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NASHVILLE NOTES

Wilmington Trust and calling it like it is

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By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence or Mercer Capital, where he is the managing director of the financial institutions group.

This week the fraud trial for the former c-suite executives of Wilmington Trust Corp. got underway in Wilmington, Del. The group includes the former president, CFO, controller and chief credit officer of a blue-blood financial institution that could be described as a trust company and asset manager in a commercial bank wrapper. The group may ultimately prevail against the government (they have pleaded not guilty), but their plight reminds me of Tom Wolfe’s 1987 classic *Bonfire of the Vanities* in which protagonist Sherman McCoy saw his successful life unravel after an inexplicable accident during which he was pushing a personal, rather than business, envelope.

The government contends that management's reporting practices hid a vast amount of past due-loans that under longtime practice were "waived” if the loans had matured. The defendants have countered the policy was known by regulators though (my speculation) maybe the envelope was pushed in 2009 when the crisis on Wall Street migrated to Main Street. The company, like many, had an extraordinarily bad run during this period. Nonperforming assets and loans 90 days or more past due rose every quarter from 1.2% of loans and ORE at June 30, 2008, to 15.8% by year-end 2010 when the company apparently changed its practice.

Wilmington Trust did not fail; rather, it was acquired by M&T Bank Corp. in a deal announced on Nov. 1, 2010, in which the announced deal value of $351 million and $3.84 per share was a fraction of where the shares traded in mid-2007 as the crisis was starting to unfold. What upended Wilmington Trust was bad loans — especially commercial real estate and construction loans in such areas as the coastal Delmar area. At the time of announcement, the company's loan portfolio had contracted to about $8 billion (against which M&T would take a 13% credit mark), while the jewel of the franchise was $58 billion of client assets under management.

In a normal market, the waived loans presumably would be renewed at Wilmington Trust, refinanced with another lender or taken to the capital markets. Markets were very illiquid by mid-2008. Cruddy loans that might have moved out of the bank were stranded and began to accumulate as time passed, in spite of stepped-up write-offs.

Wilmington Trust's plight did not entail an inexplicable accident, but I bet there was one corporate decision or maybe one large transaction that the executives wish they never entertained. There always is a tipping point, though tipping points rarely are obvious when they occur. Markets are similar. The failure of a few small subprime mortgage originators in early 2007, the failure of the Bear Stearns hedge funds and the suspension of redemptions from three subprime hedge funds managed by BNP Paribas in mid-2007 were signs the market was turning as liquidity for subprime mortgage and later a much broader array of assets evaporated.

When investors' doubts intensify, liquidity can rapidly evaporate in any market, usually when it is most needed (the caveat being markets in which a central bank is buying assets without regard to price and value). While there never has been much of a "market" for commercial-and-development loans, the property markets were indirectly shouting to the company's executives and regulators by late 2007 that losses were going to be sizable. M&T estimated at the time the acquisition was announced that losses in the C&D portfolio would total 40% of the Jan. 1, 2008, portfolio. No amount of coupon can make up for that type of loss, though no one I know, including myself, was estimating losses that big in early 2008.

Wilmington Trust executives may have had valid reasons years ago to implement a policy that allegedly understated NPAs once the system imploded. Nonetheless, lending requires a wide-eyed assessment of credit risk. A key tenet of that assessment is that there is no potential upside in lending, as is the case with investing in common equities; only the prospect of being repaid with interest.

About 20 years ago, John Holcomb, then the CEO of Alabama National Bancorp., told me during a visit to Birmingham that their policy was to classify all loans more than 90 days past due as nonaccrual regardless of how well the loan might be collateralized because the borrowers (and lender) had obvious issues. A cursory review of National Commerce Corp.'s results over the past year, where Holcomb serves as executive chairman, indicates the same policy applies.

Maybe it is simplistic, but had Wilmington Trust had a comparable policy, the executives might not be on trial and NPAs might never have climbed as high as they did because the credit committee would have said "no" a year or two earlier than when it became obvious to say so.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.