

BANKING SECRETS UNMASKED

by [Steve Brown](#)

Magic is only magic until you know how the trick is performed. Consider the "Masked Magician." This cat spent the late 1990's making various television specials, disclosing some of magic's innermost secrets. The man under the mask eventually revealed himself, which took a lot of guts because magicians the world over had screamed the entire time that he was ruining the business. Some say the magician disappeared after his final show, while others say a group of magicians banded together and cast an incantation that made him disappear. Given the enormous success of the show and the ensuing notoriety, we feel the need to give away a long held secret of banking. One issue many independent bankers face is how to price a loan, given different maturity dates a customer might request. Many independent bankers are leery of originating any loan with a maturity beyond 5Y. Instead, they opt for structures such as a 10Y loan that is fixed for the first 5Y at a given spread to Prime and then resets 5Y forward at the then-Prime rate plus the same spread. The theory goes that since the bank does not have a problem originating the loan today at such a spread, if they could flash forward in time, it would also work. Plus, the bank thinks they are getting some protection against rate movement, so why not agree to build the structure into the note from the outset. As we will see, this is not only incorrect, but also increases the risk to the bank and reduces profitability. We'll go into that in more detail in a moment, but first, let's try to better understand how to compare a loan with a 1M maturity at a given spread to one with a 10Y maturity. In general, how do we move from one end of the curve to another to ensure we are maximizing bank profitability? To begin, we introduce a concept called the "term structure" of interest rates. In short, this refers to the relationship between assets (or liabilities) of different maturity terms. When interest rates of assets are plotted against their terms, a yield curve is created. In general, the shape of the yield curve reflects the market's future expectation for interest rates. For example, the Libor yield curve currently shows a 1M rate of 5.32%, while the 10Y rate is 5.36%. That means (for example) a bank willing to lend fixed rate to a given client at Libor+200bp should be willing to originate a 1M fixed rate loan at 7.32%, or a 10Y at 7.36% (all things being equal). Put another way, the market is telling us that long term rates are going to generally stay where they are. More specifically, over the next 10Y, while the market expects rates to periodically move both higher and lower, on average Libor will be 5.36%. We will cover the forward Prime reset another time, but for now, let's reveal the rest of the trick. When originating loans, national banks are indifferent as to the maturity (if the credit quality is there). These banks simply shift up and down the yield curve, based on its term structure, while holding the credit spread constant. Therefore, in our example, the same customer quoted a 1M loan at 7.32%, would also be quoted a 3M at 7.40%, a 1Y at 7.47%, a 5Y at 7.28%, a 10Y at 7.36% and a 15Y at 7.45%. To recap, first find the term point on the curve that corresponds to the contractual maturity of the loan, apply the spread and then waive your magic wand 3 times in the air to conjure up the all-in rate. Presto - now you know the magic trick.

BANK NEWS

ATM Deal

Wamu and Cardtronics have reached an agreement for the bank to put its name of 160 ATMs in Walgreen stores later this year.

Regional Boom

In the first 5 months of the year, Atlanta GA and surrounding areas led the country in the number of residential permits issued with 32,737 single and multifamily building permits.

Construction Strain

Despite building in significant pricing flexibility, many contractors indicate they continue to lose money given sharply higher increases in raw materials costs. Studies show that in the year ended June 2006, copper prices have soared 88%, asphalt has risen 33%, gypsum products have climbed 23%, plastic is up 20%, steel has risen 18%, aluminum is up 17% and concrete has climbed 11%. As if that weren't enough pressure in the system, a slowdown in residential building, soaring impact fees, increasingly stringent municipal regulations and rocketing insurance costs are all increasing pressure on the viability of some projects.

Housing Ripple

The slowdown in housing is impacting other sectors as potential home buyers put off purchases. Not only has there been an increase in demand for apartments, but also for mini-storage facilities. Much of the demand is attributed to people losing their homes or downsizing.

Real Estate Trends

According to NAR, more than a million Americans own second homes in Mexico.

Credit Scores

A recent study by Experian found that having a mortgage positively impacts credit scores for consumers. The study found that a mortgage can add nearly 55 pts to a credit score, while having a second mortgage adds nearly 81 points. Consumers with mortgages have an average score of 713 compared to 658 for those without.

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