

The Learning Curve



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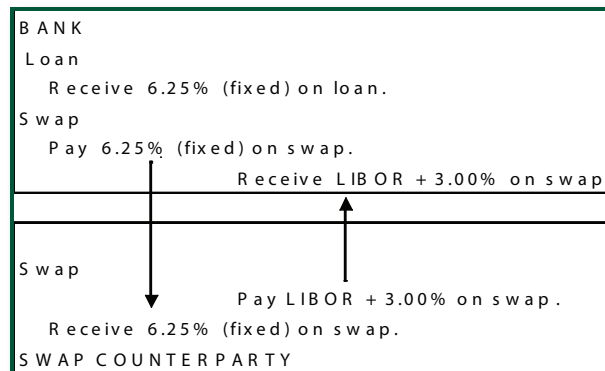
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LOAN SWAPS FOR STRATEGIC ADVANTAGE

By now, most of our customers are very comfortable with our “Easy Button Decision Matrix” (a tool our bank uses) along with our Regression Analysis on interest rates, to determine how we should position our balance sheets. The Matrix considers interest rate risk, credit risk, pre-payment risk and capital allocation. One of its conclusions is that in economic recoveries, credits in the note case will *improve* as the recovery matures. As such, we should be more willing to lend, if we are truly at the bottom of the credit cycle (i.e. economic recovery). One way to lend to your best credits (and your competitor’s best credits), is to make fixed-rate term loans at today’s still very low rates and swap those loans back to floating rates using interest rate swaps. *If* we are in economic recovery, *now* is the time for what we call “loan swaps”, that is, booking fixed-rate term loans (say 5 to 7 years) and turning them into “floaters” with interest rate swaps.

Please consider the following example: your borrower requests a loan of \$1 million with a 7-year term, 20-year amortization. You believe that the borrower will accept a rate no higher than 6.25% and you know (from our Prime Indifference Curve that you receive from us each Monday) that 6.25% is approximately equal to prime plus 25 basis points. You also know that in today’s market, your bank could make a lot of new friends with cheap, fixed-rate term loans.

This challenge is to offer a fixed-rate loan to your borrower and to convert the loan to a floating rate for the bank. This will reduce the bank’s interest rate risk and allow the bank to earn an attractive spread. The conversion can be easily accomplished through the use of an interest rate swap, which is outlined below:



As you probably know, no money changes hands when a swap is executed. Nothing is bought or sold as in a stock or bond transaction. Because no principal changes hands in a swap, swaps are correctly perceived to have relatively low credit risk.

Note that the 6.25% received on the loan exactly offsets the 6.25% paid on the swap. These payments net to \$0. That leaves the bank receiving LIBOR + 3.00% net. Where did the 3.00% spread come from? That was the spread the swap co-party was willing to exchange for the 6.25% paid on the swap. This is a market-determined spread, priced in much the same way bonds are priced.

Given that LIBOR is currently .25%, why would the bank change the loan, on a net basis, from receiving 6.25% to receiving 3.25% (.25% LIBOR plus 3.00% spread)? Has the lower interest rate risk been exchanged for a lower net spread to the bank? No, because the loan is now, in effect, a 1-month floater (LIBOR changes every month) and can be funded with much cheaper short-term funding. The loan has a lower net rate but it can be funded with much lower one-month cost funding too. A perfect match would be 1-month CDs or 1-month FHLB Advances. When the CD/Advance matures (and re-prices) the loan, with the swap, will also re-price. (For net spread comparison, the **7-year fixed rate loan would have to be compared to the spread from 7-year fixed rate advances, a much higher borrowing rate**).

This is an easy transaction to handle from the swap side. Swaps can be made to amortize on the identical schedule with the loan for very little additional cost (which is buried in the spread). The net interest spread is about 300 basis points (LIBOR plus 300, less the CD/Advance rate that is typically similar to one-month LIBOR). If that spread is inadequate, simply raise the fixed-rate. That will automatically raise the spread above 300 basis points. Note, we are using one-month LIBOR, not the usual 3-month LIBOR. The reason for this is most loans amortize monthly, like home mortgages. As such, the swap should likewise amortize monthly and the one-month LIBOR is more appropriate.

The loan documents in this kind of transaction require some attention. Specifically, there should be language including a yield-maintenance prepayment penalty (YMPP). It's important that this penalty is included and enforced because the swap, in effect, has a YMPP. If the borrower prepays the loan, the bank must enforce the YMPP on the loan to come out whole. The borrower should understand that YMPP is the price of receiving a 7-year loan. As a practical matter, the borrower can not escape YMPP by shopping the loan. None of the alternative lenders (the big banks and insurance companies, etc.) will make the loan absent YMPP. We have written extensively on YMPP, providing a YMPP calculator and suggesting language for loan documentation (free of charge, although we have asked for your consideration regarding your bond business and related services).

In the event that YMPP will not work (in other words, if the YMPP is a deal-killer for your loan customer), it is possible to "split the difference" by requiring yield maintenance for the first half of the loan term, allowing a penalty-free pre-payment in the last half. Swaps can be tailored to be cancelable in the same manner as the loan is "pre-payable". Of course, this would entail a higher rate on the swap. In round numbers, it's usually about 30 basis points, depending on the exact terms.

Another important point is that the swap entails a small but incremental credit risk. If your borrower fails to perform on the loan, your bank must still perform on the swap. This is handled normally by decreasing the loan-to-value ratio in the loan by about 5% to 10%. For example, if the loan would normally pass credit muster at an LTV of 80%, lower the LTV to 75% or 70%. That puts more borrower equity in the deal and covers the incremental credit risk from the swap.

Swap counter-party risk is also a consideration, given the reality of today's world. This is governed by the swap documentation in the "Credit Support Annex". In short, there is usually a fairly small credit line (say \$200,000 to \$500,000). After that, bonds are pledged, much like advances or public deposits. Some of the larger dealers, because of their size, insist that they do not have to pledge so long as they are able to maintain an investment grade credit rating. Of course, everything is negotiable.

We can show you all of the details in executing these kinds of transactions through our derivatives consulting service. There is some infrastructure that needs to be built before proceeding and we would welcome the opportunity to assist you in this regard.

Tom McKernan
Senior Vice President

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