HANDLING CURVES

by Steve Brown

Drivers in auto racing know that the most dangerous point in any race usually comes when trying to pass another car around a curve. The risk of a spinout increases because there is no telling what the other driver may do. Not to mention the fact that as tires heat up during a race, they respond differently than when cold. To be effective, drivers need to understand the nuances of each curve and the likely actions of other racers as they negotiate around the track. The same can be said for the manner banks originate loans. Now, while most independent banks offer Prime or fixed rate loans to their customers, some may not realize that those rates are ultimately being driven by the Libor (or swap) curve. Before we go too far down that road however, let's examine what the Libor curve is and why it has become the standard for the industry when pricing loans. To begin, when one refers to the Libor curve and the swap curve, they are generally referring to the same thing. In short, when people refer to the Libor curve, they are often speaking about that part of the yield curve (based on Libor) with less than 1 year to maturity. When they refer to the swap curve, on the other hand, they are typically referring to that part of the yield curve (again based on Libor) with a maturity of more than one year. Just as different maturities of the Treasury yield curve can be called Bills, Notes or Bonds, the Libor curve can also be called the swap curve. Global lending, high liquidity and a desire to remove risk have been the primary factors that have driven the swap curve to emerge as the de-facto benchmark for interest rates at various maturities. One problem we often see is that old habits die hard. Whether by historical practice or as a result of human psyche, many bankers continue to believe that Prime is the preeminent index. Instead of a myopic focus on a single index, bankers would be better served to originate loans based on a multitude of indices. Depending on the situation, indices such as Libor, Treasuries, FHLB Advance rates, or the price of oil may be more profitable than using Prime. Many bankers say they are not interested in fixing something that isn't broken, so why mess around with anything but Prime. There are many reasons, but perhaps the two biggest are that banks can increase profitability and acquire more customers by expanding the number of indices used. Banks should consider shifting from some required spread to Prime and instead zero in on the all-in coupon, interest rate risk and profitability of each transaction. Banks with the flexibility to shift from one index to another (and from one end of the curve to another), stand a much better chance of booking more loans and increasing profits. Some may be surprised to realize that a loan with a 5Y maturity priced at Libor+200bp, Prime-85bp, FHLB+178bp or Treasuries+249bp all carry the same gross coupon. Our point here is that the spread doesn't matter as much as which underlying index is being used. Pricing loans without understanding the linkage between various indices is about as risky as passing on the outside at 210 mph Â– sometimes the curve is negotiated and the race goes on, while other times the driver loses control and slams into the wall. Drive safely and watch out for the curves.

BANK NEWS

Acquired

Linsco/Private Ledger Corp. said it will acquire UVEST Financial Services for an undisclosed amount. UVEST provides third party brokerage services to many independent banks across the country.

Competition

Wells Fargo has followed JP Morgan into the arena of contactless or "blink" credit cards. The bank said it will roll out debit and credit cards to 400k of its customers.

Heavy Competition

Zions said it has launched several new programs specifically focused on acquiring new commercial customers. Zions said the programs put a particular focus on increasing commercial deposits.

Small Business

A new survey by Walls Fargo and Gallup finds small business owners use an average of $10k to start their business. In addition, 73% said they funded themselves with savings, while the remainder took out loans or borrowed using credit cards.

Construction

Echoing a slowdown in construction, builders took out 21% fewer permits than they did just one year ago. Meanwhile, a survey of homebuilders finds they are carrying their lowest optimism for the sector in 15 years.

Online Banking

A new study finds 61% of adults who accessed the internet from home last year banked online.

Competition

UBS said it plans to continue expanding its U.S. wealth management business and will be looking to acquire regional brokerages, trust companies and small advisory firms.