WHAT WOULD DON DRAPER DO?

by Steve Brown

Except for the constant boozing, smoking, sexual harrasment, 6-hour lunches, lying, misogynism and philandering, Don Draper really has a lot going for him. As Season 3 starts this weekend, the hit cable TV series Mad Men is poetic not only for solid writing and interesting plot twists, but because it underscores just how far business has come since 1962. Back in that era, bankers routinly followed the Don Draper 3 Martini lunch menu, because you didn't have to work that hard or smart as 5% net interest margins were the norm.

However, in 2009, margins are below 3% for many banks. While higher rates will help bring margin relief, over time, we expect banks will have to learn to be more efficient and live off sub-3% margins. That said, in the Don Draper-tradition, just because 3% may be the future, doesn't mean you can't fight it.

One of the best ways to fight margin compression is through our innovative BLP (Bankers Loan Processing) Program. Before you dismiss this as a sales pitch, hear us out because this single program could be the difference between success and failure for the next year. Not only does BLP allow banks to convert fixed-rate loans to floating without using derivatives, the program also allows banks to take advantage of the yield curve in two ways: 1) the program allows banks to generate hybrid structures that earn fixed rates where the yield curve is low followed by a floating rate where the yield curve rises and the market expects short-term rates to increase, and 2) the program allows banks to share in any upside when rates rise and borrowers prepay their loans.

First, let's discuss the hybrid structure. Short-term rates are currently low, but most banks expect rates to rise and their cost of funding to march up almost in lock-step. This is why banks resist booking long-term fixed-rate loans (especially in this rate environment). However, if banks convert fixed rate loans to floaters, they may be left with unacceptably small margins because current rates are so low. The alternative (available only through our BLP Program, if you don't want to deal with complex derivatives) is a hybrid structure. The borrower enjoys the certainty of fixed rates for the entire loan term, but the lender earns a fixed rate initially and after a pre-determined time (say 9 months) the rate converts to a floating (for the lender). In short, that can get banks an easy 6% net interest margin with minimal (9 months) worth of interest rate risk. At that future point in time, when the rate to the lender converts to floating, the bank, and the market, expects floating rates to be higher and thus the bank's gross yield to be acceptable. This isn't magic, but is simply a technique to bring income forward by making use of the shape of the yield curve. We are just spitballing here, but our guess is that your bank could use a 6% margin for the next 9 months.

Second, let's discuss the prepayment option. Many borrowers are simply unwilling to accept a breakeven, make-whole, or yield maintenance provision (all interchangeable terms). That means that borrowers are walking away from a prepayment fee that will be due to them if they prepay the loan and market rates are higher at prepayment then they were at the origination of the loan - a highly likely scenario given today's interest rates. BLP allows the value of the prepay to accrue to the lender if the borrower agrees to a prepay that equals a set percentage of the outstanding loan amount. For example, assume that a bank originates a 5Y fixed rate loan and the borrower agrees to a 5,4,3,2,1 prepay clause. In year two the borrower decides to prepay the loan and let us further assume that rates at the time of prepay are higher than at the time of origination. The lender collects the 4% prepayment penalty from the borrower and further collects a prepayment fee owed from BLP (because rates were higher at prepay than at origination). The result of both strategies is to not only increase margins back to the 1960's, but also put the probabilities in your favor for generating additional fee income.

Banks that utilize the BLP program can gain a distinct competitive advatage over other community banks and credit unions. If the Don Draper in you wants to trounce the competition, contact us and we can walk you through more of the details. Who knows, the extra success may even intice you to break out the skinny ties and the standard office bottle of scotch again.

BANK NEWS

Community Bank Stress Test

The Treasury is considering expanding the gov't stress test to banks with assets $600mm and up. This comes after a Congressional Oversight Panel reported that community banks need to raise $12B+ in capital.

Foreclosure

July marked another record high according to RealtyTrac, with foreclosures rising 7% month-over-month and 32% YOY. 1 in 355 mortgages received a filling in July.

M&A

First Farmers Financial Corp ($662mm, IN) has agreed to purchase CB Bank ($59mm, IN) for an undisclosed sum.

CU Closed

Community One FCU ($160mm, NV) was shut down by the NCUA with America First FCU ($5B, UT) purchasing most of the failed CU's assets. Community One lost $8.7mm over 2008 and $3.1mm for the first half of this year.