LOAN PRICING AND STRUCTURING

by Steve Brown

Here in CA, we pay an average of $4.16 per gallon for regular gas. Prices range from $4.07 to $4.26. That said, it just wouldn't make sense for us to drive around looking for a price below $4.05, as we would simply run out of gas. It would appear odd for anyone to target a price that is knowingly outside the prevailing market range, yet, that is exactly what some banks are doing with loan pricing.

A common question we hear is "Why the blankety-blank is that national bank offering 5Y fixed rate loans at 4.50% and 10Y fixed rate loans at 5.75%?" The answer is simple - that pricing is the going market rate. If you offer a fixed rate loan for 5Ys at 5.50%, instead of the going market rate, and the borrower takes your pricing, you should wonder why the borrower accepted the loan (given it is priced 100bps above market). Is the borrower unaware of the market? Does the borrower not qualify with competitors? Are there other factors that distinguish your bank from the competition? Is your borrower distinguished from the average market obligor?

The graph above (hard to read, but the trend is there) shows loan spreads over LIBOR from 2007 to the present (note that LIBOR + 3.00% is about prime-equivalent). Each dot represents a loan originated by a community bank for a commercial credit (CRE and C&I) that was hedged, bought or sold on our desk. The average loan size is approximately $1.5mm and all loans demonstrated cash flow above 1.0X at time of origination. All the information we have indicates that the average spread in the market today for these types of credits is an average 2.25% to 2.50% over LIBOR (or approximately 4.50% fixed for 5Ys and 5.75% fixed for 10Ys).

The more interesting question for us is this: Are loans priced at these levels profitable? On a risk-adjusted basis, a strong $1mm loan, for 10Y term at 5.75%, with ancillary business, demonstrates a positive ROE (above 10% for most banks) using our loan pricing model. However, we understand the reluctance of bankers to accept a model's calculations. Instead, bankers tend to focus on NIM and focus turns to booking a 300bps NIM loan on the balance sheet. That is unfortunate; because many 400bps NIM loans will demonstrate a negative ROE to the bank.

The pricing makes sense from a number of other perspectives as well. Loan margins are still higher today than they have been in the last decade (except during the ultra-stressed period in 2008 and 2009). Waiting to book loans as the economy recovers will probably result in a lower-margined portfolio of loans in the future. Booking a long-term loan with prepayment protection eliminates competition and the need to price down the loan in the future. Loan demand is weak and the strategy of waiting for a better priced loan to come in tomorrow is unlikely. Finally, if not loans then what? Fixed income securities are a 5bps NIM after adjusting for the yield curve, so what can one do?

If you would like to see how national banks price and hedge longer term fixed rate loans, please join us for a 30-minute webinar. We will take a live loan example and walk through the decision-making process. To sign up see our "Related Links" section at the bottom right of this page and click on your preferred time.

BANK NEWS

Industry Strain

Bloomberg analysis finds net revenue at six major lenders that include Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley and Wells Fargo fell 13.3% in the 1Q from a year earlier, the biggest percentage drop in quarterly revenue in 3Ys. Meanwhile, pretax pre-provision profit fell 40.2%. Meanwhile, analysis by KBW found average loans among the largest banks fell 6% in the 1Q vs. last year.

Moving Money

The MA State Treasurer said he plans to deposit up to $5mm in an estimated 60 to 70 community banks in the state, as he encouraged participants to make loans to small businesses headquartered in the state.

Consumer Survival

A survey by Financial Security Index found that 19% of people pulled money from their retirement savings in the past year to cover urgent financial needs. Analysts called the level "higher than normal."

Increased Risk

The WSJ is reporting that state pension gaps widened further in 2010 as states had an average of 75% of the assets required to cover long-term benefits. This compares to 77% in 2009

Projections

A survey by the Bond Dealers of America, finds 60% expect the Fed will begin to increase the Fed funds rate starting in 2012; GDP will increase to 2.9% in 2011 and 3.1% in 2012; the yield curve will flatten (short rates up, long rates up less) by the end of 2012; and home prices will remain "generally weak" through 2012.