ICICLES IN HADES AND BETTER LOAN MARGINS

by Steve Brown

The saying 'When Hell freezes over" to describe a low probability event is apt. These days, low probability events happen as often as snow in Las Vegas (like yesterday). In such odd times, bankers that can adapt will prosper.

In the last two days we have written about the challenges that the low Fed Funds rate will pose for community banks. With a 3.25% Prime rate, most community banks cannot generate positive net interest margin on floating rate loans, much less a positive ROA (after subtracting overhead). The efficiency ratio for floating rate loans is higher than fixed rate loans, translating into an even lower ROA for floating rate portfolios. Setting floors in a very low rate environment creates its own challenges - it shortens loan durations as rates rise, may come with commensurate caps that subtract ROE and detract from the marketability of the loan (since in most cases the collared rate loan is a weak substitute for a fixed rate loan).

However, with the 5Y Treasury yield below 1.50% and the 10Y Treasury yield at barely above 2.00%, this is the wrong time to originate fixed rate loans - especially, with the threat of inflation in 2010. While the average loan margin for a quality "relationship loan" is between 2.50% and 3.25% above the swap rate, most banks cannot efficiently match-fund long-term assets. Once the Federal Reserve communicates its cessation of quantitative easing (or simply states that Bernanke's comments about targeting the purchase of long-term Treasuries was taken out of context) the yield curve may rise significantly.

We are not advocating that banks stop lending. In fact, with average loan spreads above their recent 10Y trend, now is the time to replace lower spread loans with higher spreads.

One way to do this is to originate hybrid loan structures. At BIG and PCBB, we have been helping banks structure 5Y and 10Y loans with prepayment protection that yield the bank a fixed rate for the first six months of the loan (a rate that has ranged recently from 5.00% to 6.50%) and then convert for the remainder of the loan to a floating rate of an average of 2.50% to 3.25% above LIBOR. The structure provides banks with a higher yield in the immediate 6-month term when net interest margin is particularly precious, followed by interest rate protection after the initial 6-month period when rates are anticipated to rise.

The structure is particularly effective in today's rate environment when the yield curve is flat and the term premium is low (the cost to obtain yield further out on the curve is low). If you are like most people and prefer to see specific and real numbers, here is a typical structure that we have seen replicated on a number of occasions: 10Y owner-occupied or high DSC CRE loans, 6.00% fixed rate to the borrower, 5.90% fixed rate to the community bank for the first six months, followed by 9.5Y floating rate return to the bank of 3-month LIBOR + 3.30%. While 3-month LIBOR is 1.85% for loans funding today, the floating option does not start for another 6 months (when LIBOR is expected to rise). For reference, in the previous 2Ys, 3-month LIBOR has averaged 4.17%.

We expect that the next year in community banking will be as challenging as the last year. However, by stacking the odds in favor of the house, banks can continue to differentiate their products and win profitable relationships - no matter how snowy things get.

BANK NEWS

Morgan Stanley

Morgan (now a bank) posted a $2.2B loss in the 4Q with net income declining to $1.71B, the lowest in 13Y.

Goodwill

Federal banking agencies approved a rule allowing institutions to cut the amount of goodwill that must be deducted from Tier 1 capital by its associated deferred tax liability.

Biz Customer

A new study finds 40% of small businesses are reporting lower sales in Nov. and 50% say their profits are lower than 3 months ago.

Likely Result

Programs designed to bail out troubled homeowners that require borrowers to be at least 60 days late could encourage people to miss payments in order to qualify. Note that no data on this yet exists, but we will be closely watching. Of interesting note, the latest data shows a record 10% of all homeowners with a mortgage are behind at least 1 month on their payments or in foreclosure.

Getting Worse

Delinquencies on home loans not yet in foreclosure jumped 7% in the 3Q, reaching a record high.

Consumer Stress

Analysis of 3Q credit card activity finds the average person had $5,710 in credit card debt, up 6% from the same period last year. The data indicates consumers are having a harder time paying off their debts.

Loan Delinquincy

Nationwide, 3.07% of prime mortgage loans are at least 60 days delinquent.

Swipe of a Card

Over 50% of consumers with debit cards say they spend more with a debit card than with cash opposed to 16% who say they spend less. Those 18 to 41Y have a higher tendency toward this heavier spending trend.