

## A NEW IDEA IN LOAN STRUCTURING

by [Steve Brown](#)

We read somewhere that giraffes will drop 5 feet to the ground when born. That is quite a harsh introduction to the world. Many community bank lenders are feeling similarly impacted by competitive in the loan market. We hear most of the complaints first hand, including: low credit spreads, aggressive prepayment penalties and long-term fixed rates.

We not only deal with hundreds of community banks across the country, but we also see loan volume generated by national banks, CMBS conduits and alternative lenders (such as CIT and GE Capital). We originally formed our Bankers Loan Processing Program ("BLP") to help community banks compete on an equal playing field with such competitors - but that doesn't mean we aren't trying to reach for the leaves at the top of the tree.

As we continue to evolve BLP, we listen carefully to our community bank customers. As a result, we recently modified our program to better suit our customers' needs. BLP has always allowed banks to offer any term fixed rate (out to 25Ys in some instances), including forward starting loans. BLP also allows banks to capture upfront referral fees. Now we have altered BLP to permit partial term hedging of loans that qualify. This means that if a borrower is asking for a 10Y fixed rate loan, BLP will allow the bank to convert the front portion of that loan to a floating rate (the converted portion) and keep the back portion on a fixed rate basis (the non-converted portion). This has two primary benefits to community banks: 1) it allows banks to eliminate prepayment penalties for the non-converted portion of the loan, and 2) it permits the bank to increase its floating rate yield on the converted portion.

Let's consider a concrete example. Assume a \$2mm, 10Y fixed-rate loan on a 25Y amortization schedule, priced to the borrower at 6.50% fixed. Today, that loan would convert to approximately LIBOR plus 1.67% floating. Many banks will struggle with this yield and many also find it difficult to sell prepayment protection for the life of the loan. Now consider this new feature - divide the loan into a 6Y converted portion and a 4Y non-converted portion. The 6Y converted portion will now have a yield to the bank of LIBOR plus 2.21% and the non-converted portion need not have any prepayment protection - no yield maintenance and no declining balance. The same technique can be used to achieve a 5Y converted portion and increase yield on the same 6.50% loan to LIBOR plus 2.40% (a 73bps increase from the original 10Y structure).

Every week we see hundreds of loans across the country from dozens of institutions - some we hedge, some we price, and some we buy and sell. Empirical evidence shows that the average life of a 10Y fixed-rate loan is somewhere between 5Ys and 8Ys, depending on the starting rate, strength of the borrower, prepayment protection and property type. Our BLP Program simply reflects this phenomenon, doing away with prepayment protection for the portion not expected to be outstanding. It also allows community banks to maximize the yield on the converted portion of the loan and keep the non-converted portion as a fixed rate.

If you want to know if a newborn giraffe lends on its feet at birth, we can't tell you from experience. However, if you would like to learn how to make competitive and profitable loans, we do have the experience to help - please give us a call.

# BANK NEWS

## **Pressure Point**

Freedom Bank's (\$291mm, FL) former CCO has filed a lawsuit against his former employer and said he quit the bank because he was pressured not to take \$11mm in downgrades and additional reserves related to problem assets. The bank reported a \$5.8mm loss last year, but would have dipped below the "well capitalized" threshold if it had done so.

## **Online or Struggling**

In another sign the consumer is getting more sophisticated online and perhaps struggling, Intuit (the largest maker of tax-preparation software), said 2Q profit was off 21%. The company receives revenue from its TurboTax software sold in stores almost immediately, but doesn't get payment for online sales until customers submit their filings (which many have delayed).

## **Municipal Changes**

The nation's largest muni borrower, CA, will shift \$1.25B in auction rate bonds to more traditional debt issuance, after the auction rate market ground to a halt recently. Meanwhile, in an effort to ease the impact of failed auctions on municipalities, the IRS said it is working on new rules that will help cities, states and towns convert auction bonds to lower-cost debt without a significant tax impact.

## **New Projection**

The FRB has cut its growth forecast for 2008 and is now projecting the economy (GDP) will grow between 1.3% and 2.0% this year. In addition, the FRB expects the unemployment rate to rise to as much as 5.3%.

## **No Loan**

BankUnited's internal "no loan list" was leaked to the press that shows how the bank is staying away from mortgage loans on 191 condo projects due to declining market values, delinquent association dues, litigation or concentration issues. While embarrassing for the bank to have this public; having a list this is a proactive idea to get all lenders on the same page.

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