OPTIMIZING REVOLVING LINES OF CREDIT

by Steve Brown

No doubt your internal clock is still shifted, as this is the first business day of Daylight Savings Time (DST). Seriously, who can "spring ahead" after losing an hour of sleep? Granted, with commodity prices up and farmland going for $10k+ an acre, it is cool to be agrarian again, but we remain confused about why we still need to shift time to get up with the farmers. Stranger still, some states shift time, while others don't, and then there is Indiana which seems to have their own complex system unto itself. If it feels like DST has come earlier this year that is because it has (since 2007). Congress, the body voted most likely to still use sundials, felt DST wasn't confusing enough, so they voted to move it up a month from April.

Similar to DST, when it comes to banking, revolving lines of credit are equally confusing. Some banks consider these profitable, some banks don't, some hand them out freely, while others use them very sparingly or not at all. Deriving loan profitability is hard enough, let alone trying to figure it out for exposure that can change month to month. Luckily, we have done some work in this area and will be presenting some findings at our upcoming EMC Conference in May.

Banks that consider revolving lines profitable make the argument that because they receive fees without having to worry about funding, return is increased. While true on paper, for banks that look at profitability on a risk-adjusted return on equity basis, the opposite is reality. Revolving lines have all the risk of a loan, but with a fraction of the profit. A bank usually charges a small commitment fee upfront, a non-utilization fee on the undrawn portion, and then a full rate on the drawn portion. The problem is, companies pay little on the lines when they are not in use and then tend to draw on the line at the exact time that you don't want them to - when the company's credit position is deteriorating, the company has seasonal cash flow needs or they are effecting an asset acquisition. In any case, the bank is extending credit at a time when debt service coverage is most likely at its lowest point and leverage at its greatest. Banks tend to underwrite revolving credit by looking at longer term or annual cash flows, with less emphasis placed on cash flow volatility - a practice that tends to underestimate risk at the point of utilization. Highlighting this aspect, consider banks that only focus on extending term loans that make it a practice of wanting to see revolving lines in place from other banks (since that is a source of repayment should the term loan get into trouble). In other words, the presence of revolving lines reduces the credit risk of term loans, pointing to the fact that not all credit structures are equal. To top it off, revolving lines are more resource intensive in terms of operations and credit reviews, so their administrative costs are usually equal or greater to a fully funded term loan.

All that said, revolving lines of credit are very valuable for corporate customers and tend to be a requirement of garnering their business. Unfortunately for banks, quick analysis finds revolving lines of credit at community banks right now tend to have a risk-adjusted return on equity of about negative 8%. The reality is that to make these lines profitable, banks would have to charge fees that are 2 to 3x greater than they do now - a tactic that will probably lead to being priced out of the market.

While there are many structures that make relationships profitable, the most common is that if you are going to extend a revolving line of credit, then the bank must have the operating account to capture profitable DDA balances to offset. A rule of thumb is that for every $1 of notional extended in a line of credit; the target company should have DDA balances equal to at least 10% of the line (or $100k in deposits for every $1mm of credit).

There are many other ways to make relationships profitable and we will be discussing them at our EMC Conference. Until then, know that revolving lines usually sap profitability and probably should be paired with a deposit product. Incidentally, we always thought Daylight Savings Time would be a good name for a new deposit product that might accomplish this goal.

BANK NEWS

FDIC's Closures (25 YTD)

First National Bank of Davis ($90mm, OK) was closed Friday with 1 branch, all deposits (7.5% premium) and 32% of assets sold to The Pauls Valley National Bank ($167mm, OK). Legacy Bank ($190mm, WI) was closed with 1 branch, all deposits (no premium) and $166mm in assets (72% under loss share) sold to Seaway Bank and Trust Co. ($517mm, IL).

M&A

Grandpoint Capital ($581mm, CA) will buy Orange Community Bancorp ($224mm, CA) for $30mm in cash., or approx. 1.5x book. Shareholders of Orange may receive additional consideration based on earnings from Jan. 1 through the closing date.

M&A

Iberiabank Corp. ($10B, LA) will purchase Cameron Bancshares ($706mm, LA) for approx. $133mm, or 1,7x book.

TARP Profits

The Treasury announced that TARP bank programs have generated more than $36B in income for taxpayers to date. As of now, $245B was dispersed and $243B has been returned (including interest).

BofA

Rumors abound that there will be a set of leaked e-mails from the Bank around forced placed insurance.