LENDING RISK

by Steve Brown

Of all the risks inherent in lending, interest rate risk is the easiest to isolate and quantify. Because of the widespread trading of interest rate products such as swaps and futures, determining the price of rate risk is simple. Take for example a 10-year loan with a 25-year amortization that has a rate to the borrower of 6.2%. By modeling the cash flows and looking at the loan's duration (average life to the next reset can be a proxy), we find that as of this morning, the swaps curve has a fixed rate equivalent of a 4.7%. This is the rate that the market values the interest rate risk on this structure using a 3-month Libor benchmark. In other words, the 6.2% rate on this loan is equal to receiving 3-month Libor + 1.50%. This is a handy calculation because: a) it removes the interest rate risk and isolates the credit premium; and b) it assigns a handy funds transfer pricing cost which the bank can utilize in customer or product profitability models. Some banks have a different view of where interest rates are heading than the market and construct their own "curve" to handle pricing. This is perfectly acceptable for risk management purposes for a bank to take a varying view of forward market rates. The important point here is for banks to analyze, compare and document loans on the same basis (either on a fixed or, preferably, a floating rate basis). By documenting the credit spread, banks better monitor and improve their credit and interest rate management process. Whether our example loan is worth a 1.5% credit spread, only bank management can decide. What is clear is that there is very little argument about how the market values interest rate risk and so any loan debate is where it should be Â– on the credit risk premium. This concept of measuring interest rate risk also helps in determine how best to fund loan production. Banks that use brokered CDs or FHLB to match fund fixed rate loans could be hurting profitability. If a bank's cost of funds is lower than either of these two alternatives, the bank drives up the cost of earning assets, thereby hurting their competitive advantage. It is usually far better to spend time developing a stable and inexpensive set of core liabilities (which FHLB Advances or brokered CDs may be a part of) or to utilize hedge products to solve interest rate risk, than to sacrifice margins or loan growth. If a bank's cost of funds is currently at 2.25%, then utilizing wholesale fixed rate funding channels would "cost" the bank either 80bp in margin (the difference between 2.25% and current wholesale funding levels) or result in 80bp of higher loan rates. Many independent banks are not cognizant of this calculation and so often under or over factor in the interest rate risk into lending pricing. Next to differences in credit premiums, this is the 2nd largest factor that accounts for divergent loan pricing between banks.

BANK NEWS

Employee Productivity

Studies show that 48% of employees would work another hour per day if they had a better office. Experts say a properly designed office area also boosts performance and increases competitiveness.

Housing Sector

Lennar, the top national home builder by revenue, reported an unexpected loss in its 2Q and warned additional losses may be coming as industry softness continues. The homebuilder reported that the housing market continued to deteriorate throughout the quarter and expected it to continue through the rest of the year.

Loan Risk

A new study finds small businesses with startup capital of at least $25k and an owner with a graduate degree stand a much better chance of making annual profit of at least $100k and have a significantly lower chance of failure.

Hedging

The OCC is reporting that 32 more banks joined the ranks of institutions using derivatives in the 1Q, bringing the total to 954 overall. Given that there were 62 business days in the quarter, about 1 new bank every other day began using hedging instruments.

Kiosks

A recent NCR study shows that 77% of adults say they are more likely to do business with banks that offer a self-service channel. 78% if those said they would like to handle transfers, print statements or loan documents via a electronic self-service machine. However, despite the growing acceptance of automation in banking, only 26% of consumers said a machine is preferred to look at investment choices.

Interesting Choice

A new study finds subprime borrowers are more likely to pay off their credit card debt than they are to make their home payment on time. Experts say the unusual activity shows how much this group needs the credit card to keep themselves afloat between paychecks. Overall, 36% of such borrowers were late on their home payment, compared to only 24% on their credit cards.