BOTTLING LOANS

by Steve Brown

The business of bottling liquids strangely mirrors community banking in many respects. Nothing more than putting liquids into bottles, sealing and affixing labels to them, bottling has largely followed the same maturity path. Similar to unit banking, many bottlers were held within state lines until the post-prohibition era. Since then, economies of scale have dominated one side of the market, while smaller, regional bottlers have flourished handling specialty product. Like banking, bottling is a cutthroat business, with thin margins and intense competition. One aspect of the bottling business is that bottlers know the microeconomics of their business better than most industries. Bottlers understand their cost structure, fixed/variable expenses, probability of unforeseen delays (that is the deviation around the expected retooling time), run times, quality control and opportunity cost of not undertaking another run. We feel that the bank lending process is very similar. Bank lending is a batched service industry. Loans are processed in discrete runs, generally interspersed with other production procedures. Every new loan opportunity is burdened with the following costs: origination, underwriting and administration. To price a loan effectively, a banker must quantify the cost accounting for every loan opportunity. To process a loan through a bank requires a certain amount of fixed and variable costs Â– very much like retooling a bottling run. Most banks have a large fixed cost and small variable costs of processing a loan (again very much like bottling in that whether the run is 1 unit or a million units, the same amount of retooling is required). This division of large fixed costs and small variable costs is called operating leverage and it creates an economic advantage for large loans (long runs) and a strong disincentive for small loans (short runs). As the bottler will compare the trade off between retooling (a cost) and run size (revenue), so must a banker Â– however, the revenue on a loan is difficult to estimate. Banks must understand their inherent operating leverage and price loans dependent on size Â– but size is a tricky concept. While every banker knows the size of the loan in question and the coupon on the loan, the expected term of the loan is a very important determinant of revenue (another dimension of loan size). Banks generally want to maximize loan term because the quicker the loan prepays the less revenue is realized from the batch process. Yet, the incurred costs are almost exactly the same because of the high operating leverage. However, we see banks do a poor job of estimating the expected life of the loan and in fact, most banks do not even have the systems in place to measure historical loan prepayment speeds. At BIG, we spend much time tracking prepayment speeds on community bank loans and we find that the prepayment speed is largely determined by the following variables: lending class, borrower strength and migration of that strength, pricing structure, prepayment protection, point of the credit cycle and shape of the yield curve. We would like to share a few of our common observations on prepayment speeds: bankers consistently overestimate the expected term (hence revenue) on loans, do not tend to quantify the impact of prepayment penalties on revenue (and hence profitability), forget to distinguish between strong borrowers (who have ample refinance possibilities) and weaker borrowers (who tend to stay with one lender for long periods, for obvious reasons). Therefore, when we say that the size of the loan matters, we refer to the dollar size, the coupon size and the term. Next time someone in the bank doesn't support a new loan opportunity, consider the above discussion and break open a bottle of good lending practices.

BANK NEWS

M&A

The HC of First National Bank of the South ($557mm, SC) will acquire the HC of Carolina National Bank and Trust ($226mm, SC) for about $59.3mm or roughly 2.04x book.

FDIC Assessments

Invoices containing credits and new assessments will go out within the next 2 weeks for payment by Sept. 28th.

Consumer Stress

Credit card companies wrote off 4.58% of payments in the first half of the year, a 30% increase over the prior 6-month period.

Banks and CP

With more than half of the $1.1T in outstanding commercial paper coming due in the next 90 days, Fitch Ratings reported that banks worldwide have nearly $891B at risk in asset-backed commercial paper facilities.

Jumbos Back at IndyMac

IndyMac announced that it will once again offer jumbo mortgages to customers. In August, the company said it was pulling back from these loans due to illiquidity in the secondary market.

Credit Crisis

Short-term borrowing rates show that the recent credit crunch is on par with the 1998 collapse of Long Term Capital Management. The "TED" spread (LIBOR less 3mo T-bill yields) reached 1.75% Friday, the greatest divergence since October 1998. Additionally, top-rated asset-backed commercial paper yields soared to 5.99%, the highest rate since the 2001 terrorist attacks.