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# Banks teeter as credit crisis deepens

## Orange County could see first traditional lenders fail since early '90s, experts say.

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The Orange County Register

A real estate slump that has claimed hundreds of mortgage companies and recently mega investment bank **Bear Stearns** as victims now is heading straight for traditional banks and thrifts, some experts say.

Bank failures would force the **Federal Deposit Insurance Corp.** to step in and ensure consumers get their deposits back, possibly with taxpayer funds. Last year Orange County saw subprime lenders collapse, including **New Century Financial** of Irvine and **ResMae Mortgage** of Brea, but they lacked deposits.

Widespread bank and thrift failures were last seen in the late '80s and early '90s during the savings-and-loan crisis and recession. Orange County's last bank failure was more than a dozen years ago.

Richard Hollowell, partner in charge of the real estate services group of Newport Beach-based **Squar, Milner, Peterson, Miranda & Williamson**, said as many as 50 banks and thrifts likely will fail nationally over the next two years. The FDIC said on average six banks fail per year.

Continuing weakness in the housing market as well as growing weakness in commercial real estate will add to bank woes, said Hollowell. During the S&L crisis he headed a company that managed 1,400 delinquent loans and bank-owned properties.

"Banking institutions will need to merge, raise more capital or potentially be put of business by their regulators," said Hollowell, who helps struggling developers of all stripes work out deals with their lenders

"We see the depth of the problem," Hollowell said. "We see first hand how deep the losses are."

Orange County-based lenders that take deposits and are struggling include Brea's **Fremont General**, parent of **Fremont Investment & Loan**, and Newport Beach's **Downey Financial**, parent of **Downey Savings**. Others who have operations here and recently reported losses or profit declines include Pasadena-based **Indymac Bancorp** and Seattle-based **Washington Mutual**.

Experts interviewed for this story declined to predict whether any of those companies will fail. And not all experts agree that banking problems are dire.

Gary Findley, who tracks FDIC-insured lenders and heads Anaheim-based **The Findley Reports**, said he expects just a few institutions to fail, perhaps just three or four in all of California.

"The general health of the banking industry is OK. It's not fabulous, but it's OK," Findley said.

However, if real estate values drop much further, including on commercial projects, then more banks will stumble, he said.

### **Fremont's woes mount**

But it's already crunch time for some institutions, such as Fremont. Fremont, once a Top 10 lender to borrowers with spotty credit, is running low on cash.

And last week the FDIC ordered the company to raise more capital or sell its bank unit within two months. That follows previous signs of company woes.

On March 18, it said it would delay a \$6.6 million interest payment on some senior notes as it attempts to renegotiate payment. This follows a previous announcement it received default notices from two buyers of its subprime loans. Fremont has said it is considering selling itself.

The company's fortunes have fallen with the housing market. It has yet to state its entire earnings for 2007, but it reported a loss of \$202 million for 2006.

Loans it made in 2006 led delinquencies among large subprime lenders as home prices stalled, according to a report that year by financial giant **UBS**. Then in 2007, the FDIC shut down Fremont's subprime operation, saying, among other things, that Fremont marketed adjustable-rate subprime loans to consumers in a way that increased the probability of default.

The regulator also criticized Fremont's commercial loan operation, which the company later sold.

In November 2007, Fremont announced it hired Stephen Gordon as chief executive, replacing Louis Rampino who resigned. Gordon, who declined to be interviewed for this story, has a strong track record. He co-founded Irvine-based **Commercial Capital Bancorp** and served as CEO when it was acquired by Washington Mutual in October 2006 for nearly \$1 billion.

Gordon has arranged at least one deal that should help Fremont's balance sheet. The company recently said investment fund **Carrington Capital Management** is buying

rights to service \$1.9 billion in loans, or roughly 13 percent of the principal balance of loans serviced by Fremont.

Fremont did not disclose what Carrington is paying. The deal is set to close Tuesday.

At the end of 2007, Fremont told the FDIC it had more than \$7 billion in deposits, including an estimated \$1.4 billion in uninsured deposits. It sells certificates of deposit, or CDs.

### **Downey's rising NPAs**

Downey Financial has been a good company making 'prime' and near prime loans, but an increase in its troubled loans and foreclosed homes – dubbed nonperforming assets, or NPAs, – is getting serious, said Amit Chokshi, who leads hedge fund manager **Kinnaras Capital Management** in Norwalk, Conn. Chokshi previously bet against Downey's stock.

Downey's nonperforming assets totaled 9 percent of its total \$13.6 billion in assets at the end of January, up from less than 1 percent a year earlier. It reported a \$56.6 million loss for 2007.

Although it lends to folks with good credit scores, Downey made too many option ARM, stated-income loans at the peak of the housing boom, Chokshi said. Option adjustable-rate mortgages allow borrowers to select a payment, including one that defers principal and interest to the future. Under stated-income programs, borrowers say what they earn and skip the documents that prove it.

Chokshi said Downey has run out of "cushion" in case things get worse in the housing market.

"They are typically a good, solid, simple bank," Chokshi said, "but because of that they are stuck holding all this garbage on their balance sheet." Unlike pure mortgage banks, Downey doesn't sell many loans to Wall Street.

Downey, whose chief executive did not return a call seeking comment, has attempted to get ahead of the delinquency curve. The company has said it is seeking out borrowers who might not be able to afford a jump in payments on their option ARM loans and is offering to refinance them into more stable mortgages.

Its auditor KPMG insisted such refinanced mortgages be classified as non-performing assets, since Downey did not fully re-underwrite them. Excluding such refinances, its non-performing assets in January would have dropped from 9.14 percent to 5.55 percent.

### **FDIC gearing up for failures**

The FDIC plans to add 140 workers, bringing total staff to 360 workers in the division that handles bank failures, said John Bovenzi, the agency's chief operating officer.

"We want to make sure that we're prepared," Bovenzi said, adding that most of the hires will be temporary and based in Dallas.

FDIC officials said last month that they planned to bring back about 25 retirees to the agency and noted those workers will train new hires. Over the next five years, about 50 percent of employees with experience in bank failures, especially those who were at the agency during the savings and loan crisis, will be eligible for retirement, officials added.

The last time the FDIC was hit hard with failures was during the 1990-1991 recession, when 502 banks failed in three years. About 40 institutions failed in California.

There are 76 banks on the FDIC's "problem institutions" list – which would equate to about 10 expected bank failures this year, though FDIC officials declined to make projections.

While depositors typically have quick access to their bank accounts on the next business day after a bank closure, winding down a failed bank's operations can take years to finish. That process can include selling off real estate, investments and dealing with lawsuits.

FDIC-tracker Findley said if the agency takes over a troubled bank that doesn't necessarily mean taxpayers will foot the bill for consumer deposits.

Usually the FDIC finds a buyer for the bank's deposits, he said. Deposits have value and some companies will pay a premium for them, he said.

The losers generally are the bank's shareholders, Findley said.

However, if a troubled bank raised the interest it offered consumers to attract deposits, such as high yields on CDs, then bidders will offer less money for the deposits, since they are more costly to hold, Findley said. He cautioned that just because a lender offers high interest rates on deposits that doesn't necessarily mean the lender is in trouble. (The FDIC last week ordered Fremont to limit interest it pays on deposits to market rates.)

And even consultant Hollowell, who has a more severe view of banks nationally, especially banks with \$5 billion or less in assets, said Orange County residents shouldn't lose any sleep over an industry shake up.

"There is no reason for anyone to believe they will lose their principal in their savings account because of a bank failure," Hollowell said.