

Portfolio Management

The Role of the Swap Market in Loan Pricing Strategy

Has your bank been unknowingly making prime-minus loans to prime-plus borrowers? You may be surprised! In all too many cases, banks of all sizes have made three- and five-year fixed-rate loans that were equivalent to prime minus 75 to 100 basis points (bps) or more to borrowers that loan officers readily acknowledged were prime to prime-plus credits.

Astute investment/financial officers have brought valuable insights in this regard to their bank's asset/liability management committee (ALCO) and loan committee meetings. How? By simply using information they have available from the interest rate swap markets.

Swaps: A Valuable Loan Pricing Benchmark

Earlier this year, many five-year fixed-rate commercial real estate deals (resets or balloons) were priced in the 6.50 to 7.00 percent range at a time when the swap market reflected a 325 bp spread between the fixed and variable sides on a five-year prime-rate swap. In effect, the market had priced a 3.25 percent premium as fair compensation for the interest rate risk associated with a five-year asset. Accordingly, a "risk-adjusted" fixed rate for a prime flat credit was 8.00 percent. (Technically speaking,

adjusting for loan amortization, it is closer to a 4.5-year swap, and the rate was 7.75 percent for a 300 bp spread.)

Unfortunately, if presented in this manner, the rallying cry would be "but we won't make any loans at that level; competition won't allow it." However, presented in a different manner (as a floating-rate loan equivalent), the same information gets loan officer attention immediately.

Using the loan rates and swap spread described, the fixed-rate loan is converted to a floating rate equivalent of 3.50 to 4.00 percent (fixed loan rate less the 300 bp swap spread). I asked many a loan officer what they would do if the borrowers who received the fixed rates described instead requested floating rate loans at prime *minus* 75 to 125 bps. Overwhelmingly, the response was "show them the door," because they were not prime minus credits, especially to that degree.

When it was demonstrated (see Exhibit 1 on page 10) that they had indeed made loans at these levels, a greater appreciation for the role of benchmarking in loan pricing was born. And everyone wanted to spend some time with their financial/investment manager colleagues.

Understanding "Points of Indifference"

Using swap market data is not intended to dictate loan pricing. The purpose is to provide useful information to loan officers that can be utilized to identify rich vs. cheap deals, negotiate (as appropriate) more aggressively priced floating-rate deals,

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and pursue more vigorously other forms of payment, such as fees and balances.

In the final analysis, loan pricing for most community banks comes down to how badly you want the deal. Understanding the "points of indifference" can be helpful in this regard. The points of indifference represent floating-rate and fixed-rate equivalents. In the example above, a 7 percent 5-year fixed-rate and prime minus a 75-bp floater represented equivalent interest rate risk-neutral pricing for a given credit.

Using late-May swap pricing, the three- and five-year fixed-rate spreads vs. prime (adjusted for assumed loan amortization) were 200 bp and 260 bp, respectively. Accordingly, examples of credit risk adjusted points of indifference are:

Floating Rate	3-Year Fixed	5-Year Fixed
Prime - 50bp	6.25%	6.85%
Prime flat (4.75%)	6.75%	7.35%
Prime + 100bp	7.75%	8.35%

A Tool for Loan Pricing Strategy

Utilizing data provided from the investment/financial area, a number of banks have recently begun to create periodic "points of indifference" tables for the loan department, with a range of fixed-to-floating and floating-to-fixed conversions. Again, these tables are not intended to be absolute pricing dictates, but rather another tool for loan pricing.

Some banks have utilized this table to support the earmarking of a pool of funds for aggressively priced floating-rate loans (new loans only). For example, a *true* prime flat borrower translates to a 5-year fixed rate of 7.35 percent. Competition is pricing the loan at 6 5/8 percent, and your bank would like the deal. At the latter rate, a floating-rate equivalent is prime less 75 bp (4.00 percent). Why not attempt to lure the prospect into a floater at prime minus 50 bp (or less if you think can get it) for the 5-year period? At 4.25 percent floating, matched funding would translate to approximately a 250 bp spread. At 6 5/8 percent fixed, a 250 bp spread would require the loan to be mismatched with 2-3 year funding.

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If you prefer fixed, you can swap the loan (or pool of loans) to a 5-year fixed rate at 6.85 percent, vs. the 6.625 percent the customers were giving you.

Conclusion

Loan pricing discipline continues to be a challenge for many banks; especially with a low rate/steep yield curve environment, increasing margin pressures, and ample liquidity (for most). Despite good intentions, many banks have been "unknowingly" making prime-minus loans to prime-plus borrowers. Understanding the "points of indifference" given to you by the swap curve will likely influence your bank's loan pricing and product strategy (and related negotiations) going forward, particularly as it relates to examining fixed vs. floating rate deals. ■

— Matt Pieniazek, President
Jeff Reynolds, Manager Financial Analytics
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exhibit 1
examining loan pricing practices

STEP # 1: Assess what the "market" says you should be paid for interest-rate risk

Current 5-Year Prime Swap Rate	7.75
Current Prime	4.75

What Bank should be paid for interest rate risk assumed by offering 5-Year Fixed vs. Floating Loan	3.00
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STEP # 2: Assess what the Bank actually receives from loan customers

Current Pricing for 5-Year Fixed Balloon or ARM Prime	7.00	<i>(Note - Assumed to be an "A" credit)</i>
	4.75	
What the Bank is actually paid for interest rate risk	2.25	

STEP # 3: Calculate how much of a premium or (discount) you are paid by or giving to your loan customer vs. market

Bank actually paid	2.25
Bank should be paid	3.00
Premium or (discount) vs. market	(0.75)

STEP # 4: Calculate what your implied rate would be for a monthly prime floating-rate loan

Current Prime	4.75
Premium or (Discount) vs. market	-0.75
Implied rate received on a prime floating basis	4.00

If this seems out of line, you may be over- or under-pricing your 5-year loan products!