders who previously originated unsecured loans now want first mortgages. Many banks are increasing their collateralization requirements and their loan rates relative to just a year ago. These are the expected reactions of the market when loan defaults increase and underwriting standards become more stringent.

Today, comparatively weaker credits will likely need to negotiate a loan agreement by approaching a single lender rather than seeking a competitive bid in an open process. For all borrowers, it has become, and will continue to be, much more difficult and expensive to secure letters of credit and lines of credit from banks. Simply stated, it is more difficult to borrow money whether it is a first-time borrowing or a loan roll-over. In this market, banks are much more selective about to whom and under what conditions they loan money.

This situation carries over to the tax-exempt market. Fewer banks are purchasing tax-exempt debt due to decreased profits. Additionally, the banks are using those profits primarily to fund loss reserves, since many lenders do not believe the loan crisis has hit its bottom. Overall, it is more difficult to place tax-exempt paper today than it was a year ago and there is often a greater spread between high and low bidders.

There is a corollary lesson in all of this. Sometimes, simple is better. Whether you were an investor who lost money in the “derivatives” debacle of the 1990s or a borrower who has lost money because of “swaptions” this decade, the common element is that these were very complicated transactions not easily understood by even the most sophisticated investors. That is not to say there is no place for such instruments. However, Catholic institutions are often best served when they have a strong and sensible finance plan, and can explain their financing arrangements in a “sound bite.” If you cannot clearly and succinctly explain your financing arrangements to parishioners, then perhaps it warrants a second look to see if it is the best arrangement. CFC can help.

*Newsletter Issue: October 2008*