

PUZZLING ADVICE

by [Steve Brown](#)

The way people react to things can be puzzling. Consider the results of a recent study from Carnegie Mellon University. In it, researchers found that human beings do not behave as one might expect when they need to get some advice. In fact, the harder the problem that needs to be solved, the more people tend to value the person providing an answer – even if that person might be wearing an invisible dunce cap and standing in the corner. The opposite is also true. If people perceive a problem to be an easy one to solve, then individuals that might provide advice are discounted. The easier the problem, the more a person leans on their own abilities. Unfortunately, by doing so, people also tend to make suboptimal decisions. Bankers live in a constantly changing world where they have to make complex decisions, act decisively and process the value of advice, so this inherent human weakness is an important one to recognize. Think about the last big decision your bank made and note that it probably included advice from other executives, external experts and employees. Once that advice was collected, was its "quality" somehow measured? More likely, the final decision was based on a compilation of advice with a bias from the group leader based on how reliable various sources had been in the past. As humans, we take comfort in what we know to be historically true and are consciously or subconsciously leery of unfamiliar people and new/contrasting information to what we understand to be true. To prove our point, ask 1k bankers if Prime is a true index and somewhere around 99.9% will say yes. Prime is easy to understand, historically known and prevalent in independent banking. Libor on the other hand, is not as well known, is not offered by that many independent banks to their customers and is an index "out of the control" of the bank, so it is less trusted. Yet, bankers might be shocked to find out that after adding up all the loans originated in the U.S., Libor use as an index outstrips Prime by somewhere around 10-1. Shift to the liability side of the ledger and one finds that because the national banks price their deposit offerings off the Libor curve, every bank competing in the U.S. is therefore pricing their deposits off Libor. Rate surveys, gut instinct and checking around all end up in the same place – banks try to price their deposit offerings below Libor. Stepping back to the asset side and looking at the broader picture, Prime is simply Libor + about 285bp (note that this spread moves in and out as market conditions change, but over time bounces roughly around that spread). Our point is not to discontinue using Prime, but rather a simple reminder that the unfamiliar may be familiar if we slow down, are more willing to listen and can find some familiar ground. The banking industry is in a major state of change right now, so bankers puzzling how to increase profitability over the long-term may want to fight the impulse to flee when something new bounces by and take the time instead how the pieces fit together.

BANK NEWS

M&A

First Banks (\$9.6B, MO) will acquire the holding company of Royal Oaks Bank (\$180mm, TX) for \$38.6mm, or about 2.5x book, as the company continues to expand in TX.

Competition

Wachovia said it has formed an alliance with MetLife to offer variable annuities and other retirement products at its branches throughout the country.

Possible Sale

H&R Block is reportedly considering selling Option One Mortgage, its nonprime residential mortgage arm. The company is the 5th largest originator of such mortgages.

Higher Rates

Bank of England raised interest rates by 25bp to 5.0%, the highest level in 5Y as the central bank moved to control inflationary pressures.

Consumer Borrowing

The Fed reported that consumer loan balances dropped 0.6% last month, compared to a 4.6% increase in August. Driven by lower auto loan balances, this is the largest drop since April of 1992.

Restructure

Netbank (\$4.0B,GA) will sell its Beacon Credit Services division which specializes in the financing of aircraft, boats and RVs and will move some of its non-conforming mortgage employees from GA to Lake Oswego, OR. Both moves are in an effort to lower costs and increase profitability.

Fraud

Mortgage fraud increased 35% this year, while SAR filings are up for the past 5Ys over 1,410%, according to the Treasury Dept. While tougher scrutiny plays a part, more false statements and ID theft are being reported. The study concluded that the increased use of telephone technology combined with greater internet processing will exacerbate this issue in the coming years. CA, FL, IL TX and GA had the highest cases of reported mortgage fraud.

Customer Satisfaction

A study by Experian finds company executives admit they lose 6% of sales due to poor handling of customer information.

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