CREDIT MIGRATION

by Steve Brown

One of the many mysteries on this earth relates to the migration of birds. The mighty Arctic Tern travels more than 25k miles each year to its destination, yet clearly there is decent food and warmer weather many places in-between. Why birds migrate, how they find their way and how they know when to fly remains largely a mystery. In like fashion, loan credit migration can often be a mystery. A borrower, with no external influences, will become a better credit over time, simply due to debt amortization and seasoning. Add in external influences such as collateral appreciation, corporate growth and general increases in cash flow, and a borrower can substantially improve credit over the course of just 1 to 2 years. By not taking into account the future and pricing a borrower at current levels, banks may overestimate the credit spread given the actual risk. While overpricing loans is not a bad thing, it does leave the borrower with relationships open to greater competition and increases the probability of repayment. It has long been a tactic of some bankers to target those areas of high collateral appreciation, in hopes of enticing borrowers to refinance early, at a better rate, due to nothing more than credit migration. Potential credit movement is one factor that helps explain tighter competitive spreads at larger banks, as many of the top 25 banks take this into account in their loan pricing models. Many banks are starting to price loans not only where the credit is today, but where the credit may average over the course of a loan. Banks forecast everything from interest rates to staffing needs, so why not credit? Pricing a borrower using today's snapshot of information is not forward looking. Pricing off credit expectations and potential migration helps better align risk and return. Of course it pays to be conservative, as credits also have a probability of deteriorating. Banks that incorporate credit migration often build a "pricing matrix" into their loan documents. This allows credit spreads to change up or down, based on certain tests such as earnings, LTV, net worth, debt service coverage, etc. Using a pricing matrix helps better correlate pricing to credit risk and serves to reduce optionality due to prepayments. Further, the matrix gives a borrower an incentive to improve their credit, which is in everyone's best interest. More importantly, using a pricing matrix gives the borrower a feeling that they are more in control - a powerful force. This feeling in turn may keep the client so warm, that they never feel the instinct to migrate to another financial institution.

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BANK NEWS

Spanish-First Branch

Wachovia announced plans to build 3 branches in TX that target the Hispanic market. Different from past banking practices, the branch signage and marketing materials will all be in Spanish.

Bank as Developer

An OCC interpretative letter recently approved a unique financing arrangement. In order to rebuild a dated branch, the band subdivided their parcel and leased a portion to support a developer's retail center and parking lot. In return, the developer would build a new full-service facility and least the building back to the bank on a long-term basis at not cost. The bank not only conserved capital, but is expected to dramatically increase branch traffic due to the proximity to the retail center.

Fine Print

The GAO released a report that criticizes financial institutions that use small font and complex language on their credit card offerings saying that is serves little to inform consumers. The Fed is currently reviewing card disclosures and is set to make its guidance available shortly.

Power of the Internet

A survey by CashEdge shows that 74% of online banking customers prefer opening and fuding a new account completely online. Further, 80% of those opening accounts expect to be able to access those accounts the same day. 64% of the respondents said that they would choose or switch banks based on online banking capabilities. The largest current online differentiator- respondent would like to be able to make 3rd party transfers online.