FIRST FLOOR PLEASE

by Steve Brown

Elevators are great things. They save lots of time going between floors and some even provide a view along the way. Elevators won't go anywhere, however, until someone presses a button and selects a floor. Believe it or not, banking can be very much like an elevator. This is particularly true (and is an often cited example) when one is discussing floors in loans. While many independent banks do a good job at inserting floors in loans when they think rates are going to begin falling, most do a very poor job at enforcing them once rates get there. As a result, interest rate risk analysis is understated and profitability is overstated. This situation is obviously very good for the customer, but very bad for the bank. In short, most independent banks we speak with say that while floors in loans are a good idea, they are often only used to provide negotiation leverage if and when interest rates drop and customer pressure mounts to refinance an existing loan. Bankers know it, customers know it and even regulators know it. Many independent bankers say they willingly waive floors when pressed, opting instead to refinance the loan and maintain the customer. We did some analysis on about 25 banks and found that about 74% of loans on their books were Prime based. Of those, about two-thirds also had floors in them. Given the rate cycle over the past 2 years, however, a closer look found yet another two-thirds of those had floors that would not engage unless interest rates dropped at least 200bp from the current market. These banks felt they were protecting themselves by inserting floors into their loans. Not only that, but they had the ALM system produced graphs in hand proving to their Boards and risk committees that nearly all floating rate loans were carrying floors. Basically, most of these banks felt safe and secure in the knowledge that they would be protected in a down rate environment. The reality lies somewhere else. In loans without prepayment penalties, the pressure to refinance becomes nearly exponential as rates drop. The more floors the rate elevator descends from the penthouse, the more significant the customer pressure to refinance, the less likely it is that a floor will actually engage and the more likely a bank is to cave in to this pressure and ride the elevator all the way down to the basement. Floors have tangible monetary value, so banks should be reimbursed if they are waived (or dinged when calculating customer profitability). All of this discussion is great in theory, but what options does a bank really have. Our suggestion is to take a more realistic approach. Banks should admit that most floors are not enforceable without a term descending prepayment penalty (5-4-3-2-1 for a 5 year loan, etc.) or yield maintenance. Banks that learn how to use hedging instruments can buy floors or use swaps to limit downside risk. Capital markets solutions carry no emotion, so when rates fall (in this example), checks flow into the bank by contract, without additional pressure, commentary or tears. By using hedging instruments outside the loan, customers get what they want (i.e. no floor), in return for additional prepayment protection for the bank. No one likes frustrated clients, but take solace in the fact that larger national banks won't waive prepayment penalties either and rates have fallen, so the customer refinancing breakeven is shorter. There is nothing wrong with maintaining high customer service levels, but don't do so at the expense of the bank. Calculate the cost of waiving floors and prepayment penalties and bill it against the customer/product profitability. That way the elevator ride remains enjoyable for the bank and the descent can be controlled.

BANK NEWS

Heavy Competition

First Horizon Bancorp (the holding company for First Tennessee Bank) has announced it will leverage existing efforts to cross-sell small business loans through its mortgage offices. The company said it will open new offices in cities where it lacks branches that will be designed to specifically focus on acquiring small business deposit and loan accounts. The company said it is expanding the program across the country and will likely result in the hiring of hundreds of professionals.

Acquisition

American Home Mortgage Investment Corp (NY) will acquire Flower Bank ($44mm, IL) in a transaction valued at nearly $16.25 or about 6.1x book.

Cash Out

FHLMC expects homeowners to draw out nearly $257B in additional equity from their homes this year, $13B higher than 2005 levels. Despite higher overall interest rates and an expected downward trend in future years, the mortgage giant said mortgage market innovations have allowed people to continue to draw significant equity from their homes.

Branding

Washington Mutual said that it will change signage in branches, other signs and on their stationery to use the nickname Wamu, but is stopping short of a legal name change.

Cost of Driving

The cost of parking is on the rise, with a nearly 10.1% increase in daily parking rates nationwide over the past year bumping the average to $15.28. Monthly parking rates have also increased, with costs ranging from $20 in Memphis to nearly $900 in Manhattan. The rise in monthly costs reflects demand for downtown office space, while daily rates are more a function of retail sales and tourism.