Commercial Lending Strategies That Work

CenterState Bank Submitted by Chris Nichols on November 18, 2015 - 10:09am

The competition for qualified borrowers is intense, and both pricing and structure are being compromised. In our dealing with hundreds of banks and thousands of borrowers, we observe strategies and structures that have worked for our customers. In today's competitive environment, it is important that bankers keep a close watch of what is working and think creatively to try to maintain structure and price. We would like to share ten strategies that we and other community banks have effectively deployed to win business, increase credit quality and/or enhance margin. Most of these strategies can be applied by any community bank, and some require that banks utilize our ARC hedge program to mitigate interest rate and prepayment risks.

Construction Through Perm

A single close for construction through perm loan is an advantage to the bank and the borrower. The construction loan and the takeout loan are established concurrently at inception of the construction period. The borrower obtains certainty of interest rates and is not subject to repricing risk once construction is complete. This places the bank in a position of not having to compete for the semi-perm or permanent loan and enables the bank to enjoy greater pricing for the life of the relationship. National banks have been using this approach for decades and now many commercial customers are demanding this approach. A long-term customer is more profitable for a bank, thus the combination of a 1-year construction loan and 10-year perm is substantially more profitable than strictly the construction loan.

Construction Loan
$1,500,000
12 Month
Prime + 1%
1.00% Upfront Fee

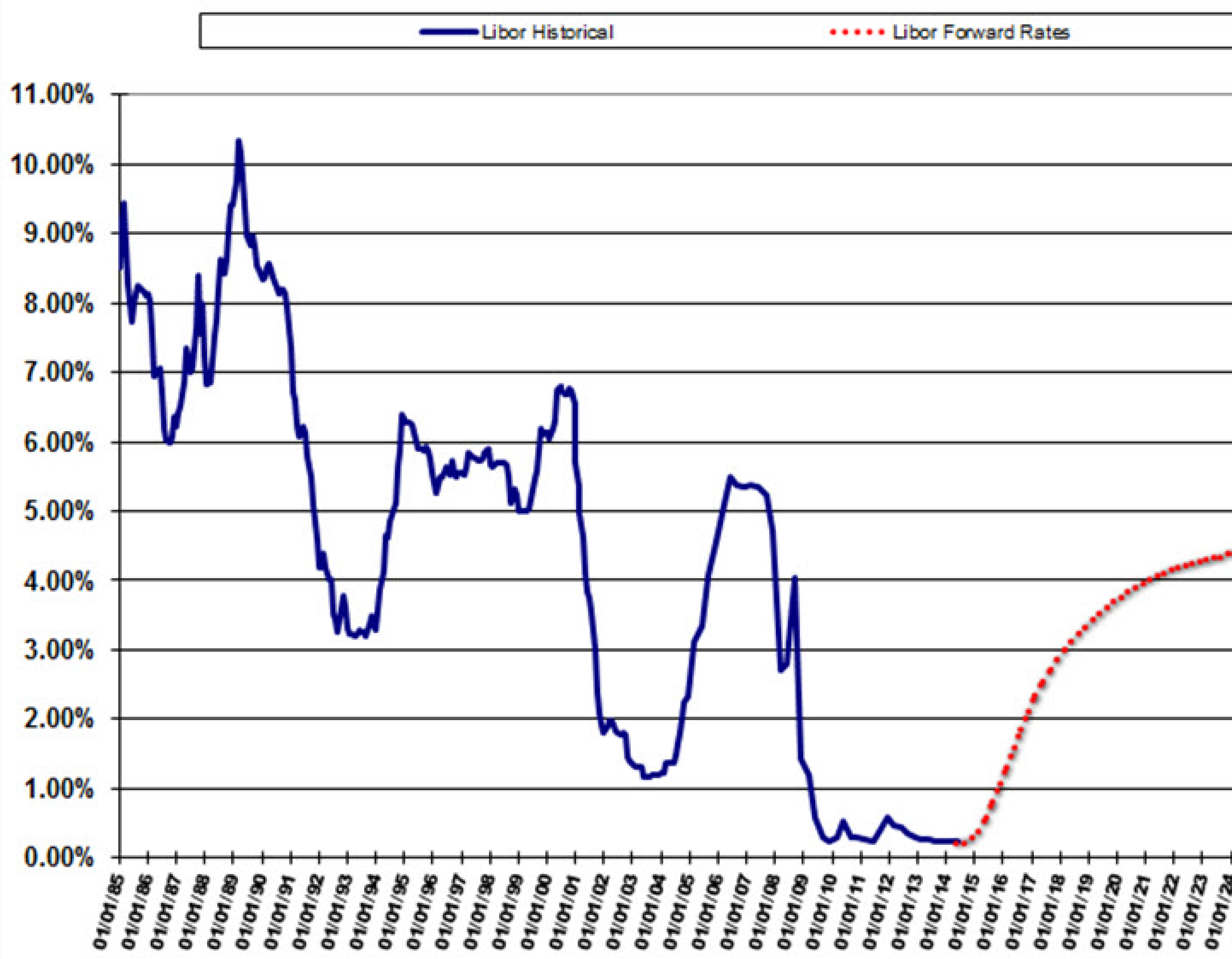
Single Close Loan
$1,500,000
11Y Maturity / 25Y Amortization
4.60% Fixed To Customer
Libor + 2.40% Floating To Bank
0.50% Upfront Fee

Portability

With the expectation of rising interest rates, most long-term fixed rate loans originated today with a 4 or 5 percent handle may seem like a highly prized asset in a few years. The ability to offer a loan that can be transferred from one property to another by the borrower is a big advantage (and can commend a sizable pricing premium for the lender). We have built this portability feature into our ARC hedge program, and as long as the new transaction is an acceptable credit, the borrower has the ability to transfer the value of the fixed rate position to a new loan or new relationship – even if the properties are substantially different, or the terms and amortization do not match. Banks that can offer this feature to their bigger and more sophisticated customers can gain a large competitive advantage in their market.

Forward Rate Lock

Existing and new customers often ask banks to lock in a rate in the future given the steepness of the forward curve (below). This request may be the result of outstanding due diligence items (appraisal or environmental), documentation items or specific contractual requirements (closings that are pending approval, or waiting periods). We have seen banks lock customers in to term loans out anywhere from 1 to 12 months. The benefit here is that the customer is no longer shopping (the borrower signs a commitment letter, provides a non-refundable fee, and also agrees to a prepayment provision upfront). The key to successful lending is to commit the customer as quickly as possible – the less time the customer shops, the fewer options they have, and the higher your chances of obtaining better pricing and tighter structure.



Market expects rates to head higher.

Assumable

An assumable loan can be an advantage to both the borrower and the lender. The borrower's ability to sell their property along with the loan can be very powerful if the loan is below market rate at the time of the sale. Each 1.00% rise in rates provides the borrower/seller with an approximate 5.3% premium price strictly from the benefit of the assumption (based on a 75% LTV, and 25 due 10 loan structure). Upfront, an assumable loan can command the bank a pricing premium. The other advantage to the bank is that the buyer of the property becomes a new customer to the bank. Of course, the assumption feature is subject to the bank's underwriting and approval.

SBA 504

One benefit of the 504 program is that it allows borrowers to obtain a fixed rate from the SBA for a 10 or 20-year period. Borrowers are also typically trying to match their first lien loan to the same fixed rate period. Also, because of the steep prepayment provision on the SBA debenture, the prepayment of the first lien loan is not a strong concern for the borrower. The ability to offer a longer-term fixed rate on the SBA 504 program is a strong appeal to many borrowers who are willing to pay up for this benefit.

Zero Cost Closing

We have seen a number of banks offering zero cost loan closings for specific types of customers. The cost of the closing (legal, appraisal, processing and certain taxes) is offset by the fee that the bank generates on the loan hedge. While the customer recognizes that the cost of the closing is embedded in the pricing, the psychological benefit to the borrower can be a big selling point, as borrowers are averse to paying fees and closing costs. Using this loan hedge technique, a bank can generate fees that range from 10bps to almost 100bps of the loan amount. In certain situations, it is possible to address the borrower's needs and still produce a sufficient return for the bank.

Fixed/Floating Combo

We work with creative banks that tailor their loan products to customers' needs. Not every borrower should maintain 100% of their financing in a floating rate, nor should 100% of the financing be a fixed rate. Creative bankers are offering borrowers a mix between fixed and floating rate in the same closing. The amount of fixed/floating rate mix for the borrower is dependent on the correlation between the borrower's cash flow and interest rates (a pretty easy analysis in most cases). Borrower's whose cash flow does not increase when interest rates rise are natural fixed rate obligors. Another advantage to mixing the rate on the loan is that while the fixed rate loan has a prepayment provision, the floating portion does not. Thus, if the borrower wants to exercise the option to prepay a portion of the loan early, the floating rate loan can be prepaid without consequences.

Callable Structures

Certain hedge programs permit the borrower to prepay the loan without a prepayment penalty after a certain period. This specific feature has been popular in municipal financing where the borrower has a lock-out provision for a certain period (no prepayment is allowed) and then a callable option after the lock-out. The benefit to the municipality is that the financing can be structured without Dodd-Frank implications – if properly structured, there is no derivative involved for the borrower.

Paying Prepayment Penalties

Because higher quality loans are difficult to find and retain, some banks offer to pay any prepayment penalties a borrower may incur in their existing loan with another lender. We have witnessed banks generate 2, 3 or even 4 percent prepayment penalties in the loan (as a higher loan balance or a hedge fee). This strategy works only if the borrower can be maintained for a long period so that the cost of the acquisition can be amortized over term. This strategy can be profitable if the new loan can be structured as a 10, 15 or possibly 20-year fixed term.

Refinancing Existing Customers

Finally, banks are taking a hard look at their existing portfolio to try to protect relationships that are at risk of being poached by competition. It is more expensive to obtain a new relationship than to defend an existing one. While it is psychologically challenging for banks to offer refinancing to existing customers at a lower yield, the alternative may be a customer walking out the door without a suitable replacement loan. Banks are looking at their portfolio and approaching customers with the following characteristics: high coupon, no prepayment protection, short term to maturity or loan structures that were originally not desired by the borrower (for example, a borrower that has been asking for 10-year fixed rate was given a 5-year fixed rate 3 years ago).

Conclusion

In a highly competitive environment, banks need to be creative in securing their existing relationships and winning new business. The creative strategies above have worked for various banks and your bank should consider incorporating some of these in your business strategy.