PARLIMENT CONSULTING SERVICES

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At the Margin

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# Duration Based Pricing

## How Community Banks Can Pirate "A" Credits Out from Under the Nose of Big Banks

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*by Dr. Tom*
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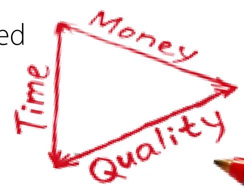
My point, in a nutshell: I am going to tell you how to originate 15 to 20 year term fixed rate mortgages in the commercial real estate markets by pricing these loans using ***duration*** as the index for interest-rate risk. Additionally, I am going to tell you to do exactly what I'm doing, hedging 20 to 25 percent of my fixed rate loan flow using a 2 through 7 year ladder of FHLB advances. That's right, given this yield curve, I am not waiting any longer to ladder advances. I started in January!

So, how did I arrive at these decisions? First, I became tired of wallowing in liquidity! Two years and counting! How much longer are we going to be required to squat on below 1% yields for securities with durations shorter than 3 years? Second, I became tired of losing the best credits in the commercial real estate markets to big regional banks who are willing to make 5% plus fixed rate loans for 15 to 20 year terms… while I was struggling to make 5 year balloon, 25 year amortizers in the low 4's!





I changed my perspective. I decided for as long as the yield curve is in its current configuration, I needed to originate high credit quality loans priced as investment surrogates. I know, I know, it's usually the other way around: buying securities as loan surrogates. **The key is to price the *duration* of the actual cash flows of the loans and not to price *term* of the loan, which after all, only tells me the date of the very last payment.**

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The table below shows the durations (Macaulay durations for you purists) of various terms of loans ranging from 30 years down to 10 years for various prepayment speeds ranging from 0% up to a 6% Constant Prepayment Rate (assuming a 3 year ramp to get to the CPR).

Macaulay Duration (Years) of Fixed Rate Term Loans (Assumes 4.5% coupon and 36 month CPR ramp)

| Prepayment (CPR) | Contractual Terms in Years | | | | |
|---|---|---|---|---|---|
| | 30 Yr Term | 25 Yr Term | 20 Yr Term | 15 Yr Term | 10 Yr Term |
| 0% | 11.75 years | 10.25 years | 8.6 years | 6.7 years | 4.7 years |
| 2% | 8.9 years | 8.2 years | 7.1 years | 5.9 years | 4.25 years |
| 4% | 7.5 years | 7.0 years | 6.25 years | 5.3 years | 4.0 years |
| 6% | 6.6 years | 6.2 years | 5.7 years | 4.8 years | 3.8 years |

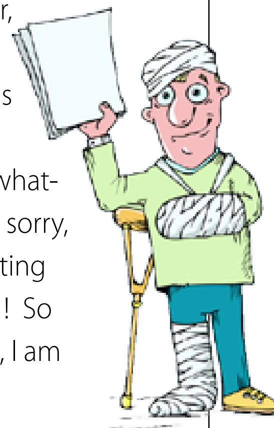
Actually I started using such a table when offering 10 year fixed term "debt buster" re-finance loans to homeowners. So many people were scared by the depth of the recession and the decimation of their retirement returns that they just wanted to follow Dave Ramsey[1] into a debt-free world. I obliged them. Even now, I am offering 10 year term home mortgages at 3.15%. Even at a nominal prepayment speed, durations of around 4 years are to be expected. For this type of credit quality, loan-to-value ratios and debt-to-income ratios, these loans might as well be investments. And considering the total cash flows coming off these loans, these cash flows can actually be re-priced in a rising rate environment.

But now back to my commercial real estate dilemma. You see, aggressively pricing my 5 year balloons was problematic. The really good credits can renegotiate the heck out of me upon re-pricing at the balloon. And, an uncomfortable number of my 5 year balloon renewals are not cash flowing because of the low square footage rental rates in the markets. I have to move loans to collateral dependency with all of the depressing devaluation problems that presents. I feel like a cow with three stomachs, continually chewing my own cud!

[1] David L. Ramsey III is an American financial author, radio host, television personality, and motivational speaker. His show and speeches strongly focus on discouraging the use of debt.

So I decided that if I could get my good credits into 15 to 20 year terms, the durations were only 6 to 7 years under modest 2% prepayment assumptions. The main feature was that I was getting real cash flows reinvested in the event of rising rates as well as placing the bank in an improved collateral position after 5 years compared to the balloon. Besides, I was able to attract demand for my 15 year term in the low 5's and 20 year terms in the high 5's.

The final piece of my attitude adjustment came from the realization that the retail deposit markets were never going to give me the opportunity to lock in low funding rates, that is apart from the longer duration checking accounts. So I began a tactic of laddering in 2 to 7 year advances for approximately 20 to 25 percent of my originations of all loans that were 10 years in term or greater, with the fulcrum of the advance ladder being the ***duration*** of the pipeline of loans that I was funding. Oh, sure, I ran income simulation and market value simulation "what-if" forecasts to test my rate sensitivity. But, sorry, I still have scars on my body from the beating I took in 1979 to 1982… yes, I am that old! So as cheap as these advances are right now, I am laddering…!



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*Dr. Parliment, Chairman & CEO of Parliment Consulting Services, has spent the better part of the last four decades working with financial institutions helping them develop solutions for their business challenges. He has served as a director of several financial institutions, and as a financial expert, has chaired ALCO, Audit, and Investment Committees. Dr. Parliment is currently Interim Chief Operating Officer of a $300 million troubled institution in Illinois.*

*Parliment Consulting Services focuses on Strategic Financial Planning and Asset/Liability Management to help community financial institutions gain and maintain superior earnings growth.*

***We specialize in retail loan and deposit strategies.***


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