THE LANGUAGE OF CALLABLE CDS

by Steve Brown

Lots of animals make noise and a majority of those sounds actually convey some sort of information. Nothing compares to human speech, however, with its sheer knowledge transfer syntax, grammar, inflection, tone, speed and general complexity. Where our ancestors might have screamed incoherently at the sight of a saber tooth tiger, speech has developed and now we can tell our comrades to double-time it stage right. When it comes to structuring bank deposits, things are still in the medieval period of where language used to be. When it comes to deposit efficiency, there is still a heavy dose of "doths" and "forever mores." Perhaps that is why the use of options on an independent bank balance sheet remains underutilized. By embedding call options in their CDs, banks gain efficiencies and flexibility that can reduce costs and mitigate interest rate risk. Specifically, banks can issue CDs either locally, or through the Banc Investment Group on a brokered basis, where the bank retains the option to call or redeem the CDs. For instance, a 6 month brokered CD might cost the bank a 5.30% rate. A 3Y CD might cost the bank 5.25%. By creating a 3Y brokered CD that is callable in 6-months by the bank, issuers would be charged an all-in cost of 5.40%. One way to look at this is that banks are paying an extra 15bp premium to have the ability to call. This may hurt margins upfront, but over time the added flexibility should improve performance. Consider the forward curve, which is projecting a rate cut in 6 months. At that time, the above structure can be called by the bank and replaced by CDs that are 25bp to 50bp lower (depending on the then current interest rate environment). Should rates go up, the bank maintains the CD for the full 3Y term and has relatively cheaper funding. For the mathematically inclined, if you ran a Black-Scholes model on the option, that 15bp premium would turn into about 22bp of value. The difference stems from the fact that callable CD buyers do not fully appreciate the embedded options. This arbitrage value should be enough to entice any bank into issuing, but the story gets even better. As frequent readers of this publication know, you cannot adequately apply a Black-Scholes model to deposit options (like employee stock options). The reason is that there are other, difficult to quantify factors at play. For deposits, a bank may improve its funding position relative to a market index (such as Libor) and want to call the CD. In similar fashion, like today's current environment, a bank may be experiencing fast prepays on its loans. Here, the bank may find that it no longer needs as much funding as it currently has and would like to retire some liabilities. In this case, callable CDs give the bank the flexibility to retire all or a portion of the funding they provide. When taking asset-liability and funding cost improvement into account, the option value of the above structure exceeds an estimated 30bp. While using brokered callable CDs has the advantage of not cannibalizing a bank's existing deposit structure, those banks that would like to issue in their local market should focus on getting better pricing than the brokered. Banks interested in expanding their language of callable deposits (or to get rates on brokered callable CDs) are urged to contact us for further details.

BANK NEWS

M&A

Fifth Third Bancorp ($103B, OH) will acquire R-G Crown Bank ($3.2B, FL) for $388mm or roughly book value. In addition, Fifth Third will pay $16mm to an affiliate of R-G Crown to buy the underlying real estate for 15 of the bank's branches. Crown said it was making the sale to allow the company to focus its operations and core competencies in Puerto Rico, while improving its liquidity and capital position.

M&A

UniCredit SpA will buy Capitalia SpA for $29.5B. The move creates the biggest bank in the European Union and the largest bank in Italy.

M&A

Blackstone Capital Partners will acquire payments and credit card services provider processor Alliance Data Systems for $7.8B. The deal is the 3rd one in 2 months in the sector, including KKR's acquisition of First Data and Warburg Pincus' 25% investment in Metavante.

Selling

NetBank Inc ($3.6B, GA) executed an asset purchase and liability assumption agreement with EverBank Financial ($4.2B, FL) amid pressure from regulators. The bank sold loans it holds as investments, all of the assets and liabilities of its small business equipment leasing unit and $2.5B in brokered deposits. Regulators have been increasingly concerned about the bank's capital and earnings trends and advised management to find an alternative immediately that covered all of the bank's deposit obligations.

Competition

Sharebuilder (WA) is offering Costco (WA) small business customers 401(k) administration fee discounts. This is another addition to the many financial partnerships that Costco has with various other companies such as American Express and Nova Information Systems. Costco customers are very good customers to have as 87% are home owners and the average household income is $76K.