KNOWING, NOT KNOWING OR SLEEPING

by Steve Brown

Ever since we heard John McCain express uncertainty about how many houses he owned, we became intrigued with the concept of not knowing what you do not know versus knowing what you don't know versus knowing what you know and finally, stay with us now, not knowing what you know.

The 1st concept is that "ignorance is bliss." The 2nd is an intermediate state of understanding (you have knowledge about topic and knowledge of what you don't know about that topic). The 3rd is a higher state of understanding (knowing a topic thoroughly and understanding how you gained that knowledge), which is the aim of most pupils. The 4th is thinking a topic is understood when it is not.

Here is what we think we know about the current state of bank lending and the future of interest rates. Loans currently originated on a floating rate basis with floors that exceed the fully-indexed rate (i.e. Prime + 1% with a staring floor of 6%) are not truly floor-protected loans. Instead they are floating rate loans that start with higher credit spreads. As rates rise, that credit spread will contract (as the loan comes off the floor). We state that loans with floors are always preferable to those without floors; however, loans with floors arbitrarily set at a higher staring rate have less value than those with a higher credit spread. This is true, even if the starting floating rate is identical to the higher credit spread. As that sinks in, note that there is no reason to offer a cap in return to the borrower. You may have to do so to get the deal, but know that the cap is a real cost to the bank as rates rise. In contrast, if rates stay low, the floor gives the borrower room to prepay the loan. As such, this collar arrangement (cap/floor) comes at a tremendous economic cost.

Here is something else we think we know about the current state of bank lending and the future of interest rates. The market is currently predicting that low interest rates will prevail for a very long period of time. Sure, Bernanke and friends have said so, but consider as well that LIBOR has averaged 5.24% for the 2Ys prior to this recession. It is expected to average only 2.40% for the next 5Ys. The market right now is predicting a new paradigm in rates ("it's different this time" - where have we heard that before?). Another example of "it's different this time" is the expectation of inflation. The market is predicting inflation to average 40bps over the next 5Ys, while the 5Ys prior to the recession, inflation averaged 220bp. While the recession may be severe, we find it difficult to believe that the market knows what it knows. We believe that the market is understating longer-term inflation and interest rates.

Finally, we do know that we know the following: strong borrowers are and will continue to demand fixed rate loans in this interest rate environment. Lenders that book fixed rate loans should not forget that rates will eventually rise and so will funding costs. If you would like to discuss how to manage fixed-rate loan risk, when to convert it to floating, how much it will cost and what work needs to be done to do so - give us a call. The markets predict rates will be low for a long, long time, so now may be a good time to give customers longer-term loans, while converting them to fixed on your own books through our Banker's Loan Processing ("BLP") program.

In closing, we share the following old proverb: He that knows not and knows not that he knows not is a fool. He that knows not and knows that he knows not is a pupil. He that knows and knows not that he knows is asleep. He that knows and knows that he knows is a teacher. If you followed all of that, then you may know what you already know - you know?

BANK NEWS

Humphrey-Hawkins

FOMC Chair Bernanke's report on the economy to Congress was as optimistic as it could be given the circumstances. Ben said he hoped to see a recovery in 2010 and he attempted to ease nationalization fears. On the negative side, he said that while inflation has dramatically decreased, it is only because GDP, employment and confidence is dropping at an accelerating pace.

Fears Ease

The number of small business owners fearing their business will go under has declined to 13% from 18% in Oct. Of note, 25% expect their business to grow (up from 23%), but only 17% are looking to hire more employees.