SAILING STONES AND LOAN FLOORS

by Steve Brown

Of all of nature's many mysteries, few are more perplexing than the moving rocks of Death Valley, CA. The lowest place in the US is home to "sailing stones" which are giant rocks weighting up to 700lbs that travel along the desert floor, leaving trails behind them. The phenomenon has left scientists scratching their heads for decades as no one has seen the rocks move, there are no footprints anywhere around them and no sign that they have been touched by any outside force. Hydroplaning, magnetism and other theories have all been tested, but to this day, no one can figure out how the rocks move.

While sailing rocks are a mystery, the utilization of floors in lending is not. Lately, floors have caused their own set of mysteries on bank balance sheets. There are some characteristics of floors that banks need to be aware of to successfully implement strategies that help shareholder value.

While we are normally strong proponents of utilizing floors in loan pricing strategy, we believe that in this interest rate environment, the strategy of setting an initial rate to the floor will erode long term profitability. For example, take a loan priced at Prime + 1% with a floor of 5.50%. With Prime at 3.25%, the computed interest rate of that loan is 4.25%. However, with the floor, the initial rate for that borrower is 5.50%. In doing so, the bank has placed a credit premium on the loan of 2.25% (5.50% floor less Prime of 3.25%). As market interest rates increase, the implied credit premium decreases to 1%. Yet, the borrower's actual credit risk profile may or may not have changed. In addition, the bank's net interest margin will suffer when market interest rates start to rise. Not only will this structure act as a fixed rate loan for the first 125bp point increase, it will continue to be priced at only 1% over Prime for the life of the loan. The bank would have been better off pricing that loan at 2.25% over Prime, thus holding the credit premium constant over the life of the loan. In order to make it attractive to the borrower and to better align risk and reward, covenants should be included that decrease the spread at a later date, should the borrower's credit quality improve. In this manner, the borrower is almost placed in the same position as utilizing the floor structure, but the bank gains the added benefit of additional spread tied to risk.

To assess the level to which this phenomenon of flooring loans above the initial start rate is occurring, we looked at all floating and adjustable rate loans originated in the 1Q of 2009 for a group of banks we work with. Here is what we found. Approximately 78% of the floating / adjustable rate loans had floors and 90% of those loans were priced on the floor. The average computed rate (rate index plus rate adjustor) was 4.40% and the average floor was 5.50%, meaning that it will take a 110bp increase in rates for these loans to start repricing. The takeaways are twofold. First, banks should be cognizant of the interest rate risk that is occurring as a result of floors (and make sure their asset / liability models are pricing this correctly). Second, when pricing a loan, be sure to price interest rate risk and credit risk premium separately. Lenders that try to manage interest rate risk and credit risk together will most likely end up doing a sub-optimal job, hurting profitability.

Utilizing floors is an effective strategy, but their use needs to be fully understood. Like the sailing stones, you want to prevent the board of directors from taking a look at your income statement at the end of the year and asking - "How did we get here?"

BANK NEWS

Forced Infusion

Documents were made public that showed former Treasury Secretary Paulson gave Citigroup, JP Morgan, Wells Fargo, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of New York Mellon and State Street Bank no choice but to take TARP. The released memos indicate Paulson told bankers present that opting out isn't an option because "your regulator will require it in any circumstance." Of note, Geithner, Bair and Bernanke were also present at the meeting.

Regulatory Consolidation

Now that bank stress tests are done for the largest banks, the Treasury is focusing attention on regulatory consolidation. Treasury Secretary Geithner said in a speech that in the next few weeks he will unveil information about "substantial changes" to the regulatory system as the US moves to a ""much more simplified, consolidated oversight structure."

TARP Changes

As a point of clarification, banks under $500mm that have already received TARP up to 3% of assets can now reapply for up to 5% providing they qualify.

Bill Seidman

The Ex-FDIC Chair will be missed. We had the honor of working with him when he headed up the RTC. We remember one early lesson of his that is more applicable today than ever - "No earnings are painful. No liquidity - terminal."