ROLLING THE INTEREST RATE/CREDIT DICE

by Steve Brown

If you ask executive management or a board of directors what their "rate view" is, they will mostly tell you it is the general consensus in the market (or that of the forward curve). At present, the forward curve shows the market expects very little rate movement for the next year and then a slight upward climb. The climb increases in slope in 2012 and then again in 2013. If your bank is keeping fixed rate loans on the books, you are most likely expressing a rate view that is different from the forward curve. Put another way, banks that put such loans on the books are indicating they believe rates are going to be low for longer than the market expects and the Fed is not going to do anything for years to come. This is a roll of the interest rate dice worthy of a closer look, so we do so today.

Our practical example begins by looking at the cash flow of a $1mm, 25Y amortizing loan due in 10Ys. The borrower on this loan wants to refinance a small medical office building. Now let's assume that this quality borrower can get a market rate loan for a floating rate of Libor + 300bp or a fixed rate of 5.55%. We examine the two options to see if we can't derive a strategy.

Option 1 is the floating rate. This loan throws off less cash flow in the early years up to year 4, but more after that. Meanwhile, Option 2, the fixed rate loan, throws of just slightly more cash flow than the floating rate loan and is slightly above the breakeven rate. Price it higher, say 6.00% (or if rates don't go up as fast as projected by the forward curve) and the fixed rate loan throws off even more.

Given rates are already near historic lows, absolute levels are limited in how much lower they can go. The current bubble in the fixed income market (lots of buyers), will one day reverse.

On the other side of the coin, competition limits how high a rate can be charged while still providing a margin of safety. For example, let's say that rates go up 100bp more than expected and that occurs 1Y from now. The math shows this rate shift would generate $69k more on the floating loan over its life than the fixed rate option. The conclusion, with regard to interest rate risk, is that unless you are confident that rates are going to remain low for longer than the forward curve expects, the floating rate loan will give you a greater chance for error. This is especially true when you consider that short term rates are now 575bp below their average rate over the last 20Ys.

However, originating the floating rate loan in today's environment means you are also rolling the dice when it comes to credit. When rates rise more than expected, borrowers can find their debt service coverage quickly 1:1 and the loan converts to a TDR. Such customers either need to have a business that is also highly interest rate sensitive (so that their cash flow keeps pace) or will need to have a higher debt service coverage ratio to maintain a break even cash flow later. Depending on the rate increase and timing, loans with a 1.50x DSCR may quickly erode and go underwater, so care must be taken.

The takeaway is that unless you have a very interest sensitive borrower or you think the economy will keep pace with interest rates, you may be putting a loan on the books that is asking for future trouble.

The economy is in a strange place, as we have record low rates, so the ideal solution to eliminate this risk is to utilize our Bankers Loan Processing Program (BLP). BLP allows your bank to transfer fixed rate exposure to us and participate back a floating rate that is better supported by funding, while protecting your bank against both credit and future interest rate risk.

To avoid future problems, find out how this program can give you a competitive edge and put the roll of the dice in your favor.

BANK NEWS

M&A

BankFinancial Corp. ($1.6B, IL) has entered a deal to acquire Downers Grove National Bank ($240mm, IL) for an estimated $2.0mm or .15x book value. Downers ended the 2Q with $26mm in nonperforming assets and posted a $4mm net loss for the 1H. A previous acquisition deal for Downers fell through earlier this year.

M&A CU

Navy FCU ($41B, VA) has agreed to purchase USA FCU ($604mm, CA) for an undisclosed sum.

No Jobs

The Department of Education is reporting that the number of college students that will default on their loan within 2Ys of beginning repayment has climbed 5% to 7% overall and reached 11.6% for students at for-profit schools.

Consumer Debt

Analysis finds the average consumer with a credit card in Aug had $7,694 in credit card debt; $174,447 in home mortgage loans; $51,721 in home equity loans; $15,186 in car loans and $28,183 in student loans.

Mobile Banking

USA Today is reporting that 17% of Bank of America online banking customers also use mobile services (such as texting or apps for smart phones). Popular apps in the banking space include viewing transactions, paying bills, making a deposit by taking a picture of a check and budgeting.

Business Survey

The most recent survey of small-business owners by the NFIB finds the 3 most important problems they are facing right now are poor sales (31%), tax uncertainty (21%) and government regulations/red tape (15%).