LOAN VALUE TO FUEL GIFT GIVING

by Steve Brown

Gift giving is one of the pure joys of the year, as watching someone's face light up is priceless. However, let's get serious; to fully appreciate the joy you have to work like a dog to be able to afford it. If you are thinking about creating gifts the old-fashioned way, carving and baking homemade gifts like our forefathers - forget about that as well. If everyone pulled that kind of subversive stunt, the economy would collapse overnight and the next thing you know we would be arguing over 1.25% 5Y loans. So, for the good of the nation, you need to spend more this holiday season, which means you need to make more money in 2012. To do this, more profitable loans are needed - because deposits aren't going to get banks there in 2012. This year was marked by more loan competition than bankers have seen in the last 3Ys and next year looks to be even more competitive. Some lenders will persistently react to borrowers, while others will make their borrowers react to them. Truly exceptional lenders preempt the borrower's decision-making process. For, example, the last place a lender wants to be is in a competitive bidding situation. In that case, the borrower is forcing multiple banks to react to a request for a financing proposal. In that situation, no bank, including the winning bank, achieves above industry returns. By the time the borrower has decided that they need financing; the structure and which banks to approach for a proposal; there is little room left for negotiation or additional profit. Take another example where a borrower only approaches one lucky bank for a loan. In this example, the banker may have avoided a competing bid, but they have still lost much of their negotiating power. That is because the banker has not created full value for the borrower. Instead, the borrower has already decided that a financing situation exists and that a bank loan makes the most sense, so alternatives are not as welcome. A relationship banker is one that proactively approaches a borrower before they are aware that a potential financing situation exists. These bankers propose multiple ideas (such as a customer buying their own distribution facility) and a solution for the borrower. The problem with relationship banking is that it also requires more work. Solutions can only be found if the banker understands the customer's business, liquidity situation, expansion opportunities, or acquisition prospects. In this case, the banker earns a premium for services rendered, because the banker acts as a consultant (solving problems, identifying opportunities or adding resources to the borrower's business). In short, the banker becomes part of the borrower's business. The most common trap many bankers fall into here is when they make the mistake of assuming relationship banking just means a legacy of business between borrower and lender. It is true that every borrower can distinguish a 4.00% fixed rate from a 5.00% fixed rate and will be motivated to choose the former. However, rate becomes less important the stronger the relationship and the more helpful the banker is as a valued consultant. While bankers have become much smarter about insisting on prepayment penalties in loans, we see a recent trend to waive these in hopes of winning. We remind all readers that the forward curve has an equal probability of going down, as up and prepayment penalties are as valuable now as they were last year (at which point we also heard that rates can't go much lower). There are countless situations where borrowers paying higher floating rate pricing (i.e. Prime+) have been approached with term sheets from competing banks offering 10Y, 4.00% fixed rate loans. By the point the current bank becomes aware of the issue it is left with only two choices - match the terms and pricing or lose the customer for 10Ys. However, if that bank preempts the borrower and approaches that client before the competition does; they may be able to lock in a new loan at a 4.75% fixed rate (and retain the customer for the next 10Ys). Sure, the bank is giving up current NIM, but retaining a high credit quality customer for 10Ys can generate much more profit than losing them entirely. The best performing lenders are those that generate the highest risk-adjusted returns. They profoundly understand the borrower's business, local economy and industry trends. These lenders continually present financing opportunities to customers before clients have the time to create an RFP. The best also sell their services as part of a package. The capital required to make a loan is a commodity, but the lending expertise tied to that loan is unique and when used properly, should command above- market returns. It is these returns that can keep that gift-giving joy coming.

BANK NEWS

M&A

Sandy Spring Bancorp ($3.6B, MD) will buy CommerceFirst Bancorp ($205mm, MD) for $25.4mm in cash and stock (50%/50%), or about 1.1x book.

Eurozone

The ECB lent 523 euro-area banks a record $645B for 3Ys. The loan amount was well above estimates and is the latest attempt to ensure credit continues to flow in the region as politicians deal with the sovereign debt crisis.

Large Bank Rules

The Fed released its 173 page proposal targeting systemically important financial firms. The rules, which aim to prevent the collapse of one large institution from triggering the collapse of another, limit the net exposure the largest 6 financial firms can have with one another to 10% of their regulatory capital (other firms covered by the rule would be subject to a 25% limit). Other requirements include: annual stress tests; triggers to determine when a bank is in trouble; new capital requirements (5% baseline capital plus 1% to 2.5% more depending on the bank as a surcharge); enough liquidity on hand to ensure 30 days of cashflow when under stress and a maximum 25% of capital at risk with any single company.