TEACHING SERVICE, NOT RATE

by Steve Brown

No one is born rate sensitive. As a baby, humans are service sensitive. The need for help with feeding, transportation and general maintenance are innate senses. Like learning about double mocha lattes, somewhere along the way we are taught the need for higher rates on our deposits. Bankers have taken it one step further and taught the investing public that a bank is the place to come to receive higher rates. We are all for competing with mutual funds, equities and annuities, but are steadfast against destroying any franchise value to do it. Banks that pay anything above a 5.35% rate to their customers in the current environment are competing from a position of weakness against other alternative investments that have the ability to add duration or principal volatility. For banks that pay above that 5.35% rate for 2Y or 3Y local CDs, the economics get even worse. The inverted yield curve means banks pay a greater premium for longer CD maturities compared to gathering funds in a money market account. A far better strategy is the core competencies in cash management and service in order to better compete from a position of strength. The recent trend to add ID theft protection, travel rewards, internet banking, remote capture or waiving ATM fees is troubling, but it is a far better option than paying higher rates. Conceptually, adding service plays to a bank's core strength. More importantly, while paying a higher rate or choosing to reimburse non-network fees may cost the same, the later strategy has two important advantages. One, layering on extra fees, may raise the cost, but it does not necessarily make an account sensitive to interest rate changes. As a result, liability duration remains little changed. If you pay a higher rate and interest rates move up, interest sensitive accounts will expect a rate increase. This is not the case on a service-focused account and as a result, the duration is longer which helps a bank over time (particularly when the yield curve steepens). The other advantage is the mitigation of cannibalization and training. By choosing to compete on service, banks can better control the effects of cannibalization or the movement of money from a lower cost account to a higher cost one. Services are less universal than rates and can serve to help segment a market. By offering a 5.75% money market or CD rate, the more you advertise it, the more other accounts start to take notice and want to switch. This further drives up the cost and makes that 5.75% rate promotion, much closer to an 8.50% once cannibalization is factored in. The easiest thing in the world is to solve funding problems through rate. However, the easiest path is not always the best. Bankers concerned with creating shareholder value must roll up their sleeves in order to deliver value by using a combination of products, services, marketing, segmentation and sales in order to grow low-cost and less interest rate sensitive deposits. By investing resources in these areas now, a bank can develop a strong core funding base based on service and the industry can stop teaching our youngsters that comfort comes from a high-interest rate CD.

BANK NEWS

M&A

First Data Corp. will acquire the Instant Cash Services business of Wells Fargo for an undisclosed sum. Instant Cash provides debit card and ATM payment processing for 500 independent banks in 20 states.

Competition

A bill has been reintroduced into Congress that would raise the cap on credit union business lending from 12.25% of total assets to 20.00%.

Interesting

Wal-Mart has withdrawn its ILC application to form a bank. We wonder if the bank charter they are likely to get in Mexico will get them to the same place by acquiring a US bank.

Ugly Subprime

A recent review of the credit default swap market finds it would cost roughly 13% per year to insure subprime mortgage bonds against default (i.e. $1.3mm to insure $10mm). The number has soared more than 300% in the past 2 months as defaults in the sector have jumped.

Better Coordination

The GAO concluded that the Fed, SEC and OTS should better collaborate on initiatives and guidance. The Gov't office said there is a need for clearer objectives and more consistent performance measures.

Competition

The IRS has ruled that credit unions must pay tax on insurance services related to car warranties, AD&D, dental, cancer and credit disability. The IRS said such activities are not substantially related to the industry's tax exemption.

LOAN PRICING ADJUSTMENTS

We are in the process of adjusting our Loan Pricing model with the latest information in order to give banks a competitive edge. Expected loss estimations in multifamily construction (down 10bp), hotel lending (down 11bp) and senior housing (down 35bp) have all improved. Of note, while independent bank SFR lending defaults increased for the month of January, February remained stable. In other areas, customer acquisition costs went up slightly (by $112 on average) and prepayments increased (shortening average loan duration by 12 days).