OBSERVING AND LEARNING

by Steve Brown

Observational learning (or social learning theory) occurs when a person observes the behavior of another and then subsequently changes their own behavior. As with most learning, students have a chance to observe and model behaviors that lead to positive or negative reinforcement. Observational learning explains some behavior in banking that we find puzzling.

To begin, banks are currently booking 3, 5, 7 and 10-year fixed-rate loans and funding these loans with short-term floating rate liabilities. In so doing, many bankers ignore where future interest rates are expected to go. While it is true that Fed Funds today are 2.25%, it is equally true that the market expects the FF rate to rise to 4.75% in March of 2013. While the NIM associated with a given fixed rate loan may be appealing to a bank at origination, the forward rate curve tells us that NIM will decrease by more than 50% in 5Ys (if the forward curve is correct). Many would argue that the forward curve is never "correct" and it is just as likely that rates will be higher in 5Ys time as lower. The problem is that this is a risk that is being borne by banks without being compensated for taking it.

Another puzzling behavior we notice is also explained by observational learning and it relates to motivation. Observational learning finds that people do something because they have some motivation or reason to do so. The problem with banking is that the reinforcement or punishment from taking certain action may not be felt for years (as rates change), so it becomes disassociated and its impact is largely unfelt. Consider that a loan booked today at 6.00% for 5Ys with an immediate 3.75% NIM is quickly forgotten. Yet, in 4Ys, when the NIM on that loan is 1.00%, it is too late to change behavior. Interest rate movement, employee turnover or an unwillingness to review and learn from past mistakes all reduce the chances that this loan will ever be looked at again (unless it underperforms). Meanwhile, the same behavior that makes today's NIM attractive also makes converting the loan to a floating rate unappealing because the give-up in yield is immediate. Despite a better risk-reward tradeoff for the bank, the benefit of a higher spread now (vs. the spread to be enjoyed when the loan floats at higher rates in the future) is intangible. There is no positive reinforcement provided to bankers and many also have unstated time horizons (that are often much shorter than the term of their assets), so there is little impact from making a suboptimal decision. This is even further compounded by lenders that receive compensation annually, who will generally have a psychological time horizon of only 1Y.

Observational learning also stresses the importance of paying attention. For people to learn they must pay attention to the observed acts. Consider that asset sensitive banks typically seek out longer-duration assets to protect against declining rates. However, given where we are in the current interest rate cycle, many bankers putting longer-term fixed rate loans on the books could be making a significant mistake. Consider that projected rates beyond 1Y probably have little place to go but higher. Put another way, the advantage of extending asset duration now offers very little benefit to community banks given that rates have likely bottomed. While knowing exactly where the bottom may be is very difficult to guess, rates are currently very low. Therefore, if rates increase, look for the value of bank fixed rate assets to decrease. If rates decrease on the other hand, look for the value of fixed rate assets to increase, but with a caveat. As rates stand today, there is very little room for further decreases, so the risk is upwardly skewed.

To conclude, observational learning is also about retention. People must not only observe behavior but must also remember it. We urge bankers to remember what happened in the last rate cycle and during the S&L crisis. Many of us learned valuable and hard lessons about interest rate sensitivity back then and we would be well-served to avoid past mistakes.

BANK NEWS

Wamu 1

In an effort to steal market share from beleaguered Wamu, US Bank will aggressively expand its "PowerBank" concept to the metro areas of WA. The concept, now rolled out in 4 other areas, is a focus on service that includes remodeling branches, extending hours, hiring new employees and bundling products together in a more efficient fashion.

Wamu 2

Analysis done by Gradient Analytics estimates WAMU could see $4.75B more in loans that go bad in 2008, much more than the $2.75B in current reserves set aside.

Wamu 3

Washington Mutual officially announced it will receive $7B in capital from a group led by TPG.

C&D

Peoples Community Bancorp ($914mm, OH) came under a cease-and-desist order last week by the OTS due to credit and earning problems

Housing Fraud

The latest statistics from the FBI show mortgage fraud convictions more than doubled in 2007.

Hotel Lending

PWC is projecting that growth in hotel room demand in 2008 will drop to 1.2%, far below the 2.1% average of the past few years. A cut back in corporate spending is being cited as the primary catalyst for the slowdown.