TRAVELING AT THE SPEED OF LIGHT

by Steve Brown

The yield spread between the 2Y Treasury and the 10Y is only 4bp. The overall yield on the 10Y Treasury is 5.10%. This environment is perfect for the small business customer seeking longer term fixed rate financing Â– particularly when you consider that 10Y fixed rate loans can now be had for an average of around 7.25%. After all, just because one operates a drycleaner, doesn't mean they don't know the difference between uncertain monthly loan payments at 8.25% and certain ones locked in for 10Y at 7.25%. When one considers the average $3mm loan saves the client roughly $30k per year AND locks in their payment for the next 10 years, it isn't hard to see why so many banks are getting pressure from clients to make long-term fixed rate loans. From an interest rate risk and liquidity perspective, however, this environment is far from ideal for most independent banks. Since most independent banks fund themselves with short-term deposits, this pressure to lend long is definitely straining net interest margins. While many banks continue to try and convince clients to accept a loan with a 3Y to 5Y maturity, they sacrifice pricing or structure (i.e. waiving prepayment penalties), thereby hurting profitability. It is far better to give the client what they want, gain a longer term asset and hedge the risk accordingly. Readers needn't take our word for the increasing popularity of interest rate swaps, however. As the most recent regulatory data shows (as of the end of March), the total notional value of interest rate swaps held by financial institutions has reached $111.2T. If you do the math, you will find that light travels at about 6T miles per year, so comparatively speaking; the swaps business has been moving at the speed of light for a long time. As the data shows, 1 in every 8.9 institutions are now using hedging instruments, a whopping 22% increase over 2005! Things are moving so fast that about 1 new institution per working day has begun using swaps in 2006 to help manage risk. In so doing, these banks found out they could give their customers what they wanted (i.e. to lock in 10 or 15 year fixed rate loans), improve credit quality (i.e. rising interest rates do not strain customers, they can budget more effectively and NOI improves) and offset risk by transforming fixed rate loan coupons into shorter floating rates through a swap. In so doing, these banks have found a simple way to fund shorter (where money is naturally available to independent banks), maintain profitability and improve borrower creditworthiness. Perhaps even more interesting, as one sifts even deeper through the data, are the statistics by bank asset groupings. While it is not surprising that most swaps are still done at the larger banks, what many may find shocking is how many independent banks have quietly been getting on board. After excluding institutions with assets below $100mm and those with assets above $10B, we find more than one in 6 banks is now using swaps. Look, we know people can find their way in the dark by feeling around. However, with the yield curve expected to remain flat for the next 5 years, flipping on the light switch is sure an easier way to go. Call us and we'll show you how to begin traveling at the speed of light.

BANK NEWS

Acquisition

National City Corp. ($147B, OH) will acquire Harbor Florida Bancshares ($3.2B, FL) in a transaction valued at nearly $1.1B or 3.4x book.

More "Touches"

A new study finds that almost 75% of affluent customers are dissatisfied with their financial counterparties on some level. Interestingly, the group that said they were "highly satisfied" had an average of 14 contacts with someone from their primary financial provider in a 6M period. Banks should take note that to be effective, they should contact top clients as much as 24x per year.

Mortgage Outlook

The new OFHEO director said FNMA and FHLMC should be allowed to maintain the U.S. mortgage market if banks and other financial institutions become defensive again the housing. Lockhart feels that it is important to ensure that there are enough funds available for people looking for home loans, and warns against endangering that.

Credit Shock

Companies in geographic areas prone to hurricanes have seen insurance costs rise 40% from 2005.

Bad News

As building activity continues unabated, banks should note that the latest analysis also shows vacation rental inventories are up 12% nationwide so far this year.

More Layoffs

The latest monthly survey by Challenger Gray and Christmas finds corporate announcements of layoffs during the first 6 months of the year surged 25% over last year.

Legislation

Two members of the House Financial Services Committee have introduced a Bill that would block Wal-Mart and other firms from owing ILCs. The Bill would force commercially-owned ILCs established after June 1 to be divested within 2Y, blocking bids from companies such as Wal-Mart and Home Depot from obtaining banking charters. There are currently 18 companies seeking ILC charters.

Student Loans

The Department of Education estimates that nearly 8mm students will borrow $60B in federal loans during 2006, a 14% increase from 2005.