LOAN PRICING WITH A VENGEANCE

by Steve Brown

"I don't care what they say about me, as long as they don't rip up my dollar bills." - Mickey Spillane. Mickey had it right - protect the dollar. Banking is a hard industry. The type of industry that can spit you out like an RC-C schedule. It is an industry that can use a guy like Mike Hammer when it comes to loan negotiation. So our story begins. What we needed was a vacation, a bottle of single malt and a companion to whisper bad things in our ear. What we had were loan goals higher than the 16" stack of papers on our desk and a borrower who thought she was god's gift to finance. She fought for every basis point in pricing, like a lion cub protecting her young. We were making a 10Y loan with 25Y amortization and we knew full well that the average life was between 2Y and 6Ys. Most banks would have fallen into the trap of pricing a 10Y loan off the 10Y part of the curve. We knew that spelled danger. Over the last 25Ys, only 10% of long-term CRE loans actually went to maturity. These days, the figure is closer to 3%. This begs the question, if so few 10Y loans make it to maturity, why do banks continue to price them as if they will? Some questions are hard to answer. We were tipped off years ago when we looked at what makes borrowers prepay commercial loans. LTV plays an important role. Not only for loss given default when it comes to credit, but also in loan structuring. LTV plays an important, but subtle role in value. The lower a loan's LTV, the higher the probability of prepayment before maturity. Like a fixed horse race, this is due to a number of factors, but usually it means the borrower has an added incentive to take the money and run. Maybe the borrower wants to take cash out or sell the property. Maybe this occurs because bankers are over eager on the amortization schedule, or maybe the project owner has a hot hand and built the property in the right place at the right time. Whatever the case, like a mob rat, lower LTV usually means a shorter life. We return to the damsel with the lion cubs that put us in distress. Her 10Y loan had a 55% LTV, strong appreciation and debt service coverage that would make a kitten feel safe. Since our loan pricing model showed a 3Y average life, we pulled out all the tricks. She got her price of Libor + 1.80%, but paid a higher upfront fee, locked in a 6.50% floor and accepted 4Ys of yield maintenance. This assured our shareholders would receive another candied apple dividend in their mitts. In fact, pricing the loan higher would have worked against us, shortening the average life by creating an even stronger incentive to refinance. Don't get us wrong. We will lace together lower LTVs and better pricing faster than the next guy, but it goes part and parcel with structure to achieve our coveted ROE. In days past, we might have put some muscle on the borrower to intimidate them. Not anymore. Borrowers are smarter and have more options. These days, we keep the rod under wraps and use the noggin' when it comes to loan structuring. Being aware of how current and future LTV (due to property appreciation and amortization) affect a loan's life and structuring it accordingly, can keep banks out of a heap of trouble. It is a hard industry and it's getting harder. We will miss Mickey Spillane, but his hard-boiled style lives on in the soul of loan structuring.

SBA CONDUIT AND SECURITIZATION

BIG is contemplating a vehicle whereby banks can pool their 504 SBA loans and participate in underwriting fees (on a pro rata portion of the loans contributed to the pool). The product would allow banks greater liquidity, increase fee income and allow an efficient way to monetize value. While we have buyers for the product, we need to aggregate a minimum of $100mm of SBA loans within a 3 month period. The question is Â– do we have enough banks willing to sell? If you have an opinion or thoughts on this topic, shoot us an e-mail.

BANK NEWS

Gunning For You

As we have written about in the past, Wells Fargo and other national banks are aggressively moving down-market chasing independent bank commercial loan customers. Wells just announced its 2Q earnings, which showed that profit jumped 9.4% from the 1Q, driven by record gains in business loans and fees. Wells' CEO said the bank remains focused on increasing its share of commercial loans to small business customers. Meanwhile, the bank also increased C&I lending, which surged 17% from the 1Q, as small businesses borrowed more heavily. Wells indicated it will now make small business loans as small as $100k.

Rising

The premium being paid for core deposits has been increasing as of late. Recent M&A trends indicate buyers are looking more critically at the deposit base they will be acquiring and placing more emphasis on core funding.

Student Lending

A new survey on college student credit card usage finds 50% have at least one credit card, 40% carry balances each month, 25% have used their cards to pay tuition, only 33% of students from the richest families carried a balance versus 50% of the poorest.

Rising Ownership

Banco Santander Central Hispano announced it has bought more stock of Sovereign Bancorp, raising its ownership stake to 23% of the company.