THE DARK SIDE OF OZ LOAN PROFITABILITY AFFECT

by Steve Brown

We are not sure who figured this out, but years ago we learned about the "Dark Side of the Rainbow Effect." If you put on Pink Floyd's 1973 classic album Dark Side on the Moon right when you hear the 3rd MGM lion's roar at the start of The Wizard of Oz, the video is synched artistically (and eerily so) to the soundtrack. The Scarecrow flops in the grass and the lyrics sing "The lunatic is on the grass." As the Oz team skips along the Yellow Brick Road the music swells and when the thumping heartbeat that ends the album's title song goes down, Dorothy is just putting her ear to the Tin Man's chest. Bloggers and chat-roomers have come up with a variety of drug-induced theories to explain this phenomenon, however it is most likely man's need to impose patterns where none exist.

A similar pattern exists when it comes to loan profitability. Bankers see the larger upfront fees on loans and assume that a loan is profitable. For example, would you rather have a $5mm construction loan at Prime + 25bp (for a 7.25% rate) with a 1% fee and 65% LTV; or a $5mm loan on a retail center that is 25Y amortizing due in 5Ys (with a 80% LTV, 50bp upfront and a fixed rate of 6.50%). Most bankers would choose the construction loan because of the higher fee and rate. In the past, we have talked about this type of loan comparison on a risk-adjusted basis. In our example, we should point out that the probabilities of default just happen to be the same. For the sake of discussion, let's also assume that customer acquisition cost, servicing and maintenance cost are also all the same. If this is the case, then comparing the two loans is a question of cashflow structure.

In looking at more than 400 construction loans over the past several months, we have a pretty good understanding of the life, cashflow and cashflow variance of this type of product. It may be interesting to note that the average construction loan has a 0.51 average life and a 55% average outstanding balance. That means for every $1mm of construction exposure outstanding, chances are high that only $550k is drawn at any one time. It also means that the loan pays off in about 335 days after origination.

In our example above, this cash flow structure equated to $229k of revenue at the end of the first year. Compare this to the retail center loan example, which produces a $377k revenue stream, or 65% more cashflow. Despite the difference in interest rates, the draw schedules on most construction loans end up hurting the cashflow profile when compared to other loans. If you just judge profitability by the stated interest rate, instead of the overall structure, you end up missing reality. This is yet another reason why banks need a loan pricing model to help them analyze cashflow and structure.

To learn more about loan structures, pricing, managing risk and how banks can take advantage of market conditions to increase risk-adjusted return on equity, be sure to attend one of our complementary, 30min. online seminars. To do so, click one of the 'Online Seminar Enrollment' links below.

If choose to attend these events, we also suggest you put on James Brown's Revolution of the Mind Album, as it will be synched perfectly.

BANK NEWS

M&A

Home Federal Bancorp ($125mm, LA) will acquire First Louisiana ($121mm, LA) for about $23.7mm or 2.1x book.

M&A

The insurance brokerage side of BB&T ($126B, NC) will purchase regional insurance company Ott & Co. for an undisclosed sum. Ott offers employee benefits, medial, dental, life and disability insurance to 400 corporate clients.

Housing

Countrywide said foreclosures doubled in November and late payments continued to rise. Foreclosures reached 1.3% for all loans serviced by the company, while late payments jumped 55% from the same period last year.

More Losses Coming

Execs at FHLMC estimated the company will lose an additional $5.7B over the next few years as loan defaults rise and the housing crisis worsens. The GSE has already lost about $4.5B YTD.

For a Rainy Day

A new report found that 44% of Americans say they have enough money saved for both short- and long-term financial needs. However, the report also found that 52% of Americans considered their savings "inadequate" and 17% said they cannot afford to save at all.

Competition

Compass Bank ($42B, AL) plans to open 15 branches next year in Forth Worth, Houston and San Antonio.