APPLES OR ORANGES

by Steve Brown

Whenever someone is comparing two dissimilar things someone else invariably chimes in by saying "that's like comparing apples to oranges". They say this to indicate a evaluation cannot be made because the two items in question are much too dissimilar. The insinuation is that anyone foolhardy enough to try is out of their mind.

In banking, commercial loans tend to be highly dissimilar in many ways, so apples, oranges, or grapes - one would be foolhardy to try. When it comes to commercial loans, dissimilarities can include term, principal outstanding, draw options and pricing, to name a few.

So, how does one compare the yield from one loan then to another? For purposes of this discussion, we will compare yield only, not gross revenue, overhead, risk, or return on capital. While these are essential elements, they are ignored for brevity.

When a loan is floating rate, things are easy. Bankers will quote borrowers a fixed spread to a floating rate index and be done with it. In 99% of commercial transactions these days, the index used is Libor (typically 1 or 3-month).

Fixed rate loans are also quoted on a spread to a floating index - behind the scenes. While these loans may be quoted as a fixed rate to a borrower, internally, most lenders view the loan as a spread to a floating rate for two major reasons: 1) the loan is almost always converted to a floating rate to better match liabilities, and 2) the floating rate is the only possible input variable to calculate ROE pricing, funds transfer pricing and internal capital allocation.

For example, assume that a bank wanted to originate a fixed rate loan and maintain it on the balance sheet as a fixed rate asset. Further, assume that the bank concluded that a 6.50% fixed rate was acceptable pricing for a 5Y maturity and quoted the borrower that rate. The question is, when documents are drawn up 2 months later, is 6.50% still an acceptable rate?

To answer that, we assume that also during the 2 month period, rates have gone up, as well as down, by 50bp (as they have done recently). To make things more complex, when the documents are drawn up, the borrower requests an 8Y loan, instead of a 5Y. The bank has to ask whether the rate on the loan should be higher or lower than 6.50%.

Unfortunately for the bank, the borrower complicates things even more, by asking that the loan start in 12-months (when an existing mini-perm expires).

As this shifting example demonstrates, trying to figure out the loanÃ¢Â€Â™s return is not only confusing, but also very difficult to do. However, if the bank had concluded that the required yield on the loan (given its risk profile) should have been Libor+175bp, then the bank could quote a 5Y, 8Y, or 10Y term (with a forward starting date), with very little effort.

Big banks like Wells Fargo do not price loans based on term or funding date. Instead these banks calculate their required yield based on credit risk, overhead, acquisition cost and other factors. Then, they can offer any maturity or starting date the borrower might request.

We see hundreds of loans every week from every part of the country. In so doing, we see most spreads on cash-flowing, real estate secured loans averaging from 1.50% to 2.50% over Libor. This spread can vary, depending on the bankÃ¢Â€Â™s relationship with the customer, deposits associated with the account, the credit risk and the size of the loan. The problem occurs because we also see lenders price loans consistently above these prevailing market averages, reducing their odds of winning (or holding onto the risk). Meanwhile, other banks will simply react to borrower demands and match pricing as a defensive move to hand onto the client.

While lending is a difficult business, there are no apples in loans. Whether fixed or floating, apples or oranges, bankers can win more profitable deals by remembering that the spread to Libor is the key to success.

BANK NEWS

Restructuring

Bank of America said it will lay off 650 people and sell its unit that processes trades for hedge funds, as it moves to tighten things up following a 32% drop in earnings from the 3Q of 2006 to the Q of 2007 (primarily related to spillover from the subprime and credit crisis). Meanwhile, IndyMac said it would fire 2,400 people, or 24% of its workforce in an effort to recover from significant changes in the mortgage sector. Indymac already slashed 1,600 jobs late last year and is not predicting it would need to lay off up to 1,000 more in the next 6 months if conditions donÃ¢Â€Â™t improve.

Banking Soap Opera

The saga continues as banking giant, Vernon Hill (former CEO of Commerce Bancorp) is sueing his former company and its board of directors over failure to honor the compensation provisions in his employment contract. Hill left under allegations of conflicts of interest between the bank and vendors that were either operated by him or relatives. Hill is claiming he is due incentive compensation and a stipulated separation payment all totaling $50mm.