100 THING CHALLENGE - THROWING OUT PRIME

by Steve Brown

A current fad sweeping the nation is a grassroots movement called the "100 Thing Challenge." The goal is to find out what is really important to you and narrow down your belongings to a mere 100 items. Clothing, sporting equipment, camera, sunglasses, watch, electronics, car and what ever else you own is up for consideration to trash, donate or sell. This Zen-like, anti-consumer movement does make you contemplate your materialism and raises the question - what would I keep?

One of the things that we decided to throw away, starting today, is our Prime swap rate. Despite all the current calculation questioning of Libor, Prime has a multitude of other problems. For starters, it is an administered rate artificially set by a group of banks. Libor, on the other hand, is one of the most liquid indices in the world, as global financial institutions trade trillions each day. When credit problems arise, liquidity dries up or inflation raises its ugly head, Libor quickly adjusts - Prime remains the same (except when the Fed shifts its target rate).

Over the past year, the basis risk (that is a bank's cost of funds versus its earning assets), has grown exponentially. Consider for example, for the first time in modern banking, the Fed cut rates by 25bp and funding costs actually went up. As Prime has fallen, Libor has more closely tracked a bank's funding cost. If you're puzzled as to why, consider that 77% of the liabilities of all FDIC insured institutions are now directly priced to Libor (and thereby influencing the rest of the deposit market).

Given the interest rate cycle, since more and more borrowers are demanding fixed rate loans, our BLP program allows us to purchase that fixed rate loan and then give it back to the original bank in the form of a floating rate loan participation (we keep a small portion). We take all the interest rate risk, while you manage the borrower and most of the credit exposure. The product has been fantastic for community banks, as it has allowed them to profitably go after borrowers that other banks can't handle.

Up until yesterday, we published a Prime Swap rate which told banks where they could exchange a fixed rate for floating Prime. The problem is that we felt we were doing banks a disservice both in our hedge work and through our BLP program. A Prime swap is more expensive than a Libor swap (that is a larger bid/ask) and it is less correlated to banks funding, thereby making it a lousy index to use as a hedge.

Going forward, the bottom right box will detail the "breakeven" or the "indifference point" to where a bank can exchange a fixed rate for a 3-month Libor floating rate. At a minimum, the level will give banks a better idea of the interest rate risk embodied in the market, thereby allowing for more accurate pricing. At a maximum, it lets banks know approximately where they may be able to exchange interest rates payments with us either through our hedge or BLP program. For example, if you had a borrower that wanted a fixed rate loan and you wanted a spread of 2.00% above Libor (since Libor is above your cost of funds your total margin would be greater), you would look at the chart and add 2.00% to the 10Y rate of 4.75% for 6.75%. That means that every quarter, your bank would pay us 6.75% and we would give you 2.00% plus Libor. If we exchanged today, we would pay 4.79%.

Now if your immediate reaction to our example was - the floating rate seems low - this is precisely why you need to use this chart. Banks in an effort to add margin today, are taking on fixed rate risk in droves, particularly in the 3Y and 5Y area. However, the swap rate below highlights the markets best expectation for rates (which calls for them to move sharply higher). In other words, if your bank has an articulated view that rates will remain low, great - keep the fixed rate. However, if you don't have that view then we highly recommend hedging the exposure by using Libor to gain profitability and manage risk.

We can't even find 100 things in our desk we want to keep, let alone in our lives. However, as we evolve, Prime is an index we have decided that we can now live without.

BANK NEWS

M&A

Whitney Holdings ($10.8B, LA) will acquire Parish Nat'l ($765mm, LA) for approx. $165mm, or 2.65x time book.

M&A Multiples

Including the latest merger above, bank sales multiples over the last 2Ys have averaged: 2.05x price to book; 2.17x tangible book; and, 22.7x earnings.

Libor Change

The British Bankers' Association, or the entity that collects and publishes Libor rates, has agreed to poll more banks in an effort to gain more accuracy. While the details were not discussed, the move will add more liquidity and comfort to the market. In related news, the BBA said that it is also considering publishing a U.S. only Libor rate as well.