

Loan-Rate Differences Are Challenge for Bankers

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Conditions are increasingly ripe for banks to start producing big lending profits. There is only one catch: They can't make enough loans.

The contradiction highlights one of the prevailing themes for 2010: Business executives on the front lines of commerce are more skittish about the economy than Wall Street stock and bond investors.

The Car Loan Curve
Approximate cost of 36-month auto loan of \$20,000

	One month ago	Now
Interest rate	4.82%	5.43%
Monthly payment	\$597.80	\$603.28

Additional cost over life of loan: \$197.28

Source: WSJ reporting

Those investors have poured money back into stocks and riskier investments while shedding Treasury notes. That selloff in government bonds has pushed up long-term interest rates, even as the Federal Reserve System's own interest-rate cuts lowered banks' borrowing rates.

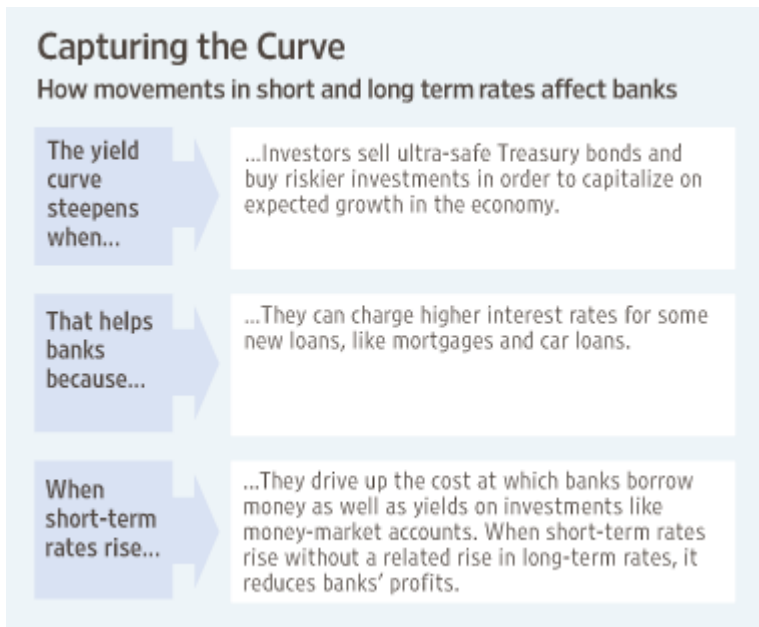
The steeper difference between short-term and long-term rates is known as the yield curve. It enables banks to earn bigger old-fashioned lending profits, because they can borrow money at low rates—often from checking- and savings-account customers—and lend it out at higher rates.

To best capitalize on the new higher rates, banks need to write new loans, for which willing and creditworthy borrowers are now scarce, say bankers. In addition, a large part of consumer and commercial bank loans track short-term, rather than long-term, rates.

"There is no question, mechanically, that a wider yield curve is better for the financial markets and the banks...in a high-school text book," said Joseph R. Ficalora, chairman and chief executive of New York Community Bancorp Inc. Mr. Ficalora said the trend may be a false start, since demand for new loans remains low, even as rates have risen.

Other bankers agree. "The caveat is that loan demand is weak. A steepening of the yield curve is nice, but the impact is limited," said one executive of a large regional bank. "You need strong loan demand to take advantage."

Interest rates on a large portion of loans—including home-equity lines of credit, credit cards and loans to larger businesses—are also rising because "banks have been very focused in reasserting their pricing power on lending," said Jeff Davis, an analyst at FTN Equity Capital Markets Corp. But those loans won't be fully impacted as long-term bond yields rise. That is because interest payments on most adjustable-rate loans are tied to the London interbank offered rate, a measure that closely tracks the federal-funds rate. That limits the benefit for banks of a steeper yield curve. Libor is at 0.25%.



One bank chief financial officer even said, "We would love to see [short-term] rates go up a little bit," just as long as the yield curve remains steep.

The 22 largest banks in the Treasury's Troubled Asset Relief Program issued or renewed \$127 billion in business loans in November, roughly the same as five months ago. But old loans are expiring faster than bankers can write new ones. Banks' total loans fell 5% in November from a year earlier to \$6.2 trillion, according to the Federal Reserve, which tracks outstanding credit at all banks rather than loan originations.

Bankers argue that business borrowers have so little appetite to borrow that they aren't even exhausting their existing lines of credit, a measure they watch closely. At some banks, business borrowers used less than 30% of available credit in the third quarter—in healthy times, it is around 50% for banks overall. Fifth Third Bancorp's fell to "the lowest levels we can remember," Chief Executive Kevin Kabat told investors in October, and J.P. Morgan Chase & Co.'s utilization rate was "at the lowest levels of all time," said Chief Financial Officer Michel Cavanagh in October.

Weak demand comes as new loans look increasingly lucrative. The spread between a bank's borrowing costs and the rates it charges on loans is known as "net interest margin." U.S. banks' net interest margins recently rose for the third consecutive quarter, to 3.51% from 3.37% a year earlier, according to the Federal Deposit Insurance Corp. Meanwhile, banks' cost of funds fell to 1.22% in the third quarter from 2.26% 18 months earlier, mostly because of Federal Reserve policies.

That is the lowest the cost of funds has fallen in the past decade—when the Fed's rate was at 1% in 2002, banks' cost of funds was 1.43%.

New mortgages, home-equity loans and commercial real-estate loans are getting more expensive for borrowers now that long-term interest rates are rising. For example, one banker calculated that with the new rates, a \$20,000 auto loan would carry an interest rate of 5.43%, compared to 4.82% a month ago, or \$197.28 more in payments over the life of the loan.

Mortgage rates already have risen. According Bankrate.com, the interest on a \$250,000 30-year fixed-rate mortgage rose to 5.33% on Thursday from 5% late last month, which translates to \$18,313.20 more in payments over the life of the mortgage.

Gerard Cassidy, a bank analyst at RBC Capital Markets, said the steeper yield curve eventually could add a total of three-quarters of a percentage point to banks' net interest margins. Like many analysts, he expects bank earnings next year to improve. Macquarie Group analyst Andrew Marquardt said in report that bank's improving net interest margins would at least offset falling loan balances and a decline in profits from originating mortgages.

Bank of America Corp. estimated in a Securities and Exchange Commission filing that a one-percentage-point increase in long-term rates would mean \$402 million more in income from interest payments, based on the bank's balance sheet in the third quarter.

Banks' continuing battles with bad loans will temper those fattening margins. Moody's Investors Service said banks could book as much as \$300 billion in losses in 2010 from loans they cannot collect, after posting losses of \$112 billion through the first three quarters of 2009 and \$88 billion in 2008. Moody's said mortgages and commercial real-estate loans will generate the most red ink. Mr. Cassidy said the number of new delinquencies should begin to fall after peaking at some point this year.

With sluggish demand for new loans, bankers have been parking unused deposits and borrowings in investments. According to Fed data, banks' securities portfolios rose 11.3% to \$2 trillion in November from a year earlier. Government agency bonds, such as Treasurys and mortgage-backed securities churned out by [Fannie Mae](#), have been the dominant investment choice of bankers.

These portfolios could lead to losses if short-term interest rates rise sooner than expected. Some investments, such as fixed-rate bonds, carry interest rates that could become less attractive relative to current rates, driving down the investments' value.

"It's a tricky game to play," said Frederick Cannon, bank analyst at Keefe, Bruyette & Woods Inc. "At some point, rates are going to go up."

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