AVOIDING ANOTHER CREDIT POP WHEN RATES RISE

by Steve Brown

We all know that a balloon will pop when it is inflated too much. Whether helping a friend get set up for a party or blowing balloons up for some event; we have all had the experience of putting in just a bit too much air, only to end up getting slapped in the face and hands with flapping rubber. We bring this up today as we continue to see banks doing things with their loan portfolio that could lead to a similar "pop" in credit. The fact is that rates are very, very low on an historical basis. That means small business customers that want to borrow money, also want your bank to give them a long-term fixed rate loan. Since most community bankers have funding structures that are short, this creates a conflict (because you want that same customer to accept a floating rate loan). The typical result is that a discussion ensues, negotiation occurs and many banks end up with some imperfect structure that tries to bridge the gap between the two - say a 10Y loan that resets in 5Y at a rate of prime and a floor of 5% for the first 5Ys. The rate then resets in 5Y at the 5Y Treasury plus some spread and has a prepayment structure of 3-2-1. Let's look at this in more detail to see what we uncover. First, from a credit standpoint, a fixed rate loan has the best chance of performing from a credit perspective. Consider a loan with a DCR of say, 1.5x right now. Once the economy improves, in all likelihood the borrower's cash flow will improve, providing an even higher level of debt service coverage in the future. This will dramatically decrease the likelihood of default and improve the loan's risk adjusted return. That is good for credit.

Now, consider the borrower that has a loan with the same DCR of 1.5x, but this loan has a floating rate. When the Fed raises rates 200bp or 300bp, it is likely this borrower's loan payment will become substantial and their debt coverage ratio will decline (perhaps even below 1x1). That strains credit, pushes the customer to refinance away if possible and leaves the bank with a potentially weaker portfolio of loans. This leads to credit issues, just when the bank is coming out of the credit crisis. It is also the latest area of focus for bank regulators, so be aware. Historically, rising rates were good for banks, because it meant the economy was recovering and customers could afford to pay more. The problem this time is that we are at historically low rates and coming out of a credit crisis so that changes things. While a 300bp rate rise isn't much in the grand scheme of things historically (when you look at the level of interest rates), it can be quite impactful for the small business customer's loan payment. That is not good for credit.

Next, consider the funding side. The internet and the fungible nature of deposits have made them less and less "core." It is very difficult to count much funding as stable or rock-solid these days, as the landscape is rapidly changing, money is flying around non-bank channels in digital form and consumers are online more than ever. This means funding is likely to remain shorter and roll over more frequently. So, when rates rise, funding costs will rise.

The way to fix this is to give the customer what they want (a long term fixed rate loan), but change that to floating on your end. If you do this correctly and include a yield maintenance provision, as rates rise, credit improves and interest rate risk stays constant. In addition, rising rates increases the average life of the loan, allowing that customer to be retained for longer periods and given your bank time to cross sell other services.

You may not be thinking about it right now because rising rates seem a long way off, but rates will rise. When they do, floating rate borrowers will likely have more difficulty making their ever-increasing payments, which in turn could drive more credit losses. There is no reason to overinflate this potential credit issue and wait around for it to pop once again. It is easy to offer long-term fixed rate loans to your customers and capture floating rate on your side. Call or email and we will show you how easy this is.

BANK NEWS

Earnings

Capital One posted net income that was up 38% due to 21% higher revenues and the bargain purchase gain associated with the acquisition of HSBC's credit card portfolio. Better credit performance also helped, as charge offs dropped to 2.04%, down from 3.25%. TCF Financial had its first quarterly loss in 17Ys as it paid off some high cost FHLB advances and sold lower yielding securities. Loan growth was 7.5%. First Horizon produced net income l3% lower than 2011 due to the repurchasing of sold mortgage loans. Capital markets activity was up and core banking operations were slightly better on higher loan volume.

OD Fees

Bloomberg reports the CFPB is closely looking at 9 banks for possible deceptive practices relating to OD fees and disclosures. JP Morgan, BofA, Wells, Regions, PNC and US Bancorp are some of the potential names.

Home Deductions

Federal tax filers claimed almost $71B less in mortgage interest deductions for 2009 than for 2007 (the latest period analyzed), a trend expected to continue for 2011.

Muni Risk

State tax collections rose 3.6% in Q4 vs. the same period in 2010. Revenues now exceed pre-recession levels

FDIC Budget

The GAO issued their approval of the FDIC's 2011 financial statements, but indentified shortcomings in internal controls over FDIC's process for deriving and reporting DIF loss estimates from resolution transactions involving shared-loss agreements.

Customer Opportunity

The National Endowment for Financial Education finds 42% of those under age 40 have received financial help from their parents as adults.

Interesting

Intuit has officially jumped into the 401(k) and healthcare businesses. The company launched a 401(k) service for small businesses at $75 per month, per employee and is also offering a health-care debit card plan that costs companies $5 per month, per employee.