ARMY ANTS AND BANKING

by Steve Brown

Army ants are interesting. Every so often, perhaps when hunger becomes insatiable, hundreds of thousands of ants wake up in the morning and swarm. As the mass forms, it creates a true army of ants powerful enough to obliterate every living creature in the way. Scientists call this action a "death march." While there is nothing as extreme to our knowledge in banking, customer response to some stimuli can resemble such action. Consider loan prepayments, as an example, where the value of a deeper understanding is critical to future success. Those thinking prepayments are not that big a deal, are unknowingly standing in the path of an imminent customer swarm. Bankers have learned over the years that fixed rate loans must include prepayment penalties whenever possible. After all, when rates fall, prepayments accelerate and these loans drop out of the portfolio like crickets caught at the front end of the ant surge. That makes intuitive sense, but what many bankers do not consider is how quickly the same thing can happen with loans that carry a floating rate. Many banks fool themselves into believing that because they originate only floating rate loans, they have no price or prepayment risk. As such, many in this group think prepayment penalties need only be applied to fixed rate loans. What many may find shocking is that in certain cases, floating rate loans can actually prepay faster than fixed rate, dramatically reducing profitability. The current environment is a perfect example, as the short-end (i.e. Prime) of the yield curve has risen to 8.25%, while the long-end (10Y and 15Y fixed) sits at 7.00%. This creates a 125bp incentive for borrowers to refinance, generating about $126k in savings in the first year alone on a $10mm loan. Obviously, the same yield curve is indicating that on average (over the 10Y period) yields will drop to 7%, but many simply ignore that fact. Instead, most tend to only focus on today's coupon difference and assume the spread will remain the same forever. While that is a nonsensical position and we all know interest rates move over time, it is also a fact of life. All loans should have yield maintenance or some sort of penalty embedded in them if at all possible, regardless of whether said loan is fixed or floating. In that manner, at the very least, when customers leave the bank and refinance away, they are also forced to leave behind a departure fee. Lenders should be specifically trained to negotiate prepayment language and other structural items in an effort to better serve the customer and protect shareholder value. Inserting prepayment penalties in loans can boost ROE from 2% to as much as 7%. For smaller loans with fully allocated costs, this is often the difference between booking a profitable and unprofitable asset. Banks often seek a given ROE hurdle at origination, while ignoring the impact interest rate movement can have on return. Consider a loan originated with a 7Y average life and all-in costs of $15k. If rates drop 200bp and the loan prepays in 1Y, all origination costs also flow into the equation, significantly damaging return. Banks should run multiple analyses of loan structures to optimize prepayment protection structures. Like army ants, bankers know that once customers mass outside the door, it is too late to do much of anything.

BANK NEWS

Acquisition

BB&T Corp ($109B, NC) will acquire from Mellon Financial ($38.6B, PA) their insurance premium finance company, AFCO credit, as well as the Canadian affiliate. Terms of the transaction were not disclosed. The deal will catapult BB&T to the 2nd largest provider of insurance premium financial in the U.S.

Down

Single family residential foreclosures in ID increased 60% between June and July, according to a recent RealtyTrac report. The increase follows a 22.8% decline from the 2Q 2005 to 2Q 2006.

Director Liability

The FFIEC clarified their position on bank director liability in a letter to Sen. Mike Crapo (R, ID) who introduced a bill aimed at easing the compliance burden on banks, thrifts and credit unions. While the bill would remove the potential for ongoing financial liability for directors, the regulatory letter said they would not "routinely" hold directors liable for bailing out troubled banks or making them liable for losses unless agreed to in writing. Further, regulators do not and will not impose capital maintenance requirements as a prerequisite to obtaining a charter. At present, regulators have the power to hold a director responsible, but usually have to prove "unjust enrichment" or "reckless disregard for the law."

Consumer Trust

A recent ABA survey reveals that consumers trust banks more than other institutions to protect their identity and personal information by a ratio of 6 to 1. Government agencies and educational intuitions came in 2nd and 3rd, respectively.

Mortgage Concerns

Regulators have expressed concern over the reliance on reduced documentation requirements as lenders look to speed up the mortgage approval process. A recent study of a sample of 100 stated-income loans found that nearly 60% of the incomes were ove