ADDING A BIT OF SEASONING

by Steve Brown

When it comes to cooking, chefs can't live without their spice racks. Banking and lending in particular can be similar to cooking Â– particularly when it comes to seasoning.

Consider that the length of time a loan has been on the bank's books, or "seasoned," the more likely it is to exhibit certain distinct characteristics. In short, seasoning affects a loan primarily through optionality and credit.

When bankers think of a loan, they intuitively know it is unlikely to go to the stated final maturity of the note. Interest rates shift, collateral values appreciate, borrower ability to repay changes and competition also drives increased refinancing activity. Understanding that seasoning plays a key role in the propensity of a loan to prepay can help community banks improve pricing as well.

Traditionally, seasoning has been thought of as a "ramp" where value increases with each passing month, until it peaks at some future point in time and then stabilizes.

After better quantitative research over the years, however, it has been found that loans will often season more like a graphic representation of an "S" lying on its side. That is to say that the value of a new loan starts high, then dissipates as the loan begins to age, then some loans stay with the organization despite logical reasons to exit (increasing their value), then even these loans eventually repay or pay off at the end of the cycle.

For example, consider the first phase where borrowers have just gone through the pain of filling out loan documents, providing financial statements and personal guarantees. Once they have been approved for a loan and signed all the necessary paperwork, people mentally move on to their next important task. During this period, people are usually less apt to refinance (or default), having just done so. For those keeping score, the length of this first phase varies from 3 to 19 months depending on type.

In the next phase, seasoning becomes more valuable along 2 dimensions. The first is the "burnout effect," where loans that will prepay as to rate or credit would have already done so during the first cycle. For interest rate sensitivity, this is especially true should rates go down, providing borrowers an added incentive to prepay. If a loan does not prepay during this period, the theory goes that the borrower is deemed less interest rate sensitive and is now worth more than a borrower with unknown prepayment or credit characteristics. Save for some start-up or small business loans (where default risk is actually higher in this intermediate period); credit risk during this phase dramatically improves, due to cash flow growth, pay down and/or appreciation.

As seasoning progresses, it eventually reaches its highest level somewhere around 80% through its original stated life. Once that occurs, value starts to decline. During this final phase, the borrower realizes that the end of the credit facility is coming due and they being to actively look for an alternative solution. Prepayments or yield maintenance penalties usually take on less meaning, as their costs are overwhelmed by possible savings from refinancing the loan. At this point, credit also has become a non-issue and seasoning value is almost entirely determined by optionality.

While each note and borrower is different, visualizing a sideways "S" and assigning value to seasoning can be beneficial to bankers. If that is too artistic for you this morning to contemplate, a good rule of thumb to use is that the more optionality a loan has the greater the value of seasoning.

Compared to the "salt" of interest rates and the "pepper" of credit, loan seasoning is more like "paprika" when it comes to mixing up a good batch of loan value. Like paprika, however, loan seasoning can also be a colorful addition to any dish, and should be considered as a way to improve overall flavor. Good chefs know it makes sense to keep a bottle of seasoning handy, just in case that next loan dish needs a little something extra so it tastes just right.

BANK NEWS

CRA Threshold

The asset-sized levels used to define "small" and "intermediate small" institutions under the CRA Act will increase Jan. 1. Based on CPI, the new levels will be less than $1.061B and between $265mm and $1.061B (for the previous 2 qtrs), respectively.

Housing Sector

A new study finds home foreclosures jumped 68% last month compared to 2006. NV had the highest foreclosure rate in the country of any state at more than 4x the national average.

BofA CEO

Ken Lewis said he is now worried even borrowers with strong credit scores may not make mortgage payments. He said pure economic reasons with moral compunction have resulted in "a huge change in social attitude towards default."