NOT FLOORING YOUR LOANS

by Steve Brown

Biblical floods, plagues of cicadas, earthquakes, tsunamis and Justin Bieber are all signs that the end may be near. Forget the end of the Mayan calendar in 2012, all this strife almost makes us concerned that those billboards telling us to "Save the Date" for the end of the world on May 21st could be right. While we did feel stupid putting the Apocalypse in our Outlook calendar, we figured that if we took the time to put ALCO meetings in there, noting the Rapture was probably worth the effort for planning purposes.

Speaking of ALCO, while this may seem trivial compared to mass cataclysm, we would like to discuss the fine art of putting floors on your loans. While we are big fans of using loan floors to protect margin, the last time you really heard us preach this was during 2007 through early 2009 when rates were dropping. Since 2009, banks that set a floor at or above the initial rate could be in for a rude awakening as rates begin to rise and wider current margins begin to erode. You see, the time to utilize floors is when rates are falling, as their value is high. Now that rates are expected to rise, embedding floors has a much lower value and starts to work against community banks.

Consider two credit-identical 5Y loans. Loan A is at Prime + 1% with a floor of 5.5%. Loan B is at Prime + 50bp with a floor of 6%. Which loan would you rather have? It is hard to tell unless you have a profitability model that prices loans such as our BIGProfit model, so you can quantify the value of the floor against the future path of rates. A model helps clearly answer the question.

If you are utilizing such a model, you can immediately see the value difference in the two loans. The Prime + 1% loan lifts off of the 5.50% floor this coming Feb (assuming no Rapture), while the loan with the 6% floor takes until Mar of 2013 (assuming no Mayan end). Thus, if you thought these loans were going to prepay, you would rather have Loan B because of the higher floor. If you are able to get prepayment protection (hard to do with floating rate) or you thought the loan was going to be outstanding longer, you would rather have Loan A, as the wider margin will create more value over the longer term.

To add another layer of complication, Loan B, with its higher floor, has a higher probability of prepayment. A loan stuck at a 6% floor is a perfect marketing target for another bank. Luckily, during this past cycle, prepayments on quality commercial loans have slowed from an average of 13% to 6%. This is yet another factor to take into consideration when pricing a loan - how long it will be around. When including floors, the optionality of the floor must be taken into account, as well as the optionality of the prepayment. The low value of these floors is one reason why large banks such rarely offer floors these days.

Trying to negotiate a floor in this environment takes up energy better devoted to trying to get wider margins or stronger loan covenants. A wider margin loan, even with a lower initial floor, will lift off sooner and provide the bank with greater cumulative cash flow. Better still; bankers can transform the fixed rate loan to a floating rate loan through our BLP program, giving you the best of all worlds. It gives your bank a floating rate loan without the swap accounting hassles and it gives the borrower a fixed rate that will serve to extend the life of the loan as rates rise. In fact, for comparative purposes, over the past several years, while CRE loans have been prepaying at 6%, banks that have utilized BLP have had just 1.2% of their loans per year prepay. That is a huge value. More important, as rates rise, that loan is less and less likely to prepay. In addition, credit continues to improve, as rising rates usually portend a stronger economy and better economic performance by borrowers and property. Conversely, un-hedged floating rate loans add refinance pressure and increase credit risk by increasing debt service cost.

Since it is Friday the 13th, we wanted to get your mind off bad luck and shift to a way to create some profitability luck. We are not sure what May 21st holds, but having a more profitable loan portfolio certainly couldn't hurt on Judgment Day.

BANK NEWS

SBLF

The Treasury has now released Small Business Lending Fund application forms, term sheets and guidance for Subchapter S corporations and mutual institutions. Subchapter C corporations have until this Mon to apply for the program.

TBTF

Fed Chair Bernanke told the Senate Banking Committee yesterday that the Fed will issue proposed rules containing more stringent prudential standards for large bank and nonbank financial firms designated as systemically important. Bernanke said standards will include enhanced risk-based capital and leverage requirements, liquidity requirements and single-counterparty credit limits.

People Behavior

A survey by the AICPA finds: 60% of working people in the US have changed their behavior to offset higher gas prices; 56% say they cannot save anything; 48% have made changes to deal with higher food prices; 40% don't think they will ever be able to afford retirement and 30% say they are worse off now than they were 1Y ago (multiple answers ok).