Corporate Debt Seen as Potential Next Wave in Lending

By: Michael Murray, Mortgage Bankers Association

Middle market loans past due between **30** and **89 days** spiked sharply in the fourth quarter to **1.25 percent**, up **54.3 percent** from the prior quarter and double the year-ago level, reported the **Risk Management Association**, Philadelphia, and **Automated Financial Systems**, Exton, Pa.

RAS data estimated increased deterioration of commercial credit risk in the middle market, represented by more than half of all middle market commercial loans in the **United States**.

"The data suggest that borrowers are increasingly tapping revolving credit lines negotiated in earlier periods," said **Kevin Blakely**, president and CEO of RMA. "Increasing utilization rates result in higher regulatory capital requirements, which the industry is responding to. We expect utilization rates under existing lines of credit to remain elevated until credit conditions ease and overall credit availability improves."

“The default rates are going through the roof, the personal bankruptcy rate filings are going through the roof,” said **Theodore Sprink**, senior vice president and national director of sales and marketing for the UCC Risk Management Program at **Fidelity National Financial Inc**., Carlsbad, Calif. “The challenges to security interests—reliance collateral—the losses given default are going to become a gigantic problem for the lenders, and the lenders are generally in denial because they haven't caught the tsunami yet on the commercial finance side. That's the next wave.”

Average use for lines of credit increased **18.6 percent** to **47.5 percent** at the end of last year as utilization rates started rising during the first quarter of 2008, RAS data said. Middle market borrowers with ties to the real estate sector showed highest utilization rates of credit lines, as did borrowers in **Arizona**, **Florida**, **Nevada** and **South Carolina**.

In ***The Origins of the Financial Crisis***, a paper from **The Brookings Institution**, a Washington, D.C. think tank, the authors said incentives from the securitization model itself caused a lack of due diligence and mortgage-backed securities issuers did not adequately assess risk in the securities they sold.

"With the ability to immediately pass off the risk of an asset to someone else, institutions had little financial incentive to worry about the actual risk of the assets in question," the paper said.

The report also said investors did not have the information or capacity to use their own judgment on the securities because of the "complexity and opacity of the securitized financial system." Instead, they relied "on rating agencies and complex but flawed computer models."

Sprink said consumer loans contributed to a set of “connected dots” from all loans, starting at subprime delinquencies and defaults but continuing into more bankruptcies as it now spreads into asset-based lending markets. Sprink estimated asset-based lending hit **$1.5 trillion** per year at one point and asset-backed securities hit **$2.5 trillion** per year. While some financial institutions sold the loans, others held them in portfolio.

“The banks are generally in denial that they have problems in these other loan markets or loan segments,” Sprink said. “Those dots connect, and you're seeing it already—particularly in **Las Vegas**, **Phoenix** and **Southern California** where the bubble became so heated in traditional residential real estate.”

Sprink said mark-to-market accounting and more writedowns would eventually create "an enormous problem for the [**Federal Deposit Insurance Corp**.]" with "trillions of dollars in assets that are way overvalued."

He said the title industry could provide title insurance coverage for lenders on **“Article 9 Collateral,”** based on Article 9 of the **Uniform Commercial Code**. The collateral could consist of personal property—accounts, inventory, equipment, deposit accounts and certificated and uncertificated securities, and mixed-collateral or mezzanine loan transactions.

“The evidence on the commercial real estate market is clear. There is very little lending and sources of capital are shifting,” Sprink said. “On the commercial finance side, or the straight corporate lending side, the banks are in denial because they haven't suffered really high defaults. Well, guess what. Subprime loans hadn't suffered real problems either until the tsunami hit.”