JUGGLING CRE LOAN PREPAYMENT PENALTIES

by Steve Brown

Yesterday's commentary on the value of prepayment penalties touched a nerve, as we were flooded with questions and comments. In light of these comments, one area that needs better clarification is the fact that the value of a prepayment penalty is constantly changing depending on rates, volatility and credit. If you think of not having prepay protection as being short an option (the option to refinance and take advantage of the market), then instituting a prepay penalty has the opposite (and positive value) affect. To put it in perspective, a prepayment penalty that is worth 40bp one day, may be worth 150bp another (say, if rates drop). As some respondents implied, then it goes to follow that loan officers can be active managers of prepay penalties in order to derive additional value for their bank. This works two ways. One, in periods where the rate view is expected to decrease, bankers can offer lower rates to existing borrowers in exchange for prepayment penalties. Given the market's expectation of future rates, now may be the time to take a look at existing loans and see which borrowers might be open to trading a lower rate for a period of prepayment protection. Those borrowers that do not have intention to refinance and/or do not fully appreciate the expected change in rates, may take a bank up on the offer. By doing so, the bank protects its quality credits by effectively extending a loans average life. The converse of this also works. For loans that already have prepayment penalties, an offer can be made to remove them either for free or for a fee. A perfect example is in cases where you have a prepayment penalty with deteriorating credit. For certain sectors, loan types or geographies, a bank may be better off to waive prepay penalties in order to entice the borrower to refinance with a different lender. In these cases, the increase in projected credit risk is greater than the value of the prepay penalty. Bankers should review their loan portfolio for opportunities and rerun credits through a pricing/credit model in order to determine which loans might qualify. In the current market, we have identified several areas of lending where the probability of default is expected to sharply rise. Loans on class B office space in areas where increased lease space is becoming available either through new construction or subprime related vacancies is one such example. We have a group of loans in our database, where the cash flow is already thin (less than 1.2x) and the coming shock will further deteriorate credit. Having a prepay penalty on these loans is actually a detractor of value, so if a bank can motivate the borrower to refinance with another institution, then it may have just saved itself a problem loan in the future. In similar fashion, loans with higher LTVs or with lower than market fixed rates, may not need prepayment protection (as the loan itself has low optionality) and the bank may wish to trade the removal of prepay protection in exchange for a one time fee. Working with prepayment structures and penalties is part of active portfolio management and can add an estimated 40bp to 250bp in total return versus those managers that do not actively manage credit and structure. If you would like to learn more about active loan management techniques and pricing, come to our next High Performance Bank Workshop in June (details included).

HIGH PERFORMANCE WORKSHOP

In an effort to single handedly bring back New Orleans, we will be holding our next High Performance Workshop in the Big Easy on June 7th, 2007. Topics will include strategies and tactics on: 1) Deposit gathering, product design, bundling and customer segmentation; 2) Loan pricing/active management; 3) Fee income generation; 4) Instituting a sales culture and a variety of other subjects which currently pose challenges to independent bank senior management. Space is limited to 20 banks per asset category (above/below $500mm) with only 1 person allowed per bank and only 1 bank per territory (in order to stimulate conversation). Aside from being one of the most educational workshops that you can attend, this one will be a whole lot of fun. Interested executives can review the attached brochure or contact us at 877-777-0412.

BANK NEWS

M&A

Everbank ($4.2B, FL) will purchase the remaining 49% of BNY Mortgage Company (and will now own 100%) from the Bank of New York for an undisclosed sum. BNY Mortgage is the 5th largest provider of reverse mortgages in the U.S.

Biz Lending

The ICBA reports that the number of independent banks that originate at least one 7(a) SBA loan each year has fallen by nearly 50% over the past 5Y (to about 2,700 institutions). Higher fees, the elimination of a rural lender program and reduced local service from SBA offices were all cited as reasons.

ATM Charities

Wells Fargo will be testing the ability to allow customers to make donations to a select group of charitable organizations through an ATM machine.

Western Union Competition

In an effort to reclaim the marketshare they once had, the company has created a separate business unit to focus on remittances sent to and from Mexico. The firm has recently seen growth stagnate due to increased competition from banks.