LOAN RETURN VOLATILITY

by Steve Brown

When picking out a new dog, we recommend that intelligence should be way up there on your list of attributes. By "intelligence" we mean when given the choice between a smart dog and dumb dog, you want the dumb dog. We have owned both and dumb is easier to work with. Take training for instance. To train a dumb dog all it takes is a small treat. It could be your 3,756th time and that treat works the same as it did the first time. A smart dog on the other hand tries to outthink you at every turn. To get them to do something may take a steak, disguise, professional actors, various sounds or live rabbits. In other words, no matter what the situation, smart dogs are more volatile.

In similar fashion, the same can be said for fixed rate loans. Risk, as a measure of volatility, is much greater for a fixed rate loan than for a floating rate loan (as can easily be seen in our Loan Pricing Model). For a floating rate loan, the return is a function of the change in credit spread. For a fixed rate loan, not only do you have to worry about credit spread, but you also have to be concerned about interest rate volatility. Of course, credit spread itself is largely a function of both the financial performance of the borrower, which includes a component on interest rate movement. For example, when working with most types of commercial real estate loans, floating debt service ads to the volatility because as rates change, cash flow changes. To sum this up, what you really want is a fixed rate loan on your borrower's books and a floating rate loan on your bank's books in order to give you the best of all worlds.

Let's look at proof that may be interesting to many of you. When it comes to volatility, a 7Y floating rate Treasury investment has a volatility of about 3%. That is, based on historical total return performance, the return varies on any given month by about 3%. In other words, a risk free floating rate investment is about as stable as you can get. Now, compare that instrument with a fixed rate Treasury with the same maturity. Here, the interest rate risk jumps the volatility up to 15%. Now, when you add credit on top of that, watch what happens.

The average community bank floating rate borrower (again looking at a 7Y maturity) has a volatility of 92% for a 1-month Libor indexed loan (as an aside, a Prime based loan has an implied volatility of 98%, as it is less sensitive to movement in a bank's funding cost compared to Libor). The 7Y fixed rate loan exhibits a volatility of about 379%. This means the average fixed rate loan returns about 5% for any given month, but that return could be 19% one month (when rates go down) or -19%. This may seem like a lot of volatility, except when you consider what happens if you assume rates do nothing for 2Ys and then rise. In this case, increasing rates 400bp in 2013 because of inflation, a loan's return would likely be a negative 46% - well in excess of predictions based on historical volatility levels.

In order to mitigate this volatility, banks either need to structure a well-behaved deposit base (our first choice), utilize a hedge program such as our Bankers' Loan Processing (BLP) (our second choice) or match fund. Of these, BLP is the easiest to do as it leaves you largely hedged on risk, gives your borrower a fixed rate loan and gives you a floating rate loan with no hedge accounting hassles.

If you are interested to see how our BLP program can reduce both your credit and interest rate risk, contact us today and see how it can be much easier than dealing with a smart dog.

BANK NEWS

Helpful Change

Community bankers will be very interested to know that the Dodd-Frank Act includes a provision that raises the threshold triggering a material loss review (MLR) to $200mm from the current $25mm or 2% of assets. MLRs are conducted when a bank fails and investigators try and explain why it failed and where examiners went wrong. The problem with MLRs is that they also tend to increase fear, change behavior and lead to second-guessing.

No Value

Both the ICBA & ABA are calling on FASB to withdraw its exposure draft and not proceed with proposed fair-value accounting changes. If passed, the proposal would require banks to record all financial assets (including loans) and liabilities at fair value on the balance sheet.

Ugly Autos

The world's 3 largest automakers reported the biggest monthly sales decline in 28Ys yesterday, as US consumers pulled back sharply on big-ticket purchases. Toyota reported a 34% drop in deliveries, General Motors slid 25% and Ford dropped 11%. All were much worse than projected.

Clear and Focused

Dallas FRB President Fisher (alternate voting FOMC member) said that while he did not have a specific position on whether Congress should launch any new spending programs, if any were to surface they should "be focused on providing incentives for job creation."

Office Stress

Analysis by CBRE Econometrics Advisors finds vacancy rates for office in the 2Q climbed to 16.7%, the 11th consecutive quarter of vacancy growth.

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