FLOORS AND PIGS

by Steve Brown

Remember the story of the Three Pigs? One pig painstakingly overbuilt his house out of bricks while another slapped his together with straw and then used the extra time to download Internet porn. What financial banking lesson does this fable teach us? It teaches us that when the Big Bad Wolf showed up, the pig with the straw house was able to claim insurance money and refinance his property, while the bank kept its loan on the brick house and had to live through the recent reset down in rates. Our point, if you have not deduced it, is the fact that banks utilizing floors on their variable rate loans are reaping a tremendous value in the current market.

Two factors have increased the value of floors as of late. One is the rise of volatility in the interest rate markets. Up until July, the interest rate market had been hovering around a 13 volatility measure (technically, the standard deviation around a simple moving average). Now, volatility is an 18. This is like the difference between a pig and bacon; it is two totally different markets. The greater the volatility, the more valuable the floor.

The second and more important factor, is the expectation that interest rates will keep dropping. The larger the expected drop in interest rates, the more valuable the floor becomes.

Let's take a real world example. The most common structure for community bank loans is to write a floor at the present rate of interest. Let's take a $1mm, 5Y CRE loan made back in the middle of June at a rate of Prime flat. Let's further say that the banker was astute enough to include a floor at the then-current rate. If the originating rate was Prime, or 7.25%, then 7.25% was floor. In derivative parlance, this is the strike price. The value of that floor at the time of origination would have been an impressive $142k. That meant that bankers could have given away a small condo in the Midwest (made out of wood and plaster board) if they had to, in order to get the borrower to accept the floor. What is even more impressive is that the floor, on that same loan, would be worth over $200k if valued this morning. That is an 89% annualized return on just the floor. Even if you put the floor 1% below Prime, it would have started out with a value of $94k and be worth more than $130k today (remember that this is just a $1mm loan).

While our little pig friends seem to be fairly well versed in derivatives, most small business borrowers are not. Most borrowers have little appreciation for volatility or the path of future rates. As such, they tend to place little value on a floor. This creates a nice arbitrage opportunity for banks. If nothing else, banks could write floors into their loans and then turn around and sell them to us in order to receive extra fee income. We agree this is a pretty good idea, but a better idea would be to negotiate both a floor and a prepayment penalty on a loan. Banks that do so would enjoy substantially wider margins as rates trail down.

There is little downside to writing floors on loans and this instrument is the perfect counter to a borrower seeking a lower rate. Management may want to consider educating their lenders about how to insert floors and maybe even offer an incentive when included in loan origination. While we have many models to help you, they are really not needed as a floor always creates a positive value. In some cases, like credit impairment, it is advantageous to remove the floor. However, that is where common sense usually matches nicely with the models.

While you could huff and puff about a lower net interest margin, you could also use that energy to get lenders to include more floors on their loans (and stem the onslaught of projected margin compression). If you do, once the headwinds of profitability pick up, it will be the difference between building your balance sheet out of straw or carbon-reinforced steel.

BANK NEWS

M&A

Bankrate made 2 acquisitions. The first is Nationwide Card Services, which provides business and consumer credit, for $26.4mm in cash and $7mm in earn outs. The second is savingforcollege.com, an company designed to help consumers and financial professionals learn more about 529 plans and options for college financing (acquired for $2.25mm in cash and $2mm earn out).

2008 Projection

The BIS, using Wall Street models that track money market rates, is projecting tight liquidity will remain through the 1st half of 2008. Weak credit market conditions are expected to push lenders to cut back by an estimated $2T.

Subprime Housing

Depending on the survey, expected total losses from subprime mortgages ranges from $150B to as much as $400B. For comparison, at $400B, the loss would shave about 3% off GDP.

Adjustable Rate Pressures

Even after the Bush plan goes through, some $500B in mortgages are still going to reset to higher rate levels in 2008.

Credit Tightening

A Duke University survey found that 33% of CFOs reported their companies are being hurt by the credit squeeze.

MBIA

Bankers are closely watching why the stock of the world's largest bond insurer is halted this morning pending financial news. MBIA credit makes up an estimated 17% of bank's municipal risk.