

The Learning Curve

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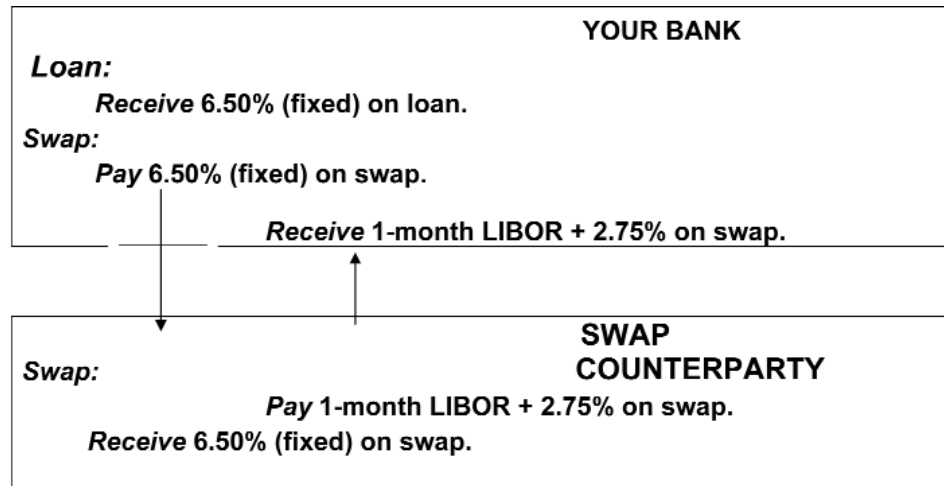
Thomas McKernan

THE WORST OF TIMES, THE BEST OF TIMES

With the subprime losses piling up, Merrill Lynch at \$22 billion, CitiGroup at \$19 billion and counting, one may reasonably ask if there are any winners in all of this carnage. Fellow community bankers and our thrift brethren, please step forward. What glorious opportunities beckon! I would like to talk about one in this Learning Curve that is particularly compelling. It is one among several that we see and are attempting to seize at our bank.

As many of you know, I joined Country Club Bank after a stint in the commercial real estate mortgage business. Suffice it to say, many of my previous colleagues are, shall we say, out of the market for now. Many are the best and the brightest and will be back, but for now, community bankers have an extraordinary opportunity to compete in their market -longer term fixed rate lending. I have described, from time to time, how to make longer-term fixed rate loans and swap the interest rate risk in the capital markets.

Here is an example that is available today. Offer your customer a fixed rate, 10-year balloon loan (20, 25 or 30 year amortization) at about 6.50%. This loan would be locked-out with yield maintenance for the first 5 years, but freely prepayable on monthly payment dates in the last 5 years of the loan. (The ability to grant the loan customer the right to prepay after 5 years is a potential competitive advantage over much of the competition). The bank would execute an interest rate swap against the loan at rates that swap to about LIBOR plus 275 basis points. As you know from our prime indifference curve (published on Mondays) this would approximate a floating rate loan at prime. Here is how it would work shown in graphic form.



As you can see from the drawing, the bank receives 6.50% on the loan and pays 6.50% on the swap. These transactions CANCEL each other. Because nothing is bought or sold in a swap, no money changes hands at execution of the swap, all that remains is the net payment to the Bank of LIBOR (one-month in this case) plus 275 basis points. If this loan were funded with rolling one-month FHLB advances (which are about equal to LIBOR), for example, the spread would be about 275 basis points REGARDLESS OF INTEREST RATE CHANGES. The swap would amortize in amounts identical to the loan amortization—they are perfect mirror images. If the customer prepays sometime in years 6 through 10, simply cancel the swap without penalty.

It is also a simple matter to commit to a fixed rate on a permanent loan to fund after a construction period. Big banks, loan conduits, insurance companies, large lenders in general, have done this for some time but they are not competitive now for obvious reasons. Will we step forward to seize this opportunity?

Actually, this is all part of a very encouraging trend we are seeing with our community bank and thrift customers: they now see how the capital markets can help them and they are using these tools for competitive advantage. In this domain is the prime indifference curve, now an industry standard for community bank loan pricing; the swapping of prime loans for fixed rates to address the asset-sensitivity common in community banking and, coming soon, the locking in fixed rates on currently floating deposit liabilities. All of this is coming in the midst of historic accounting changes that will greatly change the way we manage our businesses.

We view all of this as opportunity that will affect us for many years to come. As an economist might say, these are opportunities of secular magnitude, not just cyclical magnitude. In an age of seemingly ever-compressing margins, there are alternative ways to conservatively make money.

We have initiated these types of transactions for our own bank and we're carefully considering adding to our positions. We welcome the opportunity to share all of this with you.

Tom McKernan
Senior Vice President

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