HOW TO BOOK HIGH QUALITY LOANS WITH FEE INCOME

by Steve Brown

While some argue that innovation in the banking industry no longer exists, we disagree. Many financial institutions continue to innovate with new products, new delivery methods or new marketing strategies. Here at BIG, we strive for innovation. We created our Bankers Loan Processing program ("BLP") to allow community banks to structure long-term, fixed-rate loans and convert those loans to floating rates - without the cumbersome process of derivatives. If necessity is the mother of invention, we identify three "moms" and how we have innovated to meet those needs. First, our customers have told us that their competition is offering fixed-rate, term loans with prepayment penalties, but with carve outs permitting prepayments without any such penalty. While this structure is more common at community banks than national banks, the trend is very clear Â– to be competitive, a bank must allow some borrowers to prepay without fees. For example, on a 10Y loan, a borrower may be permitted to prepay up to 20% of the loan balance without invoking any prepayment costs. We have now structured BLP to permit just such a mechanism and up to a 20% "carve out" free of prepayment penalties is now permitted. Second, prepay protection need not cover the entire loan term. For example, on 10Y fixed rate loans, a 5-4-3-2-1% prepay structure is standard in certain parts of the country. Before, we used to require a yield maintenance provision. Now, we are now able to offer a 10Y loan with only 5 to 7Ys of prepayment protection. In fact, BLP can now be used to structure 15Y loans with only 10Ys of prepayment protection. Third, we argue some banks have innovated faster than others. One area of innovation that we have witnessed is the de-emphasis of net interest margin ("NIM") income in favor of fee income. Some banks have recognized that it is easier to charge a dollar in fee income than a dollar in interest income on the same service. This is because fees are oftentimes more inelastic than rate. The prime reason is that certain fees are less visible to the customer and only contingently incurred, so customers tend to focus less on them. Consider that the measure of NIM minus non-interest expense has slowly been trending below zero at national banks. These banks continue to focus more and more on fee income, partly for the reason stated above. As of March of '07, for example, NIM minus non-interest expense was a negative 62bps at Wells Fargo, negative 2bps at BoA, negative 6bps at Wachovia, negative 38bps at Citibank, and negative 8bps at WaMu. None of these banks hide the strategy of sacrificing NIM for fee income and all have stated that their future income growth is not contingent on growing NIM. Instead, each has stated that they will strategically maximize fee income. Under our BLP Program, most loans are now also eligible for upfront fee payouts to the referring community bank. In so doing, BLP allows community banks to monetize the upfront value of prepayment protection and receive a sizable referral fee (the amount depends on structure and loan size). This is one way that community banks can enhance fee income. Our sole goal at BIG is to help community banks across the country increase shareholder value. For banks eager to show their customers an innovative solution, such as long-term, fixed-rate loans, while enhancing fee income, BLP may be the next innovation.

BANK NEWS

Countrywide

An increase in late loan payments resulted in the #1 mortgage lender reporting its 3rd consecutive decline in quarterly profit. Impairment charges on securities backed by home equity loans and lower subprime mortgage origination were primary drivers. To potentially compensate, it makes sense that the firm has been more aggressive at hiring of CRE lenders and said they will target $20B in origination in the sector over the next 12 months.

Subprime Shift

Bowing to regulatory pressure, Wells Fargo said it would follow Countrywide, WAMU, First Franklin and others and stop originating 2/28 loans (fixed for first 2Ys, the adjusts 2x per year for the remaining 28Ys). This is very significant, since these loans accounted for 65% of all subprime origination in 2006.

Amazing

Reflecting the growing strength in China, Industrial & Commercial Bank of China has surpassed Citigroup as the world's biggest bank by market capitalization. The bank's market capitalization reached $254B, compared to $251B for Citigroup and $215B for HSBC, which held the #3 position.

Patent Infringement Bill

In a victory for the financial services industry, the Senate voted to limit the potential damages banks would face when infringing patents during the check-clearing process, setting the stage for a debate in the House.

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Trust preferreds, perpetual preferreds, subordinated debt and holding company loans are currently at their all-time tight spreads, matching the 4Q of 2005. We think this is a significant mispricing, as bank credit is far worse than 2005. However, capital remains cheap, so banks should consider taking it and now is a perfect opportunity. If you are interested in any of these forms of capital and would like assistance utilizing our capital planning model, contact us today.